BCA BUDGET SUBMISSION 2012–13

Preparing for a better future

Business Council of Australia

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About this publication

This publication is the Business Council of Australia Submission to the 2012–13 Budget. It comprises a detailed set of recommendations by the Business Council of Australia for consideration by the federal government as part of the 2012–13 Budget process, and incorporates a report by Mercer for the Business Council of Australia titled 'Back to Policy Fundamentals'.

About the Business Council of Australia

The Business Council of Australia (BCA) brings together the chief executives of 100 of Australia's leading companies. For almost 30 years, the BCA has provided a unique forum for some of Australia's most experienced corporate leaders to contribute to public policy reform that affects business and the community as a whole. Our vision is for Australia to be the best place in the world in which to live, learn, work and do business.

OVERVIEW

The challenge for the government in this Budget will be to strike the right balance between finding structural savings to underpin fiscal discipline over the longer term without detracting from programs that enhance the productive capacity of the economy

Each year, the Business Council of Australia makes a submission to the federal budget process to support the government of the day to formulate a Budget that takes account of Australia's medium, as well as short-term, wellbeing.

Last year's Budget correctly continued the process of fiscal consolidation to shore up the sustainability of Australia's public finances while investing in productive capacity including a significant workforce package and further infrastructure-related measures.

We believe the 2012–13 Budget could be a watershed for Australia. But it will need to do more than maintain the same path.

Further steps can and should be taken now to strengthen our fiscal policy foundations. The test of this year's Budget will be the extent to which the government can outline a pathway to fiscal discipline that is credible and supported by an institutional framework that provides confidence that fiscal goals will continue to be achieved.

A strong first step on this path would be to return the Budget to surplus in 2012–13, recognising that the government should have some flexibility and discretion to alter this path if there is a marked deterioration in the global economy arising from a significant downturn in the Euro area. However, planning should be occurring now to ensure that in those circumstances, any stimulus is effective and well directed in both boosting demand and enhancing Australia's productive capabilities.

These international developments underline the need for policy settings that can help Australia be resilient to global volatility, grow the economy – including and beyond the resources sector – and enable all Australians to benefit from that growth through higher living standards.

This suggests that the challenge for the government in this Budget will be to strike the right balance between finding structural savings to underpin fiscal discipline without detracting from programs that enhance the productive capacity of the economy.

To assist in the preparation of this submission, the Business Council of Australia commissioned a detailed report from Mercer that revisits the foundations of Australia's public policy framework and offers some suggestions on how it could be improved.

Our Budget Submission draws on the Mercer report, which is reproduced in the Appendix, and is set out in three parts.

Part One provides some context for the 2012–13 Budget, including the current challenges in the global and Australian economies.

Part Two outlines the importance of fiscal policy in managing these challenges in the period ahead and the case for strengthening fiscal policy foundations with new fiscal rules.

Part Three contains recommendations on specific priorities for the 2012–13 Budget, which will begin to put in place the foundations to support the fiscal rules and meet the challenges ahead.

In summary, the Business Council of Australia is calling on the government to:

- bring the Budget back to surplus
- revisit its fiscal policies and establish new medium-term fiscal policy settings to manage future risks
- implement a suite of reforms to improve Australia's productive capacity and competitiveness.

We recognise that the government must have the flexibility to respond to a potential worsening of the global financial situation and a drop in revenues. This will naturally impact on its capacity to deliver a budget surplus. However, should the government need to stimulate the economy, any additional spending measures should be directed to activities that will grow the economy over the long term – such as economic infrastructure – and support productivity and competitiveness. This is why we are calling for the federal and state governments to establish a priority list of economic and strategic infrastructure that can be rolled out quickly, including action to accelerate project planning and development approvals.

Budget context

The Australian economy has entered 2012 with relatively sound growth prospects, driven largely by strong business investment, and the continuing demand for our commodities from the rapid industrialisation and urbanisation of Asia.

Notwithstanding these sound growth prospects for the Australian economy, this year's Budget is being framed at a time of significant global economic uncertainty and with domestic challenges on the horizon.

On the international front, modest growth is being forecast for the global economy in 2012 on the assumption that policymakers, primarily in the Euro area and to a lesser extent the United States, continue to keep fiscal and economic challenges at bay for the time being.

This is by no means certain and the consequences of a further deterioration in the Euro area would be far-reaching, including the risk of a much broader freezing up of credit markets.

Australia and other economies in the Asian region would be better placed than most to respond to such a scenario, but we are not immune from the slowdown that could result from falling global trade activity, and tightening and more volatile financial markets.

Domestically, Australia continues to deal with the structural pressures emerging from our high terms of trade, lagging productivity and challenges to our international competitiveness from many of our competitors in the fastest growing region of the global economy.

Adding to these risks and challenges, the Budget and the economy are under pressure from an ageing population.

The BCA submission to the 2011 tax forum drew on the latest Intergenerational Report and fiscal modelling prepared by Deloitte Access Economics to highlight an unfolding fiscal challenge facing Australia's federal and state governments. By 2049–50, it is projected that total Commonwealth spending as a share of GDP will increase significantly, resulting in a projected primary fiscal gap (excluding interest payments) of around 2¾ per cent of GDP by that time. This is based on the assumption that the federal government achieves its goal of constraining real spending growth to 2 per cent in years where the economy is growing above trend until the Budget is in surplus.

Combining the state and territory projected fiscal positions with the Commonwealth's, it is estimated that by 2050 Australia will face a combined primary deficit of 5 per cent of GDP. Today a budget deficit of this size would be equivalent to around $70 billion.

Australia's current tax arrangements and the current approach to government spending at all levels of government will not be able to sustain deficits of that size.

> This year's Budget is being framed at a time of significant global economic uncertainty and with domestic challenges on the horizon

We need to adopt a new, more sustainable approach to fiscal discipline and greater efficiency in government spending

A conundrum

The context to Australia's current economic and fiscal situation suggests that we will face a very difficult conundrum:

- The growing significance of commodity prices and the terms of trade to tax revenues, and their inherent volatility, has heightened risks to the revenue base.
  - » Analysis prepared for the BCA's 2011–12 Budget Submission found that, at that time, a budget shortfall of between $7½ billion and $36 billion could eventuate over the forward estimates should commodity prices soften by between 4 per cent and 17 per cent respectively.
- A weakening and uncertain global environment is placing pressures on the Australian economy and the associated revenue outlook.
  - » Just six months after the 2011–12 Budget – in the Mid-Year Economic and Fiscal Outlook – tax receipts were revised down by $20 billion across the forward estimates.
- Pressures from an ageing population are building and adding stresses on the spending side of the Budget.
  - » Total spending on health care, social security and welfare is projected to grow from around 12 per cent of GDP today to 17 per cent by 2049–50.
- The serious economic and fiscal circumstances of many European countries and the reactions of markets have driven home the challenges of fiscal consolidation and the critical importance of placing government finances on a sustainable footing.
  - » As the Reserve Bank of Australia has noted, collectively the countries that now form the Euro area have been continuously in deficit for the past 40 years.

In other words, we need to adopt a new, more sustainable approach to fiscal discipline and greater efficiency in government spending in Australia to prepare for a prosperous future at a time when a range of factors, both global and domestic, are conspiring to make this task ever more difficult.

Dealing with this conundrum presents some significant challenges; however, it only elevates the importance of effective fiscal policy in the period ahead to bolster future growth prospects and to help shore up resilience to global volatility.

It was in recognition of this imperative that the Business Council of Australia commissioned Mercer to examine Australia's fiscal policy rules. The report demonstrates that adopting and adhering to a set of clear policy rules would do much to help Australia's economy stay strong in the face of global uncertainty and domestic challenges already underway.

A new set of fiscal rules

Australia has reaped substantial benefits from the reforms to the conduct of monetary policy in the 1980s and 1990s, which were introduced with bipartisan support. Such an approach should now form the basis for fiscal reforms going forward.

The certainty and credibility of fiscal policy can enhance efforts to lift productivity and workforce participation by providing greater confidence and a stable environment for investment and innovation.

Australia has been a pioneer in introducing reforms to fiscal policy and they have served us well.

It is time to go further.

Avoiding intractable fiscal difficulties in the future requires that we strengthen our fiscal foundations now, rather than being forced to make unpalatable decisions in the midst of a crisis, as illustrated by recent international developments.

Fiscal rules can play an important role in anchoring budget settings to manage medium and long-term structural and cyclical pressures, including those related to an ageing population and the risk of future terms of trade volatility.

Rules help prevent excessive spending and the build-up of unsustainable debt, placing government finances in a stronger position to respond to these pressures.

The Mercer report identifies three fundamental objectives for a new set of fiscal rules:

1. They should enforce discipline on the size of government.
2. They should ensure readiness for counter-cyclical action for any major economic shock.
3. They should ensure readiness for intergenerational pressure.

In line with these objectives, but recognising that there needs to be some discretion and flexibility to respond to major economic shocks, the Business Council of Australia is proposing that as part of the 2012–13 Budget the government commit to three new fiscal rules.

Size of government

A hard cap should be placed on the size of government as a share of GDP below 23.7 per cent, such that future budgets do not see any slippage.

Maintaining an explicit cap for the level of taxation as a share of GDP as a discipline to the size of government is an essential element of keeping Australia competitive, particularly within the region.

Counter-cyclical action

The government should prepare the Budget in a way that allows it, if necessary, to make a one-off contribution (equal to 3 per cent of GDP) to the economy, roughly every 13 years, to assist in weathering the impact of a possible major economic shock.

History would suggest that the federal government will be required to make a fiscal contribution of around 3 per cent of GDP on average to weather the impacts of an economic shock every 13 years or so, just as it did during the global financial crisis.

The immediate objective of fiscal policy – set with an appropriate medium-term perspective in mind – should be to target the generation of budget surpluses with a view to paying down debt.

Having done that, the target should be to accumulate fiscal reserves that could then be deployed should the need arise in response to a major economic shock.

Intergenerational

The government should target a modest proportion of future surpluses – to be known as an 'intergenerational surplus' – to provision for the projected fiscal gap that is expected to arise as a consequence of demographic pressures.

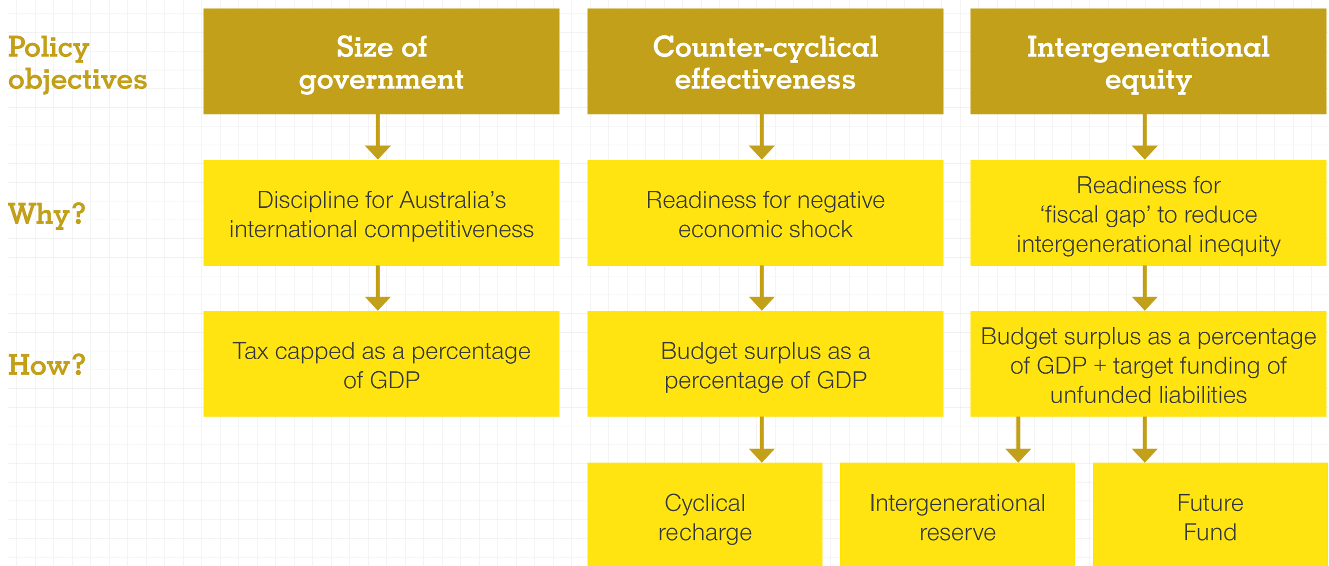
Australia has been well served by the publication of a series of Intergenerational Reports (IGRs) that have increased awareness and transparency of the costs associated with an ageing society. However, the government's existing fiscal rules do not convert the output from the IGR into an explicit fiscal rule.

It is prudent to begin to provision for the projected fiscal gap arising from intergenerational pressures by targeting (or setting aside) a modest proportion of the budget surplus as a percentage of GDP to deal with these expected future funding pressures.

Policy improvements on the supply side – particularly in terms of participation, productivity and population as well as the efficient provision of health and aged care – are also needed to alleviate the fiscal pressures of an ageing population. A related challenge for governments is to reduce the cost of providing relevant public services.

The advantage of this new rule is that it will compel governments to begin the process of fiscal provisioning and/or embark on supply-side policies to reduce the fiscal gap itself.

If nothing is done to provision for the fiscal pressures associated with an ageing society, fiscal policy will be relegated to an unsustainable position. In summary, the new framework is as follows:



Getting started in 2012–13

We believe this year's Budget is the right time to begin to take steps to address the long-term fiscal and economic challenges confronting Australia.

Our recommendations for the 2012–13 Budget can be grouped in two categories.

The first set of recommendations involves action to support long-term fiscal discipline and ensure adherence to the current fiscal rules and the new rules we are proposing.

There is broad political agreement on the fundamental need for fiscal restraint and restoring sustainability to government finances, but the government's 2 per cent real expenditure growth cap has demonstrated that achieving it can be difficult.

The following recommendations seek to make the task of living up to fiscal rules easier in the long term. They are to:

- **Return the Budget to surplus in 2012–13** to provide a strong demonstration of the government's fiscal credentials and its commitment to fiscal discipline. If Australia were to encounter a severe economic shock from developments in the global economy, then a committed return to surplus in 2012–13 should be reconsidered. But in that circumstance, any stimulus needs to be effective and well directed both in supporting demand and boosting Australia's productive potential.
- **Undertake a more structured and considered approach to improving the efficiency of government spending by:**
  - » putting in place a systematic program of audits of the efficiency of government expenditure. These audits should have a strong outputs and outcomes focus and could encompass global and domestic benchmarking on the cost and efficiency of government services.
  - » undertaking a whole-of-nation Intergenerational Report to confirm the economic and fiscal task ahead, including measuring the impact of already changing policy settings and circumstances on the long-term outlook
  - » building on the decision to increase the pension age by linking further increases in the qualifying age to changes in life expectancy
  - » committing to wholesale reform of government procurement policies
  - » implementing efficient, market-based delivery of key public services in aged care and disability to place government in a better position to fund an adequate level of service at a reasonable cost in the longer term
    - – on disability care and support, the National Disability Insurance Scheme should be funded from savings from other lower-priority expenditures if additional costs cannot be met from existing revenues when the scheme is rolled out later this decade
    - – on aged care, it would mean developing and releasing a response to the Productivity Commission's report along with an implementation plan in the first half of 2012.

The government must continue to pursue policy reforms that lift the competitiveness and productive capacity of the economy

The second set of recommendations in this submission concerns the essential, parallel objective of growing an economy that allows Australia to meet the challenges and realise opportunities from our place in the fastest growing region of the global economy.

To do this, the government must continue to pursue policy reforms that lift the competitiveness and productive capacity of the Australian economy.

To this end, the submission includes recommendations in the areas of tax, labour market, infrastructure and regulation.

- **Tax:** during 2012, the government should develop formalised, ongoing processes and an institutional model for progressing long-term, comprehensive tax reform over a 10-year period. This recognises that fiscal discipline must be matched by stable tax revenues and taxes that do the least harm to economic growth. Tax reform must be linked to improving productivity and encouraging investment, economic growth and jobs.
- **Labour market:** the government should simultaneously pursue a range of strategies, including increasing the supply of domestically trained workers, maintaining skilled migration levels, facilitating the movement of skilled workers from low-growth to high-growth sectors and regions, as well as bringing those who are most disadvantaged into the labour market. A robust temporary skilled migration program should be maintained.
- **Infrastructure:** as the BCA has previously stated, the government should ensure effective planning for Australia's infrastructure needs. The BCA argues it is essential that federal and state governments work together to establish a prioritised list of economic and strategic infrastructure requiring public funding. Such a list would constitute an infrastructure plan that would be a guide to business and provide the basis for funding decisions over time. To support the ongoing infrastructure task, a biannual strategic infrastructure needs assessment should be conducted to consider projects that could be either privately or publicly funded. It should also be setting out principles for determining the appropriate mix of funding for infrastructure projects. Action should be taken now, including by the states, to prepare to fast-track the rollout of projects should there be a need to stimulate the economy.

  In supporting the principle of efficient and effective broadband infrastructure, the government should also undertake a cost–benefit analysis of its National Broadband Network policy and apply its competitive neutrality policy to NBN Co in full.
- **Regulation:** the government should strengthen compliance with good regulatory process and lower business costs, including by reallocating resources as necessary from other lower-priority government functions to the Office of Best Practice Regulation to facilitate the preparation of – and compliance with – high-quality Regulatory Impact Statements. The government and Cabinet should also promote an internal culture of discipline when it comes to new regulation. The costs of a rising regulatory burden on the community, and the detrimental impact that excessive and poor regulation has on our growth prospects and productivity performance, should be recognised. This also means that there should be no exemptions on requirements to prepare Regulatory Impact Statements. Now is not the time to be loading more costs on businesses.

- *Regulation (continued):* On national regulation, the distribution of seamless national economy reward payments to the states should be re-phased to later years, subject to the government's consideration of the COAG Reform Council's report on progress. This is not a penalty on states but rather recognition that circumstances have changed, with slower progress in a number of key areas including harmonisation of occupational health and safety legislation and harmonisation of trades licensing and slower realisation of benefits than were envisaged when the national partnership and reward payments were first agreed. This measure should also ensure that there remains a strong incentive for states to pull out all the stops in implementing the remaining reforms – noting that this should not compromise the objective of 'deregulation' and lowering business costs.

Australia's strong record of economic reform has positioned it well to respond to a volatile global economic environment and many of the challenges and opportunities we face as a nation.

However, working from a strong foundation does not mean that we can be complacent. We believe that the broader Australian community shares our concern to see policymakers looking beyond electoral cycles to prepare Australia for the future.

In doing this preparation, however, we need to concentrate on the fundamentals of good policy. These fundamentals are about doing the simple things right and not seeking silver bullet or magic pudding solutions or attempting radical and untried policy prescriptions.

Achieving ongoing fiscal discipline and focusing on measures to enhance competitiveness and productive capacity are critical.

In the short term, delivering a surplus in 2012–13 poses a challenge, but at the present time a return to surplus remains the right policy. In the long term, the projected fiscal deficit of all governments underlines the need to start implementing structural savings, cut waste and improve efficiencies in existing spending programs and strive for contestability at all levels of government.

At the same time, fiscal discipline will need to be carefully targeted so as not to detract from programs that enhance the productive capacity of the economy and boost our growth prospects.

This submission and the BCA's submission to the tax forum highlight the task that lies before us and the choices we will face as a nation if we are to continue to maintain appropriate economic, environmental and social conditions, including through the provision of an acceptable and affordable social safety net.

Overcoming these challenges will require the government to take steps now to strengthen fiscal foundations. But stronger fiscal foundations are not the whole solution. Increased productivity and, through it, sustained economic growth will substantially strengthen our fiscal position – increasing per capita incomes, reducing reliance on government spending programs and strengthening the Budget's revenue base.

This reinforces the importance of a comprehensive reform agenda directed at lifting productive capacity in the economy. Tax reform, ongoing labour market reform, better arrangements for private sector infrastructure provision and regulatory reform will go a long way to building this capacity.

This 2012–13 Budget Submission reflects the nature of policy suggestions we will give to the country's political leaders and bureaucrats through the course of the year and in the context of the next federal election.

Taking these steps now will ensure that long-term remedies are less drastic and future policy interventions less costly.

INTRODUCTION

This is the Business Council of Australia's submission to the Australian Government as it prepares its 2012–13 Budget.

The government's preparation of this year's Budget comes at a time of significant global uncertainty and looming medium-term structural budget pressures associated with an ageing population, the rising cost of health care and the need to provide infrastructure to support an increasing population.

A key lesson that is being learned around the world is the fundamental importance of getting your fiscal house in order, because it is clear that the consequences of not doing so are dire.

The debt problems being encountered in Europe today have occurred because 'governments loosened fiscal policy during recessions but did not fully reverse those policies during the subsequent cyclical recoveries'.[1] As the Reserve Bank of Australia has identified, in aggregate the countries that now form the Euro area have been continuously in deficit for the past 40 years.[2]

Australia is not in this position because it has followed a better approach to fiscal policy through its rules that aim to balance the Budget over the economic cycle. The Business Council of Australia considers that further steps can and should be taken now to strengthen our policy foundations. The test of this year's Budget will be the extent to which the government can outline a pathway to fiscal discipline that is credible and supported by an institutional framework that provides confidence that the fiscal goals will continue to be achieved.

The Business Council of Australia would like to see a return to surplus and a demonstration from the government of policy settings that can help Australia be resilient to global volatility. We would also like to see evidence of structural steps to prepare for the medium and long-term challenges that will confront the Australian community. At the same time we would like to see economic and fiscal policy settings that will help to lift our productive capacity and competitiveness. Our recommendations are firmly focused on these objectives.

To assist in the preparation of this 2012–13 Budget Submission, the BCA commissioned a detailed report from Mercer. This report, which is reproduced in the Appendix, revisits the foundations of Australia's public policy framework and offers some suggestions on how it could be improved. The BCA's Budget Submission draws on the Mercer report and has been prepared in three parts:

- **Part One** provides some context for the 2012–13 Budget, including the current challenges in the global and Australian economies.
- **Part Two** outlines the importance of fiscal policy in managing these challenges in the period ahead and the case for strengthening fiscal policy foundations with new fiscal rules.
- **Part Three** contains a number of recommendations on specific priorities for the 2012–13 Budget, which will begin to put in place the right foundations to support the fiscal rules and meet the challenges ahead.

PART ONE

CONTEXT FOR THE 2012–13 BUDGET

Key points

- The context to Australia's current economic and fiscal situation suggests that we will face a very difficult conundrum:
  - The growing significance of commodity prices and the terms of trade to tax revenues (and their inherent volatility) has heightened risks to the revenue base.
  - A weakening and uncertain global environment is further placing pressures on the Australian economy and the associated revenue outlook.
  - Pressures from an ageing population and the rising cost of health care are building and adding additional stresses on the spending side of the Budget.
  - The serious economic and fiscal circumstances of many European countries and the reactions of markets have driven home the challenges of fiscal consolidation and the critical importance of placing government finances on a sustainable footing.
- This conundrum only elevates the importance of effective fiscal policy in the period ahead, complemented by a comprehensive reform agenda focused on lifting the productive capacity of the economy and Australia's competitiveness.
- The challenge for policymakers is to strike the right balance in finding structural savings in the Budget required to underpin fiscal discipline without detracting from programs that enhance the productive capacity of the economy.

The Australian economy has entered 2012 in better shape than most other developed countries with solid headline growth recorded in the September Quarter 2011 National Accounts. However, there is underlying softness in many parts of the economy and in particular the absence of employment growth at the aggregate level over the past year is a major concern. Measures of consumer and business confidence have failed to rebound, with a return of business confidence essential if there is to be a strong rebound in the non-resources sectors of the economy.

A central feature of the domestic economy is the substantial pipeline of major investment projects that are either under construction or in prospect. It is by no means assured that all of this investment will come on stream or be delivered on time or on budget. Reflecting the importance of these major projects to Australia, the BCA is currently examining the policies and regulations required to ensure they are delivered in a timely and efficient way, and we intend to release our analysis and recommendations later this year.

Recent commentary by Jorg Decressin of the International Monetary Fund[3] has highlighted the potential importance of this investment in offsetting the impact of softening global economic growth.

As well as developments in the Australian economy, this year's Budget is being framed amid weak global growth and continuing uncertainty in the international financial system. Much of this concern is centred on the Euro area where deep-seated fiscal, financial and structural problems have not been adequately resolved.

It is against this backdrop the Business Council of Australia believes that in developing this year's Budget, the government must take steps now to bolster future growth prospects and resilience to global volatility.

These include global economic uncertainty, domestic economic challenges around the structural pressures from our high terms of trade, competitiveness, lagging productivity, increased revenue volatility and the long-term challenges arising from an ageing population.

Each of these important contextual factors is outlined below.

The government must take steps now to bolster future growth prospects and Australia's resilience to global volatility

International developments

A feature of 2011 was a marked deterioration in the global economic outlook, with considerable uncertainty attaching to developments in Europe and the international financial system. The main consequence of this so far has been heightened financial market volatility and significant impacts on confidence.

In their most recent growth forecasts for 2012 and beyond, institutions such as the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF) have highlighted that now more than ever the growth prospects for the global economy will depend on policy decisions related to the European debt crisis and US fiscal policy.

Assuming that the European crisis does not go beyond the control of policymakers and that long-term confidence in the US economy does not weaken further, modest global growth can be expected in 2012.

The IMF projects that global growth will slow to 3.3 per cent through 2012 with real GDP in advanced economies growing at just 1.2 per cent.[4]

If the Euro area were to slip into a prolonged and deep recession, then the impacts on global growth would obviously be significant.

In a downside scenario modelled by the OECD, the whole of the OECD would move into recession with contractions in economic activity in both the United States and Japan. The OECD is careful to note that emerging market economies such as those in the Asia Pacific would not be immune from such a shock with global trade activity almost 10 per cent less than current forecasts by the end of 2013.[5]

Implications for Australia

Based on recent forecasts Australia's overall growth prospects appear relatively sound, with Treasury forecasting real GDP growth of just over 3 per cent in 2011–12 and 2012–13.[6] Projections from private sector commentators and the Reserve Bank of Australia (RBA) are not dissimilar, although the RBA is projecting growth of 4 per cent in 2011–12.[7]

These growth prospects are based on the continuation of strong growth in business investment driven by record levels of resources investment and our strong linkages to the emerging market economies of Asia – with the IMF projecting real GDP growth for China of 9 per cent.[8]

Australia and other economies in the region will be better placed than most to weather a further deterioration in Europe should it eventuate – with considerable flexibility to use both monetary and fiscal policy to support their economies should the need arise.

Nonetheless, Australia will be exposed to developments in Europe through financial and trade linkages as well as effects on confidence and wealth.[9]

Financial linkages will impact Australian banks through increased cost of funds and reduced availability of credit, as European lenders divert scarce resources to their home markets to meet more stringent regulatory standards.

While Australia's direct trade links to Europe are limited to just 4 per cent of Australia's merchandise exports, the exposure of our major trading partners is more substantial. For example the Euro area accounts for 15 per cent of China's merchandise exports.

Standard & Poors has suggested that if a recession did hit developed economies then it would have a deeper and more prolonged impact on the Asia Pacific than previous global crises, with Australia's biggest trading partners suffering heavily.[10]

It would appear that the confidence and wealth effects of recent Euro area volatility have already impacted business and consumer confidence. The Mid-Year Economic and Fiscal Outlook (MYEFO) attributed weaker business and consumer confidence and the resulting slowdown in activity and employment in parts of the economy to global economic uncertainty.

We recognise that the government must have flexibility to respond to a potentially worsening global situation and decline in revenues.

While the government's current commitment to return the Budget to surplus in 2012–13 remains the right one at this point, the BCA is cognisant of the current global uncertainty and does not underestimate the potential need for this strategy to change should there be a severe economic shock to the Australian economy – for example arising from a deep recession in Europe.

Should the need arise to consider increased government expenditure to provide an economic stimulus, it will be essential such stimulus supports the growing of the economy. This is why we are calling for the federal and state governments to establish a priority list of genuine economic and strategic infrastructure that can be rolled out quickly should the need arise, including action to accelerate project planning and development approvals.

Domestic economic challenges

Against this international backdrop, Australia will confront a number of domestic economic challenges in the years ahead – most notably in terms of managing the structural pressures that come with the high terms of trade, maintaining competitiveness and boosting our lagging productivity.

Terms of trade

A rise in prices for our key exports on the back of the industrialisation and urbanisation of Asia has produced a substantial rise in Australia's terms of trade, which are at a 140-year high and around 85 per cent higher than their 20th-century average.

This has resulted in a large boost to Australia's national income and has been the primary driver of the strong appreciation of the Australian dollar, bringing with it considerable opportunities as well as structural pressures and risks.

Strong investment in resources and energy projects will continue to have significant consequences on the demand for skilled workers, while the strong exchange rate will place pressure on the competitiveness of the trade-exposed sectors. Unless firms in the trade-exposed sectors are able to reduce costs or improve productivity, they risk losing out to external competitors.

While commodity prices are difficult to forecast with accuracy, policymakers have subscribed to the view that the urbanisation and industrialisation in Asia will support prolonged demand for commodities, thereby lasting much longer than past terms of trade booms.

Notwithstanding this view, it is all but inevitable that there will be some level of volatility and uncertainty in commodity prices. Prices will be volatile in the short run because demand is not always immediately responsive to price changes and supply will take time to come on-line. The shift away from annual price contracts to quarterly and even monthly price contracts has further increased the exposure to market volatility.

In contrast to past booms the economy is now more flexible and adaptable and seems better able to deal with the consequences. While policymakers cannot eliminate volatility in commodity prices, there is a need to manage the risk of the terms of trade volatility inducing a major economic shock through strong economic and fiscal policy settings. Part Two outlines how this might be done.

Competitiveness

Taking advantage of the opportunities from the growing middle class in Asia has the potential to increase demand for Australian products and services more broadly, including over time for those sectors under the greatest pressure now. However, taking advantage of these opportunities is dependent on Australia's competitiveness in the fastest growing region of the global economy.

The intense competition in the region is evident in the tax and regulatory environment:

- The BCA submission to the 2011 tax forum highlighted Australia's divergence from much lower average corporate and top personal income tax rates across the Asia Pacific. The Henry review has rightly acknowledged that 'Australia will need to respond if it is to remain an attractive place to invest and do business'.[11]
- Almost half of the countries ranked in the top 10 by the World Bank for ease of doing business were from the Asia Pacific region and Australia was not one of them.[12]

Australia must place itself in a strong position to attract skills and investment if it is to be competitive in the region. Strong inflows of capital and labour will allow the resources sector to grow while putting less pressure on other sectors of the economy.

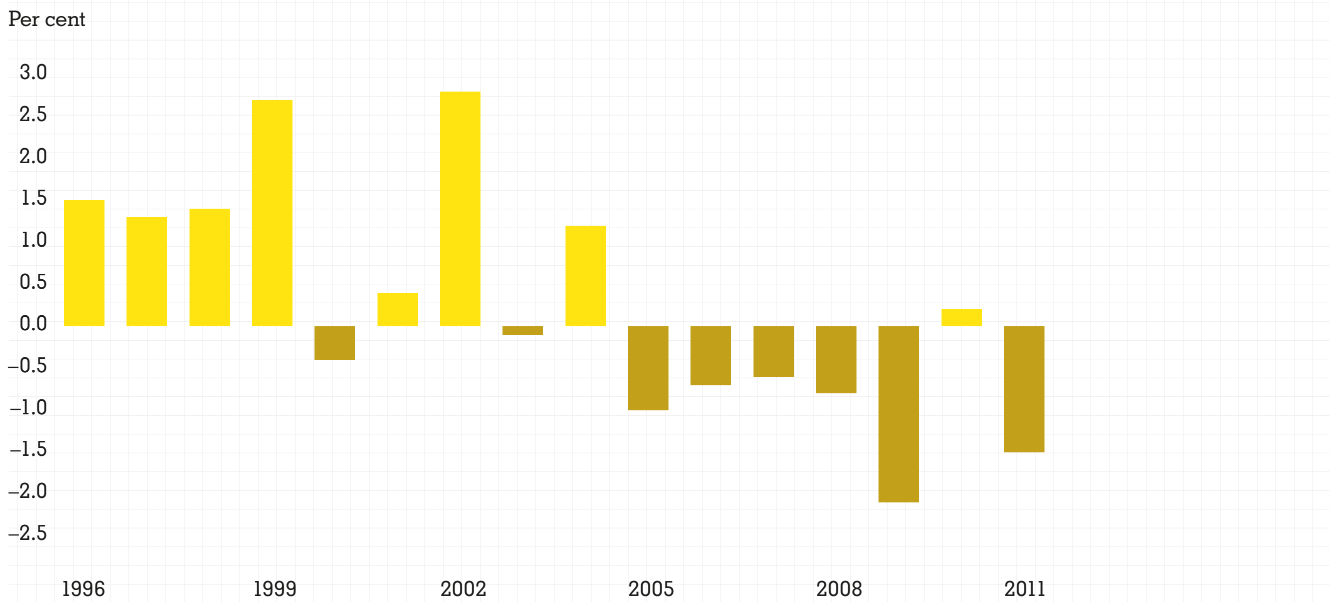
Productivity

At the same time that Australia must seek to be more competitive in the region, its weak productivity performance has been well acknowledged.

The recent intense focus on Australia's productivity performance reflects its importance as the most sustainable way of increasing standards of living over the longer term.

There are inherent difficulties in measuring productivity accurately and annual estimates can prove volatile. In addition, 'unusual events' such as the significant surge in mining investment and the recent drought can explain some of the drop in measured productivity.[13]

Figure 1: Multifactor productivity growth



Source: ABS, *Australian System of National Accounts*, Catalogue No. 5204.0, 2010–11. Note: Quality adjusted hours worked.

Notwithstanding these issues, as highlighted in Figure 1, the fact remains that Australia's recent productivity performance has been weak for a prolonged period and these 'unusual events' are not the only reason for this weakness.

With wages pressures building and a lack of productivity apparent, there has been a strong increase in unit labour costs. Through 2011 nominal unit labour costs increased by some 5½ per cent, well above their historical average growth of 3 per cent per year. Such increasing unit labour costs ultimately impede competitiveness and serve to reinforce the need for a strong focus on improving productivity across Australian workplaces.

Productivity is best enhanced through business investment in technology, human and physical capital, and innovations in management practices, industrial organisation and work arrangements.

This investment and innovation will be encouraged by having the most supportive business environment possible – flexible product and labour market regulation, competition, openness to trade and investment for knowledge transfer as well as education and skills all play a part in shaping this environment. This suggests the need for continued attention on how various government policy settings impact on the business environment.

Revenue outlook

International economic developments and uneven economic activity have weakened revenue collections recently. At the same time the high terms of trade mean that the Budget is more sensitive to developments in commodity and currency markets than it has been in the past.

In just six months since the last Budget, the impact of the shift in global economic conditions and uneven domestic conditions led to a further downward revision to Commonwealth tax receipts by some $20 billion across the forward estimates period.

Company tax receipts have weakened as a result of strong capital investment (and higher associated levels of depreciation expenses) in the mining sector along with softer conditions for some sectors arising from the strong dollar and subdued consumer spending.[14]

These weakened revenue collections can be expected to persist for some time yet. The Treasury Secretary has noted the impact of global economic developments means that 'tax receipts are expected to stay below 2007–08 levels as a share of GDP for much of this decade'.[15]

Australia's fiscal position is sound compared with many overseas countries but our longer-term fiscal task poses major challenges

Current revenue projections are also contingent on the terms of trade remaining high for some time relative to historical standards. Treasury is forecasting a slow reduction with the terms of trade falling by 20 per cent over the next 15 years, settling just above their 2006–07 level.

However, a more sudden reduction in the terms of trade could see a more dramatic deterioration in revenue. Analysis prepared by Access Economics for the BCA's 2011–12 Budget Submission highlighted that, at that time, a Budget shortfall of between $7½ billion and $36 billion could eventuate over the forward estimates should commodity prices soften by 4 per cent and 17 per cent respectively.

These recent developments and possible risks only serve to emphasise the importance of achieving restraint on the expenditure side of the Budget.

Long-term fiscal challenges

While Australia's fiscal position is sound when compared with many overseas countries, our longer-term fiscal task remains difficult. Like most other countries in the developed world, Australia faces spending pressures as its population ages. The structural spending problems are most evident in the areas of health care, aged care, social security and welfare, where expenditure is over 12 per cent of GDP.

Total spending on payments for social security and welfare account for one third of total Commonwealth spending and according to the Department of Finance[16] it is these payments where the effects of demographics will have their greatest impacts.

Commonwealth spending on health care currently accounts for around one sixth of total spending. By 2049–50, Commonwealth spending on health care, social security and welfare is projected to increase further to around 17 per cent of GDP.

Drawing on the 2010 Intergenerational Report, and fiscal modelling prepared by Deloitte Access Economics,[17] the BCA highlighted the extent to which Australia's fiscal challenge will unfold over coming decades – at the Commonwealth and state levels – in its submission to the tax forum.

Such analysis does have some limitations and it is acknowledged that the projections prepared in those reports are not forecasts. Rather, they are a tool to provide an indication of future demographic and other fiscal pressures under existing policy settings.

By 2049–50, it is projected that total Commonwealth spending as a share of GDP will increase significantly, resulting in a projected primary fiscal gap (excluding interest payments) of around 2¾ per cent of GDP by that time.

This result relies on the assumption that the government achieves its goal of constraining real spending growth to 2 per cent in years where the economy is growing above trend until the Budget is in surplus.

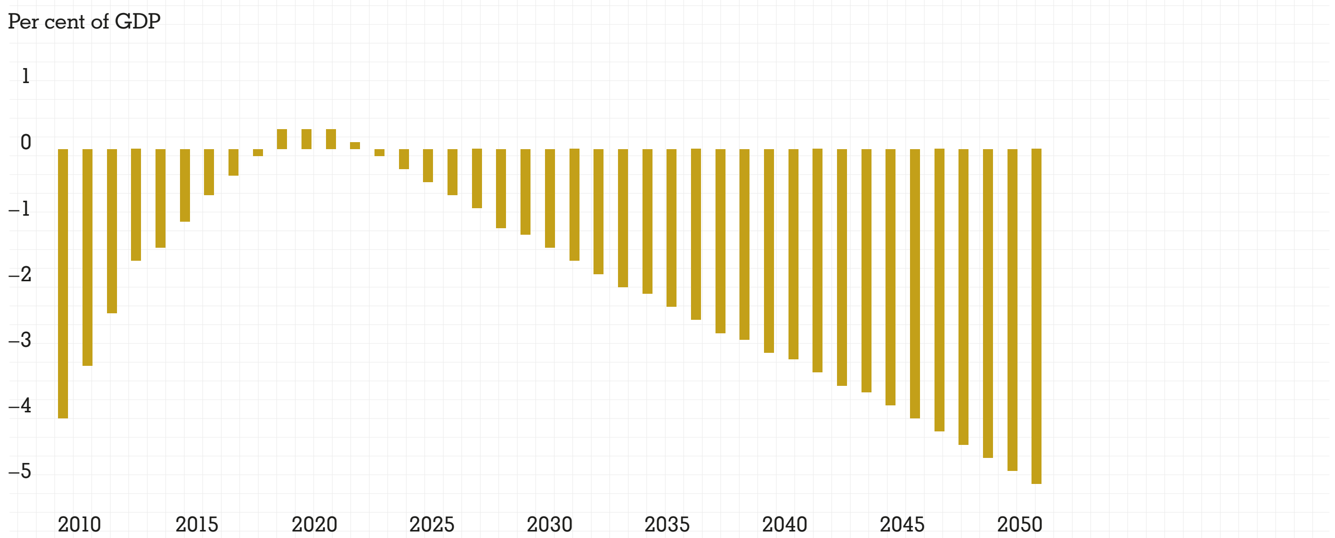
In relation to the states and territories, the Deloitte Access Economics modelling shows that although pressures on the states are not quite as notable as those on the Commonwealth Government, they are considerable – and have not been widely recognised. The states, for example, bear a considerable load on the healthcare cost front, even after allowing for recent proposed changes in state arrangements in this area.

Whereas the shortfall on primary balances for the Commonwealth is projected to reach 2¾ per cent of GDP by 2049–50, the Deloitte Access Economics modelling indicates that the states will see a shortfall of much the same size: almost 2½ per cent of GDP by 2050.

Combining the state and territory projected fiscal positions with the Commonwealth's it is estimated that by 2050 Australia will face a combined primary deficit of 5 per cent of GDP. Today a budget deficit of this size would be equivalent to around $70 billion.

Australia's current tax arrangements and the current approach to government spending will not be able to sustain deficits of that size. Indeed, as noted by the Secretary of the Department of Finance and Deregulation, despite these pressures citizens' expectations of government show no sign of abating and they seem to be increasing at the same time as a large part of the population wants reduced taxation.[18]

Figure 2: Projected primary fiscal balance – all governments



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', incorporated within the Business Council of Australia Submission to the 2011 Tax Forum.

A conundrum

The context to Australia's current economic and fiscal situation that has been outlined above suggests that we will face a very difficult conundrum:

- The growing significance of commodity prices and the terms of trade to tax revenues (and their inherent volatility) has heightened risks to the revenue base.
- A weakening and uncertain global environment is placing further pressures on the Australian economy and the associated revenue outlook.
- Pressures from an ageing population are building and adding stresses on the spending side of the Budget.
- The economic and fiscal circumstances of many European countries and the United States, and the reactions of markets, have driven home the challenges of fiscal consolidation and the critical importance of placing government finances on a sustainable footing.
- In other words, we need to adopt more sustainable fiscal discipline in Australia to prepare for a prosperous future at a time when a range of factors, both global and domestic, are conspiring to make this task ever more difficult.

Dealing with this conundrum is no easy task. It will involve resolving many challenging and demanding issues – many of which might otherwise seem to be beyond the capacity of governments to deal with in the current climate.

The challenge for policymakers is to strike the right balance in finding structural savings in the Budget required to underpin fiscal discipline without detracting from programs that enhance the productive capacity of the economy. The other challenge for policymakers is to improve the efficiency of all governments in Australia.

This conundrum only elevates the importance of effective fiscal policy in the period ahead. Recognising this, the BCA commissioned Mercer to examine the appropriateness of Australia's fiscal policy rules in light of the current economic landscape and the long-term fiscal challenges.

Informed by Mercer's analysis, the BCA is recommending a number of key mechanisms to address this conundrum beginning with the 2012–13 Budget. Part Two sets out the first of these mechanisms – three new fiscal rules designed to bolster Australia's fiscal policy framework. Mercer's full report 'Back to Policy Fundamentals' is included as an Appendix to this submission.

Part Three contains specific priorities for the 2012–13 Budget that will begin to put in place the right foundations to support the fiscal rules and meet the challenges ahead.

Conclusion

While Australia does confront a challenging set of circumstances in securing future economic growth, it comes to the task with a relatively strong foundation of fiscal policy that has served it well and market reforms that have made the economy more resilient.

There is no reason why the conundrum confronting Australia cannot be overcome through government beginning to build on this strong foundation in the 2012–13 Budget and beyond. As outlined in Parts Two and Three, bolstering the fiscal policy framework, and complementing it with a comprehensive reform agenda focused on lifting the productive capacity of the economy so that it is flexible and resilient, will go a long way in carrying the challenge.

PART TWO

REVISITING AUSTRALIA'S FISCAL POLICY RULES

Key points

- Recent international developments suggest that a lack of disciplined fiscal policy over time can place governments in a very difficult position, often forcing them to impose significant tax increases and/or spending cuts.
- While Australia's finances are much healthier than those of most other developed nations and we have a strong record of fiscal policy reforms, avoiding intractable fiscal difficulties in the future requires strengthening our fiscal foundations now rather than being forced to make unpalatable decisions in the midst of a crisis.
- Staffing levels in the general government sector have increased by some 24 per cent since 2001–02, reaching over 260,000 in 2011–12.
- The certainty and credibility of macroeconomic policies can help underpin efforts to lift productivity and workforce participation, recognising that credibility in policy-making contributes to reduced uncertainty and creates the environment conducive to investment and innovation.
- It is important to note that fiscal policy is not a very flexible instrument and should not be used to finetune the economy. Rather, it should be reserved to stimulate growth in deep recessions. It was used successfully in this role during the global financial crisis and with economic recovery well established in Australia, fiscal policy should resume its position as a contributor to medium-term stability.
- Fiscal rules can play an important role in anchoring budget settings to manage medium and long-term structural and cyclical pressures, including those related to an ageing population and the risk of future terms of trade volatility. Rules do this by preventing excessive spending and the build-up of unsustainable debt, thereby placing government finances in a strong position to respond to these pressures.
- The BCA considers that it is appropriate to implement three new fiscal rules:
  - » **Size of government:** placing a hard cap on the size of government by holding tax as a share of GDP below 23.7 per cent, such that future budgets do not see any slippage.
  - » **Counter-cyclical readiness:** specify a new objective that targets a percentage surplus based on 'recharging' fiscal readiness around every 13 years such that fiscal policy is able to make a 3 per cent of GDP contribution to the economy should the need arise.
  - » **Intergenerational equity:** target a modest proportion of the surplus – to be known as an 'intergenerational surplus' – to provision for the projected fiscal gap that is expected to arise as a consequence of demographic pressures.
- Provisioning for intergenerational pressures through this last rule does raise the second-order issue of what is done with the reserves and what if any role there is for a sovereign wealth fund. At this stage, we believe that the focus should be on returning to surplus and paying down debt. Once this task is nearing completion the merits of different forms of wealth funds should be given detailed consideration.
- The purpose of the fiscal rules is not to restrict flexibility at all costs but to enhance the role of fiscal policy as a contributor to medium-term stability. These rules are not designed to limit the flexibility of government budget settings in any particular year, but to provide a medium to long-term anchor for fiscal policy.
- The BCA does not underestimate the practical challenges in implementing these rules. On this basis, Part Three outlines the BCA's recommendations for taking institutional and structural steps in this year's Budget that will support fiscal restraint in the context of both the existing fiscal rules and the proposed rules outlined here.

We believe that against the backdrop set out in Part One, the 2012–13 Budget could, if correctly formulated, be a watershed for Australia. But it will need to do more than continue along the path of last year's Budget.

The fundamental premise of the 2011–12 Budget was right – to continue with fiscal consolidation and shore up the sustainability of Australia's public finances while at the same time investing in productive capacity.

However, an opportunity exists to build on this direction by locking in a number of mechanisms that will enhance Australia's medium-term fiscal and economic policy settings.

The first such mechanism is new fiscal rules which will better underpin sustainable public finances and support a rebuild of surpluses over the next 13 years.

The case for new fiscal rules

There are good reasons for having clearly articulated rules for the conduct of fiscal policy.

The conduct of fiscal policy is critical to the certainty and credibility of macroeconomic policies, which can help underpin efforts to lift productivity and workforce participation, recognising that credibility in policy-making contributes to reduced uncertainty and creates the environment conducive to investment and innovation.

It is important to note that fiscal policy is not a very flexible instrument and should not be used to finetune the economy. Rather it should be reserved to stimulate growth in deep recessions. It was used successfully in this role during the global financial crisis and with economic recovery well established in Australia, fiscal policy should resume its position as contributor to medium-term stability.

As noted in the Mercer report, excessive levels of public deficits and debt are intrinsically linked with significant costs for an economy. Sustained periods of government deficits exert upward pressure on interest rates which adversely impacts private investment and productivity growth. Consistently high debt ratios increase the tax burden, generate distortions in the economy and create barriers to improvements in productivity and efficiency.

A material stock of government debt can become difficult to control and expose economies to greater volatility and the risk of economic shock. As we are seeing in many European states, ill-disciplined fiscal policy over time can result in governments finding themselves backed into a policy corner – compelled to impose material discretionary tax increases, severe spending cuts or an unpalatable combination of both.

Australia has been a pioneer in introducing reforms to fiscal policy and they have served us well. As noted by the Mercer report, the general approach of focusing fiscal policy on ensuring that governments balance the Budget in the medium term and using monetary policy to manage demand in the economy is consistent with the different characteristics and effectiveness of the two policy tools.

The so-called automatic stabilisers associated with fiscal policy including welfare payments and income taxes play a role by helping to moderate demand when the economy is growing strongly and boosting demand when the economy slows. For example, welfare payments will usually increase automatically in an economic downturn as unemployment rises with more people receiving benefits. Conversely, these payments will automatically decrease as the economy recovers and employment increases.

However, in extreme circumstances discretionary fiscal stimulus can make a strong and useful contribution to economic management by supporting economic activity and preventing a large increase in unemployment (and indeed this was Australia's experience during the first global financial crisis). In order to effectively manage such extreme circumstances, governments have to create the capacity through prudent fiscal management in normal times.

Improving and enhancing our approach to fiscal policy is timely given the consequences of undisciplined fiscal policy that are currently playing out in the Euro area and the United States. A revised approach to fiscal policy would allow governments to better deliver on future fiscal policy objectives against the background of an economy in transition and growing intergenerational pressures associated with an ageing society.

In suggesting a resetting of the rules for fiscal policy in Australia, the Mercer report identifies three fundamental objectives that they should satisfy. They should:

- enforce discipline on the size of government
- ensure readiness for counter-cyclical action for any major economic shock
- ensure readiness for intergenerational pressure.

The 2012–13 Budget could be a watershed for Australia, but it will need to do more than continue along the path of last year's Budget

Size of government

The BCA considers that it is appropriate and a good fiscal policy to maintain an explicit cap for the level of taxation as a share of GDP – as a discipline to the size of government. Such a discipline is essential, because ultimately it has fundamental implications for Australia's competitiveness particularly within the region.

Empirical research on whether there is an optimal size of government is inconclusive.[19] However, the common finding is that an overly large and growing size of government is not conducive to higher productivity growth and economic performance. In that sense there is an intuitive maximum size of government.

Not only do governments do little to generate wealth, it is the inefficiency and waste of many of the peripheral European governments that have contributed to the material difficulties in their economies now. Indeed, if the tax burden on the private sector wealth generators becomes too heavy then economies have less capacity to withstand shocks and pressures from demographic changes.

In Australia we must maintain pressure on governments to lift efficiency. This means for example getting better results from the billions of dollars spent each year on Indigenous welfare.

In Australia, a cap on taxes as a share of GDP was set at 22.3 per cent as far back as 1985–86. The current announced cap of taxation as a share of GDP is set at the level for 2007–08 of 23.7 per cent.[20]

The level of government tax receipts as a percentage of GDP is cyclical by nature although recently there has been a stronger linkage to movements in the terms of trade. Also increased expenditure has typically accompanied higher tax receipts.

The Mercer report notes that based on historical trends the current target of keeping tax as a percentage of GDP to 23.5 per cent exceeds the 40-year average of 21.4 per cent.

Mercer further notes that compared with other developed economies and our Asian counterparts, Australia's tax revenue as a percentage of GDP has been materially lower than the OECD average over time. However, data from the emerging economies of Asia and the Pacific demonstrates that our closest trading partners have materially lower tax receipts as a percentage of GDP. For example, data from the World Bank suggests that the tax-to-GDP ratio for the east Asia and Pacific region was around 12 per cent in 2008.[21]

Given this starting point, the BCA considers that the current cap on the size of government of 23.7 per cent should be retained but it should become a hard cap so that future budgets do not see any slippage as has occurred in the last 15 years.

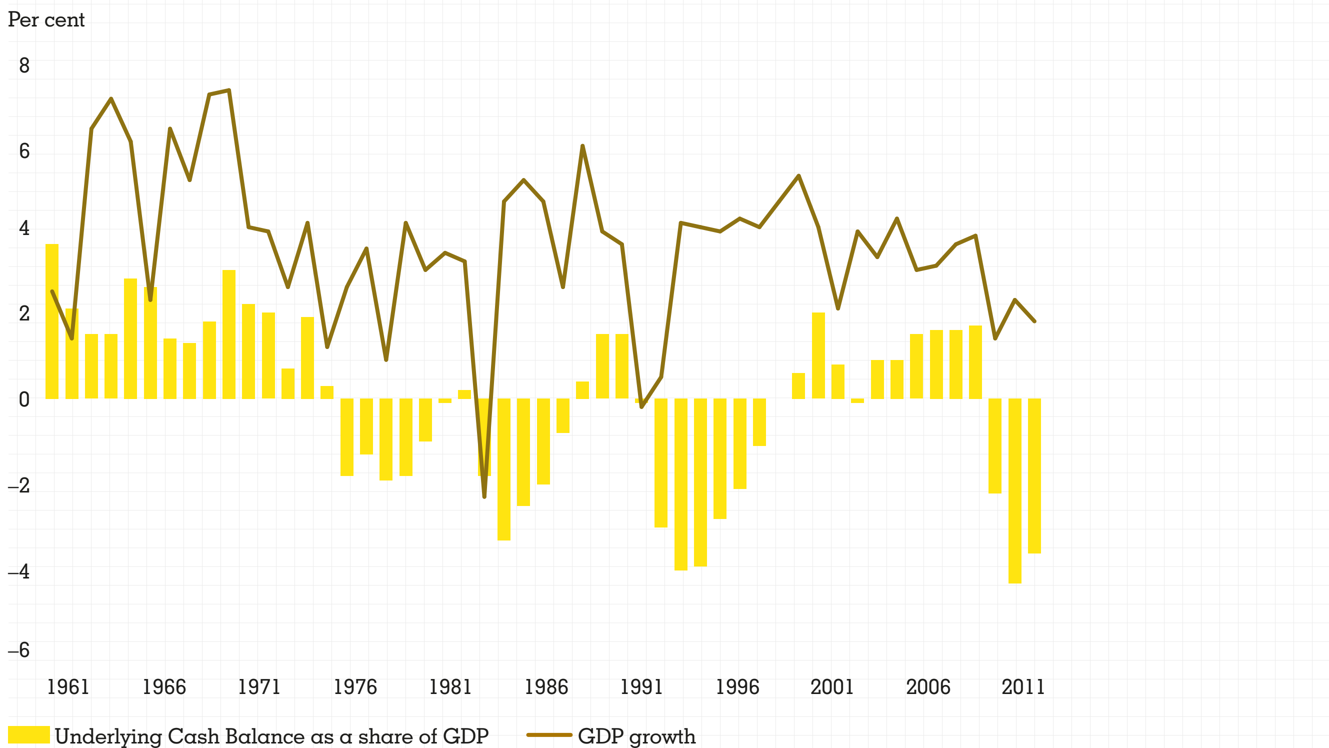
It will be important to review the effectiveness of this cap in providing a discipline on the size and productivity of government through the regular audits the BCA is recommending later in this submission.

Counter-cyclical readiness

As outlined above, discretionary fiscal policy has been most effective when it is deployed at times of significant economic shock and when that shock cannot be managed through monetary policy alone.

The historical experience in Australia shows that at a federal level the budget position has moved into deficit after commensurate pronounced falls in GDP that occurred during the late 1970s, the mid-1980s, mid-1990s and late 2000s.

Figure 3: Commonwealth underlying cash balance as percentage of GDP



Source: Commonwealth 2011–12 Budget, Budget Paper No. 1, Statement 10. Note: Underlying cash balance is equal to receipts less payments less expected future fund earnings. Since 1976 shown on a consistent basis. Earlier data are classified on the basis applying in the relevant budget year.

The average level of the budget deficit (as a per cent of GDP) in each of the four tranches was 2.2 per cent (although the average over the 1990s and 2000s episodes has been 3 per cent of GDP).

There are few hard rules as to the appropriate size of budget deficits needed for counter-cyclical stimulus during major economic downturns. This will typically require a judgement call from policymakers.

The Mercer report considers it reasonable and prudent to assume that the Commonwealth Government will be required to make a contribution to the economy through counter-cyclical fiscal policy on average every 13 years or so. The size of this contribution is estimated to be 3 per cent of GDP. Previous downturns have been accompanied by a deterioration in the budget deficit of 2 to 4 per cent of GDP, comprising both automatic stabilisers and discretionary loosening.

The current fiscal policy rules address cyclical readiness by ‘achieving budget surpluses on average over the medium term’. While the government’s current rule – to aim for surplus – is right, an opportunity exists to shore up the integrity of the rule with hard targets informed by the overriding objective of having fiscal policy ‘ready’ to deal with an economic shock.

The immediate objective of fiscal policy – set with an appropriate medium-term perspective in mind – should be to target the generation of budget surpluses with a view to paying down debt and, having done that, accumulate fiscal reserves that could then be deployed should the need arise in response to a major economic shock.

The benefit of having these reserves ready to deploy is that the government should not find itself in the position of having to implement dramatic fiscal consolidation after the stimulus has been applied, when the economy may still be weak and recovering from the shock.

We believe that the government should specify a target percentage surplus in the fiscal policy rules based on recharging fiscal readiness over a 13-year cycle so that fiscal policy is able to make a 3 per cent of GDP contribution to the economy should the need arise. It is important to note that the building up of this cumulative surplus equivalent to 3 per cent of GDP would come after paying off debt. The BCA supports the government’s priority to pay down the current net debt position to zero by 2020–21.

This highlights a key point that the approach to fiscal policy is necessarily geared around a medium-term timeframe. Surpluses need to be built up to reduce and eliminate debt and then used to ‘recharge’ the fiscal arsenal.

Applying the counter-cyclical readiness rule flexibly

The purpose of the fiscal rules is not to restrict flexibility at all costs but rather to enhance the role of fiscal policy as a contributor to medium-term stability.

The counter-cyclical fiscal rule should allow the automatic stabilisers to continue to play a role. For example, and as noted in the Mercer report, should a slowdown in Asia occur the macroeconomic policy response would likely see the RBA ease monetary policy, the dollar depreciate and improve competitiveness, and automatic fiscal stabilisers would support growth. In this instance discretionary fiscal stimulus would not be warranted.

However, if a slowdown in Asia turned out to be severe then discretionary fiscal stimulus may be appropriate as occurred in response to the global financial crisis. In this regard, there is a need for the budget balance to improve during periods of moderate to strong economic growth so that we can be in a position to take counter-cyclical policy action in the event of a material economic shock.

In a related vein, it is generally accepted that counter-cyclical fiscal policy will help protect the economy from the volatility inherent in commodity prices. Budget surpluses should be built up when commodity prices are strong and can be used to support the economy during a material downturn.

Should a major economic shock requiring discretionary fiscal action occur prior to accumulated surpluses being built up over the 13-year target period, the government should borrow in order to finance the fiscal stimulus. However, such borrowing should only occur on the basis that the government undertakes to return to surplus as soon as is practicable and thereby return the net debt position to pre-stimulus levels.

The BCA recommends that the government specify a new fiscal rule that targets a percentage surplus based on 'recharging' fiscal readiness around every 13 years for fiscal policy to be able to make a 3 per cent of GDP contribution to the economy. That is to say, a series of small annual surpluses need to accumulate over 13 years to enable debt to be repaid and fiscal capacity to be recharged to be able to deploy a fiscal stimulus equivalent to 3 per cent of GDP.

Intergenerational equity

Australia has been well served by the publication of a series of Intergenerational Reports, which have increased awareness and transparency of the costs associated with an ageing society. However, the government's existing fiscal rules do not convert the output from the IGR into an explicit fiscal rule.

As noted above, the expected fiscal gap of the Commonwealth is projected to reach around 2¾ per cent of GDP in 2050. When combined with the fiscal pressures that will be encountered by the states and territories in their expenditure responsibilities, that fiscal gap will extend to around 5 per cent of GDP.

A fundamental point made by the Mercer report is that if nothing is done to provision for the fiscal pressures associated with an ageing society, then fiscal policy will be relegated to an unsustainable position.

The approach to dealing with these intergenerational challenges should cover two actions.

First, it is prudent policy to begin to provision for the projected fiscal gap arising from intergenerational pressures. This could be achieved by targeting (or setting aside) a modest proportion of the budget surplus as a percentage of GDP to deal with these expected future funding pressures. A medium-term milestone, by possibly 2025, could be set in terms of a 'reserving target' to fund a percentage of the future fiscal gap to begin to instil discipline now.

Estimates compiled by Mercer suggest that on the basis of a whole-of-federation fiscal gap of 5 per cent of GDP by 2050, a collective contribution from Commonwealth and state governments equivalent to a surplus of 0.6 per cent of GDP could be required to provision for the fiscal gap by 2050.

Any proposed surplus targets and medium-term milestones to address intergenerational concerns could be developed and announced by the government in the forthcoming Budget.

Second, policy improvements on the supply side in terms of productivity, participation and population as well as the efficient provision of health and aged care can help to alleviate the fiscal pressures of an ageing population by growing the economy, which will both increase government revenues and reduce demands on the expenditure side by growing incomes.

The involvement in the private sector in the provision of health and aged care services will be essential to improving efficiency.

The advantage of provisioning now through a new fiscal rule is that it will compel governments to either begin the process of fiscal provisioning or embark on supply-side policies to reduce the fiscal gap itself, or a combination of both.

Provisioning for intergenerational pressures in this way does raise the second-order issue of what is done with the reserves and what if any role there is for a sovereign wealth fund. These issues are addressed in Exhibit 1.

At this stage, the BCA believes that the focus should be on returning to surplus and paying down debt, with net debt forecast to be over $130 billion in 2011–12.[22] Once this task is nearing completion, then the merits of different forms of wealth funds should be given detailed consideration.

The BCA does not believe the establishment of a sovereign wealth fund is a priority for the medium term. Instead, the focus must be to return to surplus, pay down debt and implement fiscal rules about how future surpluses should be managed and national wealth created.

Recommendation 1

The Business Council of Australia recommends that in the forthcoming Budget the government commit to a new set of fiscal rules that:

a. Place a hard cap on the size of government by holding tax as a share of GDP below 23.7 per cent, such that future budgets do not see any slippage.

b. Specify a new objective that targets a percentage surplus based on 'recharging' fiscal readiness around every 13 years such that fiscal policy is able to make a 3 per cent of GDP contribution to the economy.

c. Target a modest proportion of the surplus – to be known as an 'intergenerational surplus' – to provision for the projected fiscal gap that is expected to arise as a consequence of demographic pressures.

Exhibit 1: Sovereign wealth funds

There has been significant debate about whether Australia needs a sovereign wealth fund to assist in the management of revenues from the resources boom. In assessing this issue it is essential to be clear about what the objectives would be in establishing such a fund.

Sovereign wealth funds have typically been established to:

- meet fiscal stability needs which would insulate the Budget and the economy from the volatility of commodity prices
- for long-term saving or intergenerational needs to assist in positioning the fiscal gap as the population ages.

Mercer has noted that these objectives apply to an Australian economy currently in the midst of a commodity boom. That said, the critical issue is how these objectives would be best met – including after taking account of the proposed fiscal rules outlined here and whether they should be accommodated through a new sovereign wealth fund or by other means.

The Mercer report notes that there is general acceptance that counter-cyclical fiscal policy will help protect the economy from the volatility inherent in commodity prices. Budget surpluses should be built up when commodity prices are strong and can be used to support the economy during a downturn.

In this sense, a stabilisation (or sovereign wealth) fund is not essential to implement counter-cyclical fiscal policy. The Australian Government was able to implement significant discretionary fiscal policy stimulus in response to the global financial crisis. As outlined above, it is possible to design new fiscal rules involving the accumulation of sufficient surpluses into a so-called 'cyclical readiness recharge reserve' that will ensure readiness for counter-cyclical action needed in response to future economic shocks.

A key point is that the 'cyclical readiness recharge reserve' would have to be able to be deployed quickly so accumulated surpluses would need to be invested in liquid, cash-like instruments that are relatively short-term in nature. Mercer suggests that they could be managed by the Australian Office of Financial Management.

In the case of the need to provision for intergenerational issues, the proposed new fiscal rules suggest that there is a need for an 'intergenerational reserve' to fund the ageing of the population irrespective of our greater exposure to terms of trade movement.

As funds comprising the intergenerational reserve would need to be invested over a longer horizon a different investment strategy would be required.

The position outlined by Mercer is that the primary policy imperative for now is to 'raise the bar' on our fiscal policy framework through the creation of new fiscal rules. Under a new framework it is proposed that the government target two 'reserves' – a cyclical readiness recharge and an intergenerational reserve.

According to Mercer, what is done with the reserves is a second-order issue, as long as they are earning interest for the government and not being used for competing objectives. The primary issue is how our fiscal policy rules will deliver adequate reserving for the cyclical and intergenerational issues the Australian economy will face in the future.

The BCA does not believe the establishment of a sovereign wealth fund is a priority for the medium term. Instead, the focus must be to return to surplus, pay down debt and implement fiscal rules about how future surpluses should be managed and national wealth created.

Conclusion

We believe that resetting the medium-term fiscal settings by committing to these fiscal rules in the upcoming Budget would provide a strong demonstration of the government's long-term fiscal credibility. However, we also realise that this is only the first step and that a credible pathway to fiscal discipline should underpin these rules.

This requires a more structured, deep and considered approach to improving the efficiency of government spending. The task will also be made easier by a strongly growing economy supported by policies that improve competitiveness. Recommendations for the 2012–13 Budget supporting these aims and the required fiscal discipline to underpin the fiscal rules are outlined in Part Three.

New fiscal rules are the first step; a deep and considered approach to improving the efficiency of government spending is also required

PART THREE

2012–13 BUDGET PRIORITIES

Key points

- This year's Budget must begin to take steps to address the long-term fiscal and economic challenges confronting Australia.
- Firstly, this involves taking practical steps that will support long-term fiscal constraint and ensure adherence with the current fiscal rules and those outlined in Part Two. In this regard, the government should:
  - » return the Budget to surplus in 2012–13, subject to the prevailing global economic conditions and their impact on Australia. However, given the risk of global conditions deteriorating markedly, planning should be occurring now to ensure that in those circumstances, any stimulus is effective and well directed both in boosting demand and enhancing Australia's productive capabilities
  - » put in place a systematic program of audits of the efficiency of government expenditure including overlaps in federal and state funding of health care and education, as well as the environment and Indigenous welfare to ensure a more structured, deep and considered approach to expenditure restraint
  - » undertake a whole-of-nation Intergenerational Report to confirm the economic and fiscal task ahead, including measuring the impact of already changing policy settings and circumstances on the long-term outlook
  - » undertake the necessary modelling and analysis to provide the basis to consider further increasing the eligibility age through a link to changes in life expectancy
  - » request the Productivity Commission to undertake an inquiry into the effectiveness and efficiency of Commonwealth procurement, with a particular focus on areas where current practices could be strengthened to achieve better value for money. The review should be completed by the end of 2012 and the government must be prepared to embrace the commission's recommendations
  - » implement the efficient market-based delivery of key public services in aged care and disability as well as health care to place government in a better position to fund an adequate level of services at a reasonable cost in the longer term
    - – on disability care and support, the National Disability Insurance Scheme should be funded from savings from other lower-priority expenditures in the event that the additional costs cannot be funded from existing revenues when the scheme is rolled out later this decade
    - – on aged care, it would mean developing and releasing a response to the Productivity Commission's report along with an implementation plan in the first half of 2012.
- Secondly, the government must continue to promote policy reforms that lift the productive capacity of the economy. Growing the economy will assist in meeting long-term challenges by building fiscal capacity and reducing demands on the Budget through increased incomes.
- Therefore, the BCA is recommending that the government take a number of steps to ensure that tax, regulation, labour market and infrastructure policies are all better geared to support economic growth. In this regard, the government should:
  - » during 2012 develop formalised ongoing processes and an institutional model that would be suitable for progressing long-term comprehensive tax reform over a 10-year period, as outlined in the BCA's submission to the 2011 tax forum
  - » support more effective regulatory scrutiny by reallocating resources as necessary from other lower-priority government functions to the Office of Best Practice Regulation to facilitate the preparation of – and compliance with – high-quality Regulatory Impact Statements. The government and Cabinet should promote an internal culture of discipline when it comes to new regulations, recognising the costs of a rising regulatory burden on the community
  - » re-phase the distribution of seamless national economy reward payments due in 2011–12 and 2012–13 to the states to 2012–13 and 2013–14, subject to the government's consideration of the COAG Reform Council's report on progress. This would recognise the changed implementation profile of the seamless national economy reforms since the original national partnership with the states was signed. It would also keep up the incentive for states to pull out all the stops in expediently implementing the remaining reforms

Key points (continued)

- boost the effectiveness of the labour market by pursuing a range of workforce development and deployment strategies as well as strategies to bring those who are most disadvantaged into the labour market, including:
  - maintaining skills reforms initiatives introduced in the 2011–12 Budget and increasing flexibility in the way in which funds are applied
  - commissioning an independent review to identify the key causes of low take-up of advanced mathematics in schools and advise on appropriate strategies to overcome this
  - complementing demand-driven funding arrangements in higher education with reforms to domestic student fee-setting arrangements and student contribution amounts. This would better align funding with public and private returns to investment in education and training and ensure that the shift to entitlement-driven funding is fiscally sustainable. In particular, this should involve education and training providers in receipt of government subsidies having reasonable flexibility to adjust fees in order to ration available places in areas of high demand
  - developing a new pathway for international students completing their education in Australia to convert from temporary to permanent visas
  - reviewing and reforming the design of job services agency contracts to better align agency incentives with improved outcomes for those experiencing labour market disadvantage
  - requesting the Productivity Commission to undertake an inquiry into entrenched disadvantage
- support the ongoing infrastructure task by:
  - determining the list of prioritised federal and state economic infrastructure projects requiring public funding, advised by Infrastructure Australia, which will provide the basis for future public funding decisions
  - charging the Productivity Commission with undertaking a regular assessment of the economic benefits of Australia's infrastructure policies
  - setting out principles formulated with the states for determining the appropriate mix of funding for infrastructure projects that emphasise greater application of user charges and which agrees a consistent methodology for Commonwealth–state funding allocations
  - announcing in the Budget, or preferably beforehand, that it will undertake a cost–benefit analysis of the National Broadband Network and apply the competitive neutrality policy to NBN Co in full, in recognition of the importance of an efficient and competitive broadband market.

The BCA is firmly of the view that long-term fiscal credibility requires governments to begin to take structural steps now to prepare for the medium and long-term challenges that confront us. This means that this year's Budget must set out a credible pathway to fiscal discipline while at the same time continuing to support policies that grow the productive capacity of the economy.

It is in this context that the BCA provides a number of practical recommendations for this year's Budget that build on the fiscal rules set out in Part Two. This includes the foundational steps for building long-term fiscal restraint, along with measures that support competitiveness and economic growth. These measures are detailed below.

Supporting fiscal restraint under the new rules

While there is broad agreement on the fundamental need for fiscal restraint and restoring sustainability to government finances, there will be considerable practical challenges in delivering this commitment.

The practical challenge of delivering fiscal rules has been apparent in the implementation of the government's commitment to hold real growth in spending to 2 per cent per year until the Budget returns to surplus.[23]

Meeting this target in the short term is proving difficult with the MYEFO indicating that real growth of 3.7 per cent in expenditures is expected in 2011–12. In the longer term, the task is only likely to get harder with the Department of Finance noting that continuing to achieve the 2 per cent real spending target will become more challenging once stimulus spending is fully withdrawn in 2013–14.[24]

The 2012–13 Budget provides the perfect opportunity for Australia to build on its long-term fiscal credibility

The 2012–13 Budget is the perfect opportunity for Australia to build on its long-term fiscal credibility, the kind of fiscal credibility which has been lacking in global markets of late. In order to secure the realisation of the fiscal rules in the long term, the government must begin to take clear actions now, including to:

- return the Budget to surplus in 2012–13, subject to the prevailing global economic conditions and their impact on Australia
- put in place a systematic program of audits of the efficiency of government expenditure
- undertake a whole-of-nation Intergenerational Report to confirm the economic and fiscal task ahead, including measuring the impact of already changing policy settings and circumstances on the long-term outlook
- build on the previous decision to increase the pension age, by linking further increases in the qualifying age to changes in life expectancy
- undertake wholesale reform of government procurement policies, with a view to taking advantage of more sophisticated market-based approaches
- implement the efficient market-based delivery of key public services in aged care and disability and health care to place government in a better position to fund an adequate level of services at a reasonable cost in the longer term.

Even without the adoption of the new fiscal rules outlined previously, taking these actions would be beneficial in strengthening the foundations for fiscal discipline and expenditure restraint. Further detail on each of these actions is provided below.

Returning to surplus in 2012–13

The Business Council of Australia reaffirms its support for the government's policy to return the Budget to surplus in 2012–13. Returning the Budget to surplus in 2012–13 would provide a strong demonstration of the government's fiscal credentials and its commitment to the fiscal discipline that is needed to underpin the right economic strategy for Australia.

In the event that Australia was to encounter a severe economic shock – arising from a marked deterioration in the global economy brought on by a significant downturn in Europe – then it is self-evident that a committed return to surplus in 2012–13 should be reconsidered.

As outlined in Part Two, assuming such a slowdown is not severe then it could be expected that discretionary fiscal stimulus would not be necessary with monetary policy, the exchange rate and the automatic stabilisers all playing a role in cushioning the impact on Australia. However, if such a slowdown turned out to be severe then it would be appropriate to consider if discretionary fiscal stimulus is necessary.

Should the need arise to consider increased government expenditure to provide an economic stimulus, it will be essential such stimulus supports the growing of the economy. This should be through initiatives such as investment in economic infrastructure that provides the short-term stimulus and the long-term economic return.

To this end, planning should be occurring now to ensure that stimulus is effective and well directed. For example, action should be taken now, including by the states, to prepare to fast-track the rollout of projects should there be a need to stimulate the economy. This includes action to accelerate project planning and development approvals.

Recommendation 2

That the government returns the Budget to surplus in 2012–13, recognising that the government should have some flexibility and discretion to alter this path in response to the prevailing global economic conditions and their impact on Australia.

Reviewing program efficiency

We believe that several key actions are necessary in establishing a structured, deep and considered approach to reviewing government efficiency and ensuring expenditure restraint. These actions include:

- an independent review at the whole-of-government level to establish the principles and framework for assessing government efficiency, including criteria for determining whether particular public services should be delivered by the public or private sector and areas of greatest potential for increased efficiencies
- further ongoing audits of government spending and program efficiency conducted through an expanded role for the new Parliamentary Budget Office or the BCA's previously proposed Commission of Budget Integrity.

An independent review

In strengthening institutional arrangements around achieving expenditure restraint, there is a case to be made to conduct a one-off audit of government spending and program efficiency.

The last such exercise was undertaken by the National Commission of Audit in 1996. The National Commission of Audit sought to apply a consistent set of principles in assessing a broad range of government activities to assess what government does, how it does it and the implications for the fiscal position. Critically, the commission recognised that:

- The performance of government programs can deteriorate markedly over time despite the best of intentions.
- The community would prefer the more efficient delivery of services rather than reducing assistance to those most in need.
- Government efficiency contributes to a more competitive business environment.[25]

An independent review of efficiency at the whole-of-government level, conducted through an expert panel of eminent public finance experts, could provide increased confidence in those areas where the government is operating efficiently, while setting out a prioritised program of strategic audits in those areas where there is evidence of inefficient government expenditure.

An ongoing program of strategic audits

In its Budget Submission to the government last year, the BCA argued that the government's longer-term fiscal strategy could be bolstered by the establishment of an independent Commission of Budget Integrity.

In the 2011–12 Budget, the government announced funding of $24.9 million over four years to establish an independent Parliamentary Budget Office (PBO) to assist parliament in its scrutiny of budget and fiscal policy. While this is a positive development, it remains a second-best approach and there is a case for such a body to go much further than simply assisting parliament. As noted in research undertaken by former senior Department of Finance official Stephen Bartos for the BCA, the disadvantage of such a model is that the priorities are likely to be driven by immediate parliamentary requests rather than the underlying economic importance of issues.

Despite these concerns, if the functions that the BCA envisaged under its Commission of Budget Integrity model can be executed effectively through existing institutions or through an expanded role for the newly established Parliamentary Budget Office then they should be. The primary function that was envisaged for this commission was to fill the gap in existing mechanisms that review the efficiency of public spending programs by making clear public judgements about whether particular programs are achieving the key fiscal priority of 'value for money'. Existing program assessment mechanisms are also not suited to examining large systemic issues as they affect the Budget – for example population and social disadvantage. In addition, there are areas of government spending considered to be 'off limits' for political reasons even though there may be good reasons to examine them on the grounds of public finance sustainability.

A strategic program of independent audits that responds to the systemic issues with a mandate to tackle previously 'off limits' issues may go a long way to embedding fiscal discipline now and into the future.

In the medium term it is recommended that the government initiate a series of audits of government spending and program efficiency as well as the effectiveness of the cap on the size of government conducted through an expanded role for the new Parliamentary Budget Office or a new Commission of Budget Integrity.

Similar to exercises such as the Productivity Commission's annual benchmarking of regulation, a long-term agenda should be established with bipartisan commitment to progressing a specified number of audits each year and responding to their recommendations in a timely manner.

Some immediate areas for audit and review could include identification of any overlap between the Commonwealth and the states in health and education, and options for a clearer delineation of responsibilities for policy and service delivery. A closer examination of factors behind the growth in public service staff to current levels (including at the senior executive officer level) is also an area warranting attention.

Recommendation 3

a. That the government commissions a whole-of-government audit of spending and program efficiency including assessing what the government does, how it does it and the implications for the fiscal position.

b. That a series of audits of government spending and program efficiency be conducted over the medium term through either an expanded role for the new Parliamentary Budget Office or a new Commission of Budget Integrity.

c. Areas that may be warranting audit and review in the first instance include:

   » identification of any overlap between the Commonwealth and the states in health and education, as well as aged care, Indigenous welfare and environmental approvals and options for a clearer delineation of responsibilities for policy and service delivery

   » factors behind the growth in public service staff to current levels including at the senior executive officer level.

Preparation of Intergenerational Reports

Since 2002 the preparation of Intergenerational Report-type analysis at the Commonwealth level has helped highlight the full cost of government in the face of unfolding demographic challenges.

As outlined in Part One, the Business Council of Australia prepared a submission to the tax forum, which was supported by an Intergenerational Report-type analysis at a whole-of-federation level.

As outlined previously, such analysis does have some limitations and it is acknowledged that the projections prepared in those reports are not forecasts. Rather, they are a tool to provide an indication of future demographic and other fiscal pressures under existing policy settings.

The results of such reports are typically intended to inform policymakers and the public of emerging pressures that will affect fiscal sustainability and in that respect can play a useful role in contributing to the policy debate.

As noted in the Mercer report, most state governments have specific rules relating to their levels of debt to address broader objectives of fiscal responsibility. However, at the state level there is a general absence of explicit fiscal policy rules to address intergenerational equity.

Although the most recent IGR for the Commonwealth Government was prepared in 2010, we consider it would be timely for the Commonwealth Government, in conjunction with the states, to reaffirm the projected fiscal challenge by extending the Intergenerational Report-type analysis across all levels of government. This would also assist in confirming the fiscal contribution necessary under the intergenerational equity fiscal rule outlined in Part Two.

Recommendation 4

That the Commonwealth facilitates the preparation of a whole-of-nation Intergenerational Report in 2012. This analysis would not only focus on health and social security pressures at the Commonwealth and state levels, but may also take account of population growth and community expectations around the provision of infrastructure by state governments.

Responding to changes in life expectancy

The size of the intergenerational fiscal task will be significantly affected by the adequacy and source of retirement incomes and the capacity to control healthcare expenditures.

As noted in the Mercer report, the speed with which the Australian population will age depends critically upon the assumptions used for future improvements in mortality. Based on the standard population data and not allowing for any improvements, 50 per cent of men aged 65 can expect to live to age 84 (with 25 per cent living to 89). However, if we apply the most recent trends in mortality improvement then we see a substantial increase in life expectancy. Under some scenarios a 65-year-old man today may have a 50 per cent probability of living to 93 and a 25 per cent probability of living to over 100.

Recognising these trends, the government has already legislated to increase the Superannuation Guarantee progressively from July 2013 to July 2019 (see Exhibit 2).

The government has also taken the prudent step of progressively increasing from July 2017 the qualifying age for the age pension such that the qualifying age will increase to 67 years by July 2023.

Depending on how the improvement in life expectancy plays out in practice there may well be a need to increase the qualifying age for the age pension further. As a means of addressing this issue now, consideration could be given in the 2012–13 Budget to a commitment to legislate an indexation of the age pension qualifying age to future increases in life expectancy.

The rate of indexation could be determined following the preparation of updated long-term fiscal projections through a whole-of-government Intergenerational Report. This would permit latest fiscal projections and modelling of the impact of different rates of indexation and different scenarios for improvements in life expectancy. This analysis would facilitate an informed judgement, balancing the objectives of fairness and affordability.

Recommendation 5

That the government commits to an indexation of the age pension qualifying age to future increases in life expectancy, with the rate of indexation to be determined following the preparation of updated long-term fiscal projections through a whole-of-government Intergenerational Report.

Exhibit 2: Superannuation

A significant aspect of the savings story in Australia is the policy of compulsory retirement contributions – a policy used to boost private saving and to provision for retirement.

The importance of superannuation is on the rise. Reserves that have been accumulating for over 25 years now form a substantial pool of savings within the economy and as of June 2011, Australians had $1.340 trillion invested for retirement provisions.

Superannuation contributions (including the superannuation guarantee and salary sacrifice) are considered part of disposable income for the purposes of the National Accounts and are therefore included in the household savings ratio even though they cannot be accessed. However, compulsory superannuation will only increase savings to the extent it is not offset by a fall in other savings.

The Mercer report notes that overall the impact of compulsory superannuation is estimated to be positive with the current contribution to private saving estimated at 1.5 per cent of GDP and rising sharply to 3 per cent of GDP in 2040 following the proposed mandatory increase in the superannuation guarantee to 12 per cent. Given its increasing importance to the country, a strong case can be made to strengthen the governance arrangements around superannuation.

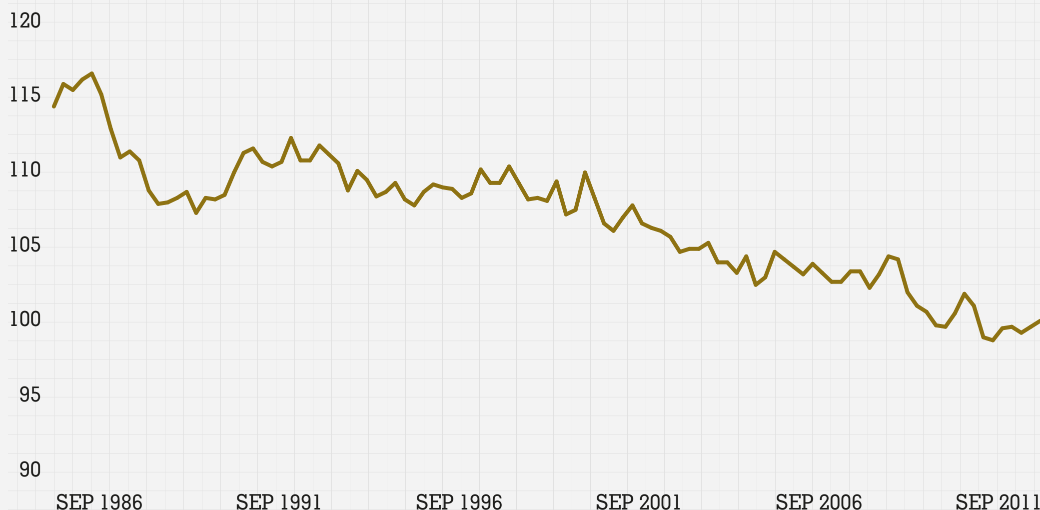
From a public policy perspective, the BCA accepts that increased superannuation saving is important to reducing future reliance on the age pension. However, the proposal to stage an increase in Superannuation Guarantee charges from 9 per cent to 12 per cent over the period July 2013 to July 2019 will need to be handled carefully.

There are a number of complex issues around superannuation, including the adequacy of different levels of retirement incomes. There are also differing views on whether it is employers or employees who ultimately bear the cost of higher superannuation contributions.

Arguments have been made that the experience with the introduction and progressive increase in the superannuation guarantee from 3 per cent to 9 per cent over the period from 1992 to 2002 coincided with a marked decline in real unit labour costs and an upward shift in the profit share of factor income and a commensurate fall in the wages share. Proponents suggested this supported the contention that the cost of the rise in superannuation was borne by workers.

It is reasonably clear that Australia has experienced a sustained period of falling unit labour costs over the past two decades. However, since the middle of 2010 the downward trend has stopped and real unit labour costs have been rising. To the extent that wage rises are not offset by improvements in labour productivity, pressure will continue to come to bear on unit labour costs and therefore inflation. The RBA reiterated this point in testimony to the House of Representatives Standing Committee on Economics in August 2011.

Figure 4: Real Unit Labour Costs



Source: ABS Catalogue No. 5206.0, *Australian National Accounts: National Income, Expenditure and Product*, Table 38, Unit Labour Costs.

Exhibit 2: Superannuation (continued)

Unless future increases in the superannuation guarantee are traded off against future wage increases, there is a risk that businesses will bear the cost and that this will be to the overall detriment of the economy. The government has suggested that the phasing in of the increase in the Superannuation Guarantee will allow employers to take the increased Superannuation Guarantee contributions into account when negotiating future wage settlements.*

The BCA's strong view is that any increase in the superannuation guarantee must be traded off against future wage rises.

*Information regarding the phasing in of the increase in the Superannuation Guarantee was taken from the Australian Government Fact Sheet, 'Increasing the Superannuation Guarantee Rate to 12 Per Cent', 26 July 2011.

Healthcare expenditure

Healthcare outlays have been increasing faster than either GDP growth or CPI for the past decade, leading to substantial increases in the proportion of GDP spent on health care. Driven by fast-growing demand (in turn driven by the onset of chronic disease, technology and consumer preferences) and escalating healthcare costs, these outlays are now the fastest-growing element of Commonwealth and state expenditures. Healthcare reforms to date will not put the system onto a sustainable financial basis or address models of care issues.

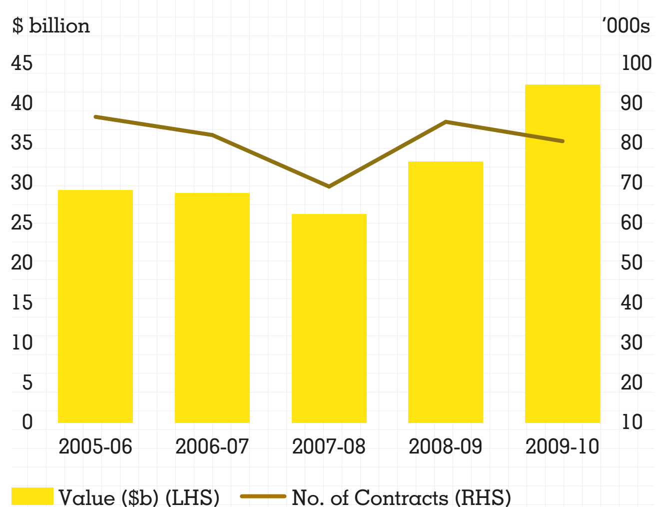
Between 1999–2000 and 2009–10, the federal government's expenditure on health grew at an average of 5.1 per cent per year in real terms, compared with average real growth in GDP of 3.1 per cent per year.[26] Healthcare expenditure is projected to continue to grow faster than the economy, with federal government spending on health care expected to grow from around 4 per cent of GDP to 7 per cent of GDP in 2049–50.

Healthcare reforms need to be pursued far more strongly to deliver the reduction in demand and improvements in the efficiency and productivity of health care consistent with the overall fiscal target and rules proposed in this submission.

Reviewing government procurement

In 2009–10, the government reported almost 81,000 total contracts with a value of over $42 billion. While much of this amount reflects the implementation of temporary stimulus programs, even at pre-GFC levels the substantial procurement spend is suggesting a role for disciplined monitoring and review.

Figure 5: Value of Commonwealth Government Procurement



Source: Department of Finance and Deregulation, Statistics on Australian Government Procurement Contracts.

The government has, to date, recognised some potential for savings in government procurement with reviews of contract arrangements in areas such as travel, legal services and information and communications technology to improve value for money.

In addition, there have been a number of reviews of the Commonwealth procurement framework in the last decade. The Commonwealth Procurement Guidelines were updated in 2008. Prior to this a review of Commonwealth procurement policies occurred ahead of the introduction of the Australia–United States Free Trade Agreement (AUSFTA) in 2005, which was primarily focused with meeting the legal obligations flowing from the AUSFTA.

Recent reviews have been largely mechanical in nature and have not focused more fundamentally on whether the intent of value for money is being realised in practice and if the policy or compliance practices warrant further reform.

While institutions such as the Australian National Audit Office undertake audits of procurement processes, such exercises provide limited tangible evidence of the extent to which the government is achieving value for money in its procurement. It has been some time since the Productivity Commission has been tasked with reviewing procurement; as the former Industry Commission, it reviewed defence procurement in 1994.

We believe that it would be timely to examine:

- how government procurement could benefit from a structured microeconomic focus, particularly for higher-value procurements that may benefit from the application of a more sophisticated market design approach
- the role of procurement local content rules, noting that to the extent that they are successful in diverting purchases from the lowest cost sources internationally, merely reduce a government's purchasing power
- whether existing probity rules have the balance right between risk management and efficiency of procurement
- the growing trend towards the use of government procurement to drive broader social objectives. These objectives would be better delivered through more fit-for-purpose policy tools.

Recommendation 6

That the government requests the Productivity Commission to undertake an inquiry into the effectiveness and efficiency of Commonwealth procurement, with a particular focus on areas where current practices could be strengthened to achieve better value for money. The review should be completed by the end of 2012 and the government must be prepared to embrace the commission's recommendations.

Disability care and support

The implementation of the Productivity Commission's proposed reforms to disability care and support will also require detailed attention from the government in the period ahead.

The BCA supports the establishment of the National Disability Insurance Scheme (NDIS). If implemented effectively and accompanied by structural changes to the market for disability care and support, the NDIS will place Australia in a better position to fund an adequate level of disability care and support at a reasonable cost in the longer term.

An adequate level of support, delivered by an effective market, will enhance participation in the workforce and community for people with a disability, their families and carers. It will also take pressure off other services such as health care, where costs are already expected to increase substantially in the years ahead.

The BCA recognises the need for stable funding to create certainty of access to appropriate support for people with a disability and to provide important signals for investment to service providers. In this regard, the BCA believes that the NDIS should be funded through:

- The redirection of current state and territory funding ($4.7 billion), disability specific purpose payments ($904 million) and the Commonwealth's appropriation to disability spending ($1.4 billion).
- If the government cannot fund the remaining $6.5 billion from existing revenues when the scheme is rolled out later this decade as recommended by the Productivity Commission, then it should find savings by cutting other lower-priority expenditures and poorly performing programs.

As the Productivity Commission notes, if the government were starting with a 'blank slate', then there would be strong reasons for disability services being a high priority for funding.

The BCA's proposed Commission of Budget Integrity or the Parliamentary Budget Office could play a prominent role in finding savings to help fund the NDIS, if necessary.

The BCA does not support a specific levy or additional tax being raised to fund the NDIS. Seeking to implement such a tax at this time would be premature in the absence of a detailed analysis of possible savings and with the prospect of an improved fiscal position by the time the scheme is rolled out in 2015.

Recommendation 7

That the government commits to funding the National Disability Insurance Scheme through:

- the redirection of existing Commonwealth and state and territory funding on disability care and support
- savings from other lower-priority expenditures and poorly performing programs in the event that the remaining $6.5 billion cannot be funded from existing revenues when the scheme is rolled out later this decade as recommended by the Productivity Commission.

Aged care

The Productivity Commission's Final Inquiry Report, *Caring for Older Australians*, released in July 2011, sets out a blueprint for change that will simultaneously address longstanding issues of access and quality and the economic performance of the sector. Much like the proposed NDIS, implementing the Productivity Commission's recommendations will place Australia in a better position to fund an adequate level of aged care at a reasonable cost in the longer term.

The *Caring for Older Australians* Final Inquiry Report envisages the development of markets, under appropriate regulatory oversight, which will provide consumers with more choice and investors with a sound platform for capital formation, greater investment in skills and professional development and enabling technologies.

The BCA supports the implementation framework set out by the Productivity Commission but believes that greater emphasis is needed to embed implementation in the principles of good governance and a contemporary approach to program management and innovation, including:

- utilising the expertise of business to advise on the drafting of new regulation
- appointing a 'managing agent' to translate the Productivity Commission's recommendations into a strategic blueprint for change
- the potential need for embedding some level of independence into the implementation with a board of governance with an independent chair and membership drawn from all stakeholders
- supporting industry capability by building on natural collaborations between larger, more capable providers and smaller providers that may experience greater challenges in transitioning to a new system
- establishing a national Information Technology and Communications Strategy to guide necessary changes around work practices and IT systems associated with new business models
- establishing centres of excellence in partnership with universities to inform development of new service delivery models
- strong risk management and evaluation frameworks to support implementation
- effective communication of the benefits and progress of reform.

Recommendation 8

That the government develops and releases its response to the Productivity Commission's *Caring for Older Australians* Final Inquiry Report, along with an implementation plan, in the first half of 2012.

Budget measures to improve competitiveness and productivity

In addition to improving the effectiveness and efficiency of government spending, pursuing policy reforms that help to grow the economy by improving competitiveness and supporting productivity remains critical. Growing the economy will be able to do much of the 'heavy lifting' in meeting long-term challenges by building fiscal capacity and reducing demands on the Budget through increased incomes.

We believe that the best policies to support a more competitive and productive economy include those that:

- facilitate a positive business environment, including tax and regulatory settings that do not present barriers to investment and innovation
- promote a flexible and mobile labour market with the skills and education that match the demands of a growing economy
- support effective and timely provision of infrastructure through rigorous and strategic coordination of infrastructure planning.

The BCA's recommendations for each of these areas in the context of the 2012–13 Budget are outlined below.

Tax policy

Based on the fiscal projections outlined in Part One, it is clear that fiscal discipline must be matched by stable tax revenues and strong economic growth. While the Australian economy will continue to grow and tax revenues will grow along with it in absolute terms, if the tax system can be geared to be more efficient and competitive then it will be less of a brake on economic growth. This means less reliance on personal and company taxes that impact on decisions to work, save and invest, and a greater reliance on indirect taxes, such as consumption and land tax.

While some positive steps have been taken since the tax forum last year, there is considerable work needed to begin to progress the kind of 10-year overhaul of the tax system that the BCA proposed at the forum.

As a critical element of fiscal policy, Australia should begin to progressively improve the tax system now rather than waiting until economic shocks or the rising costs of an ageing population force a more dramatic adjustment over a shorter period of time. The BCA considers that if tax reform is confined to narrow-based changes then it could limit options for broad-based reform in the future – thereby reducing the economic gains of reform.

The BCA continues to support the government and parliament mapping out a process for comprehensively overhauling the tax system over a 10-year period.

This should begin with a focus on removing the most inefficient state taxes and identifying options for replacing that revenue. The other platform for improving the tax system is to improve the overall tax mix, rather than introducing new taxes. That tax mix should gradually reduce the reliance on direct taxes such as personal tax and company tax and increase the reliance on indirect taxes including the consumption tax. Such reforms will help simplify the system and provide better incentives for jobs and will ultimately support a stronger growth outlook.

Recommendation 9

That the government during 2012 develops formalised ongoing processes and an institutional model that would be suitable for progressing long-term comprehensive tax reform over a 10-year period, as outlined in the BCA's submission to the 2011 tax forum.

Regulation

Given the current structural pressures in the economy, it is particularly important that regulatory interventions do not become a barrier to resources flowing to areas and activities where they can be put to best use.

The business community accepts that there is a rightful role for regulation in the economy. The entire community benefits from good regulation that supports the effectiveness of markets needed to underpin economic growth.

But good regulation gets the balance right, recognising the roles played by the formal device of the law and the informal device of reputation as enhanced by competitive markets.

Reviewing regulatory impacts and renewing a culture of better regulation

One step that will be critical to improving this balance and reducing costs to business will be government re-committing to strict adherence to the preparation of effective Regulatory Impact Statements (RISs).

The number of exemptions and non-compliant proposals has increased from seven in 2007–08 to 30 in 2010–11.[27] In this regard the government's recently announced review of Regulatory Impact Statements, to be completed in the first part of this year, will be timely in addressing the shortcomings of the current processes. As part of this process there needs to be a change in policy so that no exemptions are allowed from the requirement to prepare a RIS.

At the same time, the government has agreed to new measures to assist agencies in the preparation of Regulatory Impact Statements with staff from the Office of Best Practice Regulation assisting line departments in preparing better-quality statements.

The BCA supports these measures. If further resourcing is necessary for the Office of Best Practice Regulation to facilitate the preparation of high-quality RISs, including the rigorous identification of the problem and robust quantification of the costs of proposed regulation on business, then these resources should be reallocated as necessary from other lower-priority government functions.

At the same time, it is essential to recognise that achieving better regulation requires a whole-of-government commitment. This necessitates more than one or two champions and a Minister for Deregulation. It needs a 'hearts-and-minds' commitment from the Prime Minister, Cabinet ministers and those devising policy within the Australian Public Service to better appreciate the costs of regulation. The government must promote a renewed culture of discipline when it comes to new regulation, recognising that now is not the time to load more costs onto business.

Recommendation 10

That the government reallocates resources as necessary from other lower-priority government functions to the Office of Best Practice Regulation to facilitate the preparation of and adherence to high-quality Regulatory Impact Statements at all times. The government should commit to promoting an internal culture of discipline when it comes to new regulation, recognising the costs to the community of a rising regulatory burden.

National regulatory reforms

Progressing the national regulatory agenda through the seamless national economy agenda also remains important, with the states and territories eligible for reward payments of $200 million in 2011–12 and $250 million in 2012–13.

The BCA remains of the view that there are considerable risks to the most significant first tranche reforms. Considerable effort will be necessary in fully implementing OHS, occupational licensing and standard business reporting reforms effectively so that the maximum possible benefit is realised by business.

This view has been confirmed recently by the Productivity Commission, which revealed that while the benefits to business of the seamless national economy are likely to be $4 billion, realised benefits to date are just over $100 million.[28]

The most recent report of the COAG Reform Council on progress in implementing the seamless national economy reforms has highlighted concerns with reforms in a number of key areas including harmonisation of occupational health and safety legislation and harmonisation of trades licensing.

Given the current fiscal circumstances, and incomplete progress with some of the more important seamless economy reforms, the BCA considers that distributing the full amount of the associated reward payments at this time is not justified.

On this basis and subject to the government's consideration of the COAG Reform Council's report on progress early this year, the BCA would support the re-phasing of these payments to a later date when a greater proportion of the benefits of reforms are realised by business.

The BCA does not see the re-phasing of these payments as a penalty on states but rather as an acknowledgement that circumstances have changed with slower progress and slower realisation of benefits than was expected at the time of the national partnership being developed. The timing of these payments should be adjusted accordingly.

This should ensure that there is still a strong incentive for states to pull out all the stops in expediently implementing the remaining reforms – noting that this should not compromise the objective of 'deregulation' and lowering business costs.

Recommendation 11

That, subject to consideration of the COAG Reform Council's report on progress, the government re-phases the distribution of seamless national economy reward payments to the states to 2012–13 and 2013–14 when a greater proportion of the benefits of these reforms are realised by business.

Policy reforms to improve competitiveness and support productivity remain critical

Labour market

The economic challenges for Australia outlined in Part One imply significant structural adjustment will be necessary to sustain growth and prosperity. That adjustment could falter if labour market inflexibility or migration policy impedes labour mobility or education and training institutions fail to respond in a timely way to changing skill needs.

A massive construction effort is required to deliver Australia's pipeline of resource projects and will require a major boost in the supply of workers with the requisite skills. No single strategy will be sufficient to supply these skills. Rather, the scale of this challenge demands simultaneous pursuit of a range of workforce development and deployment strategies, including increasing the supply of domestically trained workers, increasing skilled migration and facilitating the movement of existing skilled workers from low-growth to high-growth sectors and regions.

The current review of the Fair Work Act provides an important opportunity to ensure legislation governing the employment relationship does not impede flexibility and innovation so that Australia can improve its productive capacity and competitiveness.

Targeted investment in skills and better tailoring of available government funding to the specific needs of workers in restructuring industries should remain a high priority for the 2012–13 Budget.

Education and training

The government has committed to growing the productive capacity of the Australian labour force through a substantial investment in higher education and an extensive suite of reforms to education and training systems. In addition to a targeted increase in the proportion of young people with higher education qualifications, the government is also working with the states and territories to achieve increased participation in vocational education and training and the proportion of the workforce with post-secondary qualifications. In particular, a greater focus is needed on increasing the number of people commencing and completing a traditional trade apprenticeship. This requires going further with more flexible arrangements such as the fast-track of apprenticeships that were included in the government's response to the National Resources Sector Employment Taskforce.

A key strategy for delivering on the government's higher education targets is the introduction from 2012 of demand-driven funding arrangements. This will permit Australia's public universities to enrol as many eligible students as they are able to accommodate. A number of states are also moving to introduce demand-driven funding for vocational education and training courses, commencing with Victoria in 2011.

To complement these funding reforms, parallel reforms to fee-setting arrangements are now needed to balance supply and demand for particular courses, better align funding with public and private returns to investment in education and training, and ensure that the shift to entitlement-driven funding is fiscally sustainable. In particular, and subject to sufficient competitive market discipline or to appropriate regulatory oversight, education and training providers in receipt of government subsidies must have reasonable flexibility to adjust fees in order to ration available places in areas of high demand.

Equitable and efficient funding principles would also imply that those enrolling in courses with high expected private returns in terms of lifetime earnings should meet a higher proportion of course costs. Implementation of these pricing and cost recovery principles may require some adjustment to equity funding streams to ensure that higher fees are not a barrier to participation by students of lesser means.

While growing the productive capacity of the labour market is a clear priority for the longer term, improving the alignment of skills training with current and emerging labour market needs remains an immediate priority as the Australian economy undergoes the necessary adjustment to a sustained resources boom. The skills reform package introduced in the 2011–12 Budget was an important step towards encouraging more flexible and responsive training arrangements. This package should be maintained and the opportunity taken to further increase the flexibility with which training funds can be customised to suit the circumstances of different firms and employees facing adjustment pressures.

In addition, to avert a looming medium-term crisis in the supply of engineers and related technical and professional occupations, action is needed to turn around the poor take-up of advanced mathematics and science in schools.

Recommendation 12

a. That the government maintains skills reform initiatives introduced in the 2011–12 Budget and increases flexibility in the way in which funds are applied.

b. That the government commissions an independent review to identify the key causes of low take-up of advanced mathematics in schools and advise on appropriate strategies to overcome this.

c. That the government complements demand-driven funding arrangements in higher education with reforms to domestic student fee-setting arrangements and student contribution amounts by:

- allowing greater flexibility for universities to adjust domestic student fees in response to market conditions for bachelor degree courses
- broadly aligning public/private funding shares with the expected public and private returns to investment in each discipline cluster
- addressing equity and access objectives through direct and transparent subsidies targeted to less advantaged students.

Skilled migration

In addition to investing in the development of the productive capacity of the domestic workforce, a strong ongoing skilled migration program will remain an important part of an overall workforce readiness strategy.

Some continued reliance on temporary skilled migration is likely to be necessary to address immediate skills shortages that could halt the progress of major investments in the resources sector, and flexible employer-sponsored temporary migration arrangements through Section 457 visas will continue to be important.

In addition, in an increasingly globalised labour market for selected professional and technical occupations, an ongoing program of permanent skilled migration will be required to meet some part of projected future shortfall in specialised skills occupations, including engineering and a range of health professions. The 2011–12 Budget increase in the Migration Program to 185,000 places, 125,850 of them skill stream places, should be maintained at a minimum in 2012–13. Australia's strengths as a provider of education services to overseas students should also be recognised as a major asset in the competition for future skilled workers, and more done to encourage high-quality international students to stay in Australia.

Recommendation 13

That the government develops a new pathway for international students completing their education in Australia to convert from temporary to permanent visas.

Welfare to work

In addition to improving productive capacity, further improvements to Australia's workforce participation rates will also be critical to offset the adverse labour market impacts of an ageing population and to ensure that those disadvantaged in the labour market are able to share in the benefits of future economic growth and prosperity.

Better tailoring of employment programs and job services assistance to ensure jobseekers satisfy employer needs will be necessary to improve employment outcomes for those who experience barriers to labour market opportunity, including Indigenous Australians, older workers and people with disabilities.

Australia's job services agencies provide an efficient and effective job matching service for many unemployed, but they perform relatively poorly in successfully placing people who experience barriers to employment opportunity. A number of BCA member companies keen to offer entry-level employment opportunities for disadvantaged individuals find job services agencies do not always take the time to understand employer requirements and may miss the opportunity to direct suitable candidates to them. Improving the design of job services agency contracts to provide stronger incentives to find jobs for difficult-to-place clients could help to overcome these shortcomings.

To further improve the evidence base for effective employment interventions for those experiencing ongoing labour market disadvantage, the BCA considers there would be merit in commissioning a comprehensive review of entrenched disadvantage.

Recommendation 14

a. That the government reviews and reforms the design of job services agency contracts to better align agency incentives with improved outcomes for those experiencing labour market disadvantage.

b. That the Productivity Commission be asked to undertake an inquiry into entrenched disadvantage.

Infrastructure

Regular investment in transport, energy, communications and water infrastructure, coupled with efficient maintenance and use of the existing infrastructure stock, are critical for growing the productive capacity of Australia's economy. The private sector should be engaged to provide and operate infrastructure wherever possible under contracts that ensure acceptable standards of service.

As the BCA has previously stated, the government should ensure effective planning for Australia's infrastructure needs. Infrastructure Australia has a central role in this regard. The BCA argues it is essential that federal and state governments work together to establish a prioritised list of economic infrastructure requiring public funding. Such a list would constitute an infrastructure plan that would be a guide to business and provide the basis for funding decisions by government over time. To support the ongoing infrastructure task, a strategic infrastructure needs assessment should be conducted considering projects requiring private or public funding. Such an approach will support more effective provision of infrastructure to meet community and business needs.

A significant amount of this spending is being undertaken by private and public companies.

Australia has experienced a heightened level of investment in infrastructure in recent years, reaching $58.4 billion in 2009–10 – a rise of 48.3 per cent over four years. Furthermore, there is an estimated $375 billion of infrastructure projects currently underway, in planning or being proposed.[29] The successful completion of these projects will have substantial positive impacts on the Australian economy and it is for that reason the BCA is currently examining the policies and regulations required to ensure they are delivered in a timely and efficient way. We will be releasing our analysis and recommendations later this year.

Notwithstanding these high levels of overall investment and the projects pipeline, there is a specific set of challenges associated with the funding and delivery of public infrastructure projects that requires action in this Budget.

The quality of infrastructure assessment has improved markedly since Infrastructure Australia was established in 2008 to work with state governments to identify nationally significant infrastructure projects and policy reforms. Infrastructure Australia has now identified $86 billion of national priority projects of high economic value to Australia consisting mainly of rail, road and port projects.

Funding constraints are, however, emerging as a barrier to the implementation of these and other priority public infrastructure projects under consideration by governments. State government budgets are stretched, the Commonwealth's Building Australia Fund is more or less exhausted and a comprehensive review and identification of the role of user charging in future public infrastructure provision has not occurred.

A related issue is the quality of the decision-making processes across governments for determining the appropriate funding shares for projects.

The 2012–13 Budget can start to address these challenges ahead of the release of the government's next major infrastructure funding statement, 'Nation Building 2'.

- First, the processes for identifying the infrastructure projects with the highest economic value should be strengthened. Infrastructure Australia is rightly positioned to undertake a regular strategic assessment of Australia's current and future infrastructure gaps and identify the infrastructure needed to support a growing economy and population. This process should produce infrastructure proposals that complement those made by state governments and strengthen our productive capacity.

- Second, the government should continue to require all projects on Infrastructure Australia's priority projects list to be subjected to a rigorous and transparent cost–benefit analysis. It is imperative that scarce resources are allocated to the projects with the highest economic and social value. The decision by Infrastructure Australia to publish its reviews of cost–benefit analyses last year was a step forward.
- Third, the government should institute a procedure, in collaboration with the states, to determine the appropriate funding mix for national priority infrastructure projects. The possible sources of funding are essentially user charges, state government contributions and federal government contributions. To the extent possible, project costs should be recovered through user charges, supported by government policies that allow full recovery of the efficient costs of provision. For other projects with social benefits not easily captured in user prices, the best mix of user charges and public funding should be identified. Some projects will continue to be completely funded by government.

We recognise that Infrastructure Australia is the appropriate body for providing advice on Australia's infrastructure priorities. Critically, it is independent. Processes that support or strengthen this independence are warranted. Such support could include regular assessments by the Productivity Commission of the effectiveness and economic and productive benefits of Australia's infrastructure priorities and policies at both state and federal government levels. It could also identify gaps that should be addressed to enhance the economy's productive capacity.

In the longer term, it will be necessary to further consider issues around the funding and financing of public infrastructure. This will include finding a way of making regular provisions in the annual Budget to cover the Commonwealth's contribution to paying for Australia's future infrastructure needs. There also needs to be consideration of how this is financed – whether through current tax receipts or borrowing. The BCA's forthcoming work on major investment projects will address some of these matters.

Communications infrastructure

At the end of last year the Australian Government Competitive Neutrality Complaints Office (AGCNCO) found that NBN Co's business model was potentially in breach of the government's competitive neutrality rules. A key recommendation was for a detailed assessment to be undertaken of the non-commercial benefits of the NBN and for that assessment to inform a revised approach to NBN's business model that would ensure compliance with competition policy.

Under the government's competitive neutrality complaints process the Treasurer is required to make a determination in relation to the AGCNCO's findings within 90 days. The government should announce in the Budget, but preferably beforehand, that it will undertake a cost–benefit analysis of its National Broadband Network policy and commit to apply in full its competitive neutrality policy to NBN Co. The cost–benefit analysis should be used to identify whether broadband services can be delivered more effectively and at lower cost to users than under the present policy as well as to inform the government's public policy agenda for extracting the economic and social benefits from the use of broadband. An efficient and competitive broadband market is critical for giving all consumers and businesses the products they need at lowest cost.

Recommendation 15

a. In anticipation of future commitments to infrastructure spending in the 2013–14 Budget that will support the funding and delivery of Infrastructure Australia designated priority projects, the government should reaffirm processes to:
   - » determine the list of prioritised federal and state economic infrastructure projects requiring public funding, advised by Infrastructure Australia, which will provide the basis for future public funding decisions
   - » charge the Productivity Commission with undertaking a regular assessment of the economic benefits of Australia's infrastructure policies
   - » set out principles formulated with the states for determining the appropriate mix of funding for infrastructure projects that emphasise greater application of user charges and which agrees a consistent methodology for Commonwealth–state funding allocations.

b. The government should announce in the Budget, but preferably beforehand, that it will undertake a cost–benefit analysis of its National Broadband Network policy and that it will apply its competitive neutrality policy to NBN Co in full.

Conclusion

Addressing the medium and long-term economic challenges must begin with this Budget. The recommendations for the Budget outlined here would represent a strong start to this task.

Notwithstanding the importance of a medium to long-term focus, we are acutely conscious of the short-term challenges, particularly those attaching to current global economic uncertainty and a return to surplus in 2012–13. However, if the 2012–13 Budget and the Australian economy is able to navigate these challenges effectively then we will be well placed to take the right steps to make the economy and the Budget stronger and more resilient to the challenges of global volatility, an ageing population and risks and pressures that come with our elevated terms of trade.

CONCLUSION

Taking firm steps now will ensure that long-term remedies are less drastic and future policy interventions less costly

Australia's strong record of economic reform has positioned it well to respond to a volatile global economic environment and many of the challenges that now lie ahead of us. However, working from a strong foundation does not mean that we can be complacent.

Achieving ongoing fiscal discipline and focusing on measures to enhance productivity will be critical in the period ahead. The Business Council of Australia does not underestimate the inherent challenges involved in meeting these goals.

In the short term, delivering a surplus in 2012–13 will require considerable effort, but at the present time a return to surplus remains the right policy. The risk of softer economic conditions will, however, make the task even more difficult. In the long term, the projected fiscal deficit of all governments of 5 per cent of GDP by 2050 underlines the need to begin the task of implementing structural savings and efficiencies in existing spending programs.

At the same time, fiscal discipline will need to be carefully targeted so as not to detract from programs that enhance the productive capacity of the economy and boost our growth prospects.

Overcoming these challenges requires the government to take steps now to strengthen its fiscal foundations.

The government should reset the rules for fiscal policy in Australia, with a focus on enforcing discipline on the size of government, building readiness for counter-cyclical action for any major economic shock and provisioning for intergenerational pressure.

Spending restraint must also be more strategic; a major audit of government spending and program efficiency could provide a rolling set of recommendations for reducing expenditure that could be implemented through the Budget each year.

There are also a range of steps that the government can take now to alleviate fiscal gap pressures including around eligibility for the age pension and increasing the efficiency of the market for aged care.

We should be under no illusions as to the magnitude of the challenges ahead. The BCA's submission to the tax forum highlighted the task that lies before us and the choices we will face as a nation if we are to continue to maintain appropriate economic, environmental and social conditions, including through the provision of an acceptable and affordable social safety net.

Of the choices between higher taxes, reduced entitlements or a combination of more efficient government spending and better tax system design, it is the latter approach that offers the best prospects of success.

Nonetheless, even pursuing this approach will present many demanding issues for future resolution. Indeed, the BCA is realistic that stronger fiscal foundations alone cannot be expected to do all the work.

Productivity and through it sustained economic growth will substantially strengthen the fiscal position, increasing per capita incomes and reducing reliance on government spending programs at the same time as strengthening the Budget's revenue base.

This reinforces the importance of a comprehensive reform agenda directed at lifting productive capacity in the economy and making us more competitive. Tax reform, ongoing labour market measures, continued work on better arrangements for private sector infrastructure provision and regulatory reform will go a long way to building this capacity and must continue to be a priority focus for government.

A comprehensive reform agenda that supports a strong and growing economy is undoubtedly the best thing that we can do in seeking to meet the challenges that lie ahead.

Building momentum now on policy decisions that will have a lasting and permanent structural impact on the Budget has significant benefits.

Australia will continue to build on its long-term fiscal credibility, the kind of fiscal credibility that has been lacking in global markets of late. More importantly, taking these steps now will ensure that long-term remedies are less drastic and future policy interventions less costly.

NOTES

[1] R. Battelino, Reserve Bank of Australia Deputy Governor, Address to the 24th Australasian Finance and Banking Conference, 14 December 2011.

[2] ibid.

[3] J. Decressin, Deputy Director of the IMF Research Department, in an interview on ABC Radio National Breakfast program on 25 January 2012, in which he said that: 'We believe that Australia will be affected by these downgrades everywhere in the world only to a limited extent and the reason is that Australia is importantly driven by major investment projects that are in the pipeline and these are funded by strong multinationals that do not have problems accessing funding so growth in Australia will be somewhat lower but not by a whole lot'.

[4] International Monetary Fund, *World Economic Outlook Update*, January 2011.

[5] OECD, *Economic Outlook*, November 2011.

[6] Commonwealth of Australia, *Mid-Year Economic and Fiscal Outlook 2011–12*, p. 11.

[7] Reserve Bank of Australia, *Statement on Monetary Policy*, November 2011, p. 66.

[8] International Monetary Fund, *World Economic Outlook*, September 2011.

[9] See Battelino, op. cit.

[10] Standard & Poors, *A Slowdown in Europe and China and Sluggish Exports Moderate Asia Pacific Outlook in 2012*, 20 December 2011.

[11] Commonwealth of Australia, *Australia's Future Tax System Final Report*, December 2009, p. 6.

[12] World Bank, *Doing Business 2012: Doing Business in a More Transparent World*, June 2011.

[13] B. Dolman, 'What Happened to Australia's Productivity Surge?', *The Australian Economic Review*, Vol. 42, Issue 3, pp. 243–263, September 2009.

[14] Budget Paper No. 1, Statement 5, p. 5–13.

[15] M. Parkinson, 'A Year in Retrospect, A Decade in Prospect', Address to the Sydney Institute, 13 December 2011.

[16] D. Tune, 'Laying the Foundations for Future Prosperity: The Longer-Term Challenges of Managing Government Spending', Address to the Corporate Members of the South Australian Centre for Economic Studies, 19 August 2011.

[17] Deloitte Access Economics, 'An Intergenerational Report for the States', Report for the Business Council of Australia incorporated within the Business Council of Australia Submission to the 2011 Tax Forum.

[18] See Tune, op. cit.

[19] See p. 83 of the Mercer report, 'Back to Policy Fundamentals', incorporated in this submission.

[20] After taking account of revisions published by the ABS and the government, the tax share of GDP as of 2007–08 is now estimated to have been 23.7 per cent compared with previous estimates of 23.5 per cent.

[21] World Bank, *World Development Indicators*, 2010.

[22] Commonwealth of Australia, *Mid-Year Economic and Fiscal Outlook 2011–12*, p. 50.

[23] The principal means of achieving fiscal discipline through the deficit exit strategy was a commitment from government to hold real growth in spending to 2 per cent per year until the Budget returns to surplus. This has since been augmented by a second element to restrain real spending growth to 2 per cent on average once the Budget has returned to surplus until surpluses are at least 1 per cent of GDP and while the economy is growing at or above trend.

[24] Department of Finance and Deregulation, Incoming Government Brief, September 2010, p. 1.4.

[25] National Commission of Audit, *Report to the Commonwealth Government*, June 1996.

[26] Australian Institute of Health and Welfare, *Health Expenditure Australia 2009–10*, 2011.

[27] Office of Best Practice Regulation, *Best Practice Regulation Report 2010–11*, p. 4.

[28] Productivity Commission, *Impact of COAG Reforms: Business Regulation and VET*, December 2011.

[29] Deloitte Access Economics, internal report to the Business Council of Australia, October 2011.

MERCER

BACK TO POLICY FUNDAMENTALS

A REPORT BY MERCER FOR THE BUSINESS COUNCIL OF AUSTRALIA

DECEMBER 2011

CONSULTING. OUTSOURCING. INVESTMENTS.

MARSH & McLENNAN COMPANIES

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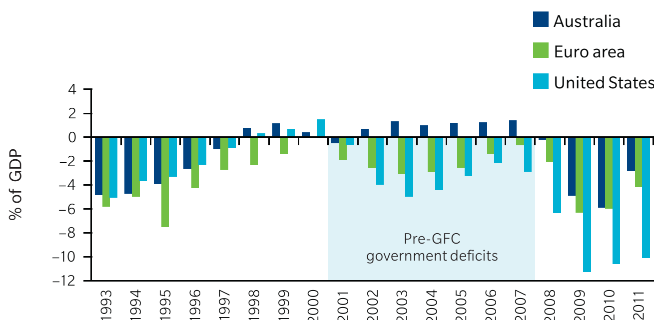
EXECUTIVE SUMMARY

The GFC and its continuing aftermath highlight the integral role of fiscal, monetary and prudential policy in weathering economic shocks. The enduring takeout for policy makers must be to never again lose sight of the fundamental objectives of economic policies.

Australia's fiscal stimulus package was one of the largest in the world relative to GDP. It was implemented quickly and closely followed the guidelines developed by the IMF. The monetary policy response was also fast and decisive. Reforms in monetary policy and the establishment of, and compliance with, a set of disciplined fiscal rules, positioned Australia to be able to respond boldly to the challenges of the GFC. The powder was dry in both fiscal and monetary policy barrels and the Australian authorities were able to pull both triggers at the time when it mattered most.

In stark comparison, poor fiscal discipline in the period leading up to the GFC saw the US and many European countries launch stimulus from a weak fiscal starting point. They are now grappling with unsustainable debt, enforced spending cuts and tax rises against the punishing backdrop of global market volatility.

General Government Financial Balances



Australia's track record of economic reform was concentrated in the 1980s, fell away during the 1990s, and most recently has been quite sparse. The imperative for policy action seems to be concentrated in periods when our relative economic performance is at its lowest.

We know that the Australian economy is in transition. Our reform efforts must not continue to rest on past laurels and simply rely on our strong terms of trade. Not least as we know this transition opportunity is not without risks. Risks will be realised and opportunities lost if we erode the hard earned integrity of monetary, fiscal and prudential policies. We will not be able to deliver sustained economic growth now and for future generations if we fail to deliver greater flexibility in our labour markets and immigration liberalisation to meet skills shortages and alleviate the pressures of an ageing population.

Reform is needed to alleviate many of the supply side pressures that the economy will face over the next forty years and to preserve both the adequacy and the integrity of the objectives of fiscal and monetary policy — the primary levers for managing our economy.

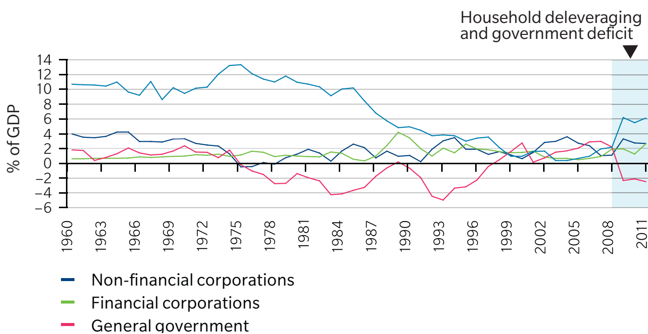
There is a "window of awareness" now. A public of cautious consumers, fearful of the "patchwork" economy, pronounced global economic uncertainty and market volatility, may be ready to accept change. Particularly if that change offers future economic stability.

Fiscal policy is not a very flexible instrument. It should not be used to fine tune the economy. It should be reserved to prime growth in deep recessions, where monetary policy alone is judged unlikely to be effective. It was used successfully in that role during the GFC. Now that recovery is well established fiscal policy should resume its position as contributor to medium term stability. For the sake of credibility in a future period of crisis, it is imperative that the Government delivers on its pledge to return the Budget to surplus by 2012–13.

NATIONAL SAVING AND INVESTMENT

Despite Australia's sound international reputation and ability to finance investment from foreign savings, domestic saving remains important. Even more so as our economy moves through transition.

Net Savings



Movement in household saving has traditionally been the driver of the overall savings rate. The collapse in household saving after 1975 to a low in 2003 and 2004 drove the overall decline in national saving. More recently the household sector has gone through rapid deleveraging, increasing savings to levels last seen in the late 1980s.

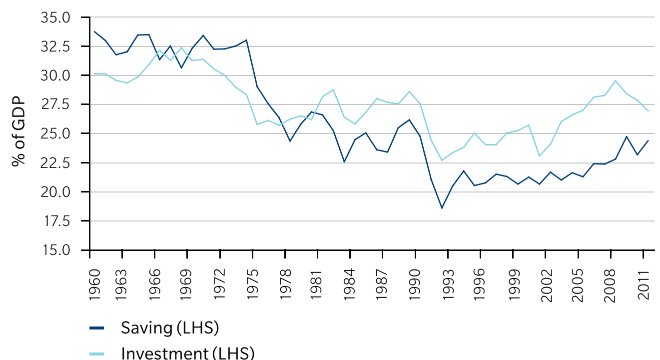
Fiscal discipline of the 1990s has seen government saving, which spent much of the previous two decades in negative territory; enjoy a steady increase to be around 3% of GDP before the Government's GFC fiscal stimulus. Corporate saving became more important as household saving declined. Increased corporate profitability and hence retained earnings has seen these savings rebound strongly post GFC.

The deleveraging of the household sector is also a welcome development. Household deleveraging is not so pronounced to pose a barrier to growth in Australia, given the Government's fiscal position coupled with the relatively low leverage in the Australian corporate sector.

That said, Government policy, through the tax system, continues to encourage households' greater consumption of housing. This consumption bias is perversely further reinforced, by the ability of households to access retirement income as a lump sum, thereby allowing a one off deleverage at retirement. Whilst this bias has been in play for decades, it has become more critical as superannuation balances increase. We need to address the imbalance between lump sum and income streams as part of the overall superannuation mix.

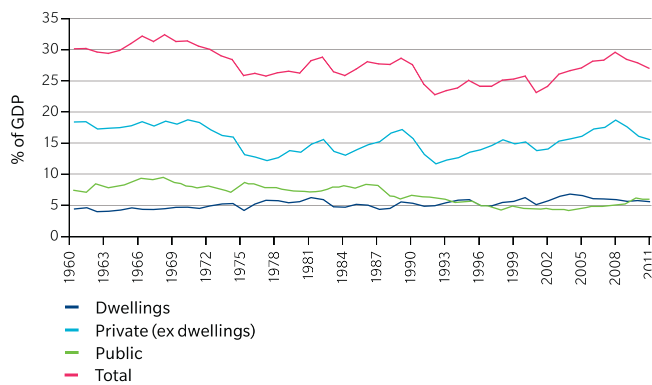
In its simplest form national investment is financed through the availability of domestic savings. Investment has outpaced savings since 1981 — reaching 29.5% of GDP in 2008.

Gross National Savings and Investment



High levels of investment over the last decade have been financed through a consistent current account deficit — the gap between national investment and national savings. The private sector has historically driven and continues to drive national investment - accounting for 63% of total investment.

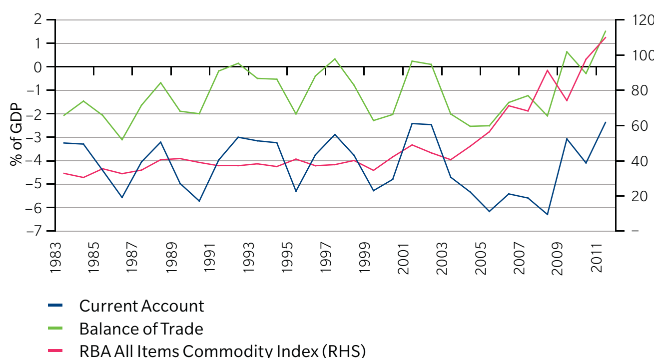
Gross Investment by Sector



Public sector investment has accounted for a falling share of total investment. Although the government contribution to investment is small, it is often deployed to projects that, although limited in commercial value, have economic merit such as arterial infrastructure. Given the dominant nature of private sector investment, government policy should focus on facilitating efficient private investment and ensuring public investment targets investment with economic merit.

Australia's divergence between saving and investment has led to a current account deficit that has fluctuated around 4% of GDP before increasing to 6.3% in 2008. Since 2008 strong growth in exports, driven by the mining sector and increasing commodity prices, has meant the current account balance has recovered to 2.4% of GDP. Our reliance on strong commodity prices are highlighted here.

Impact of Commodity Prices of Current Account



A persistent current account deficit, particularly when combined with a high stock of external liabilities, does heighten our vulnerability to external shocks. For Australia this means that the financial health of the economy — currently bolstered by our strong terms of trade — is acutely sensitive to any slowing in China or emerging Asia's growth and a consequent decline in commodity demand and prices. Negative developments, even temporary, could cause an adverse change in foreign investor sentiment and hence a marked increased in the financial costs at which Australia borrows to fund the investment needed for productivity and growth.

The relative robustness of the economy means that we have been able to borrow internationally on relatively favourable terms. And with Australia continuing to rely on foreign savings to fund a large part of investment, it remains important for public policy to be formulated with a view to retaining this confidence.

We can say that where the current account deficit has arisen as a result of total investment the deficit is not seen to be an issue. But this assertion rests on the government shoring up confidence through: credible monetary policy; preserving flexible, open and transparent markets; credible market governance frameworks; and disciplined fiscal policy.

Mercer believes that with renewed impetus for structural reform the Government can satisfy the first three criteria. But we need to revisit the fundamentals of fiscal policy before signing off on it.

INFRASTRUCTURE

Infrastructure investment is in catch up mode but recent increases point to some inroads to what is widely regarded to be an infrastructure under-spend. There is a strong case that governments need to work harder on defining sound approaches to the private provision of infrastructure.

Infrastructure in Australia continues to face a debt financing dichotomy. While Australian Government funding costs are at historically low levels, the cost of private finance remains elevated. This manifests in higher debt margins; constrained debt availability for economic infrastructure projects from the domestic banks with little risk differentiation and most importantly shorter tenors. In short, material refinance risk for long life projects has imposed a higher risk profile.

There is a long way to go in getting the funding economics right - pricing and charging for using

economic infrastructure. The reality is that while many of these projects have net economic benefits they are not commercially feasible because we cannot or do not price for the positive externalities they bring to the economy. As such, there remains scope for broader adoption of user charging or direct government support in recognition of those externalities.

There are signs of some, albeit slow, progress on getting the balancing act right in the risk sharing between the government and the investor particularly for greenfield projects and patronage based infrastructure projects. A balance needs to be reached without overly compromising one party lest it is not a sustainable partnership. There are a number of innovative models where the risks (patronage, policy and refinance) are shared and the state government need to be encouraged to adopt these in order to access private sector financing of infrastructure. State governments can and should borrow for infrastructure projects that produce a commercial return without trepidation of rating agency concerns.

Bid costs and tender risk continue to act as a disincentive for early involvement of long term investors such as superannuation funds. This has seen short term investors, the investment banks and construction companies, driving the investment metrics. The state governments and long term investors need to agree on sustainable investment metrics for individual projects. Government can defray some of the costs by injecting common information and due diligence report requirements that bidding parties can rely upon. This coupled with pricing and underlying modelling based on the government's base case, should facilitate greater discipline in the metrics and involvement of long term investors such as superannuation funds.

Governments' infrastructure deal pipeline remains largely glacial and uncertain. There is clearly a need for an infrastructure audit and for all states to undertake forward planning (at least 10 years out) in order to provision for financing the requisite infrastructure task for their respective jurisdictions. In essence, the "infrastructure task" should be incorporated in the much needed state level intergenerational reports.

While it is always difficult to say how much infrastructure is enough, there does seem to be a pervasive view that Commonwealth and state governments have under spent over the past few decades. Although the states are constrained in the revenue they can raise, for many years they have enjoyed ample capacity to borrow from public markets. Clearly, Australia's fiscal framework needs to ensure we make room over time for such borrowing and investment, and this may require revisiting the current fiscal policy rules and how they are applied.

THE FISCAL POLICY FRAMEWORK

WHY DO WE NEED FISCAL POLICY RULES?

Excessive levels of public deficits and debt are intrinsically linked with significant costs for an economy. Sustained periods of government deficits exert upward pressure on real interest rates, which adversely impacts private investment and productivity growth. Consistently high debt ratios increase the tax burden and elevate consumer and business expectations of higher taxes to pay for that debt, generating distortions in the economy and creating barriers to improvements in productivity and efficiency. A material stock of government debt can become difficult to control and expose economies to greater volatility and the risk of economic shock. As we are seeing in many European states, ill disciplined fiscal policy over time can result in governments finding themselves backed into a policy corner — compelled to impose material discretionary tax increases, severe spending cuts or an unpalatable combination of both.

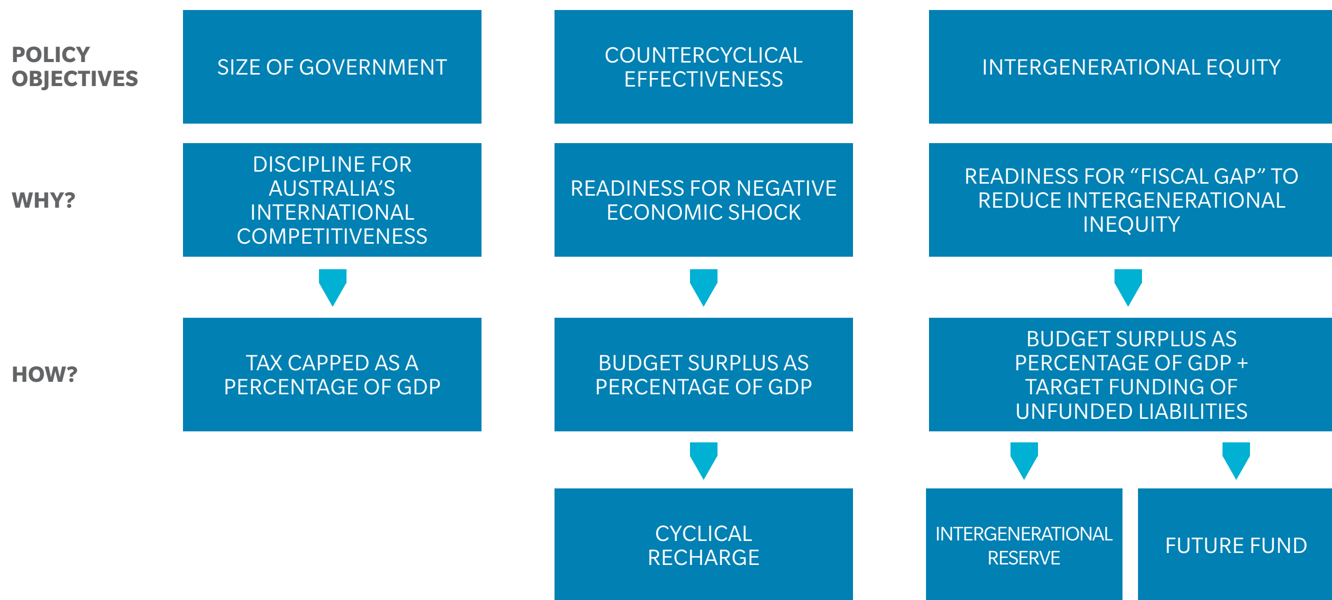
In short, public finances managed in line with transparent and well articulated rules enhance the prospect for strong, sustainable growth in an economy.

Fiscal rules are integral for a medium to long term focus of government action. The transparent discipline of a responsible fiscal framework and accompanying rules provide a policy anchor that will prevent excessive spending that would be unsustainable as the tax base narrows and social requirements grow due to an ageing population.

So what should we expect fiscal policy rules to deliver? Broadly speaking, fiscal policy rules should satisfy three fundamental objectives. They should:

- Enforce discipline on the size of government for Australia's international competitiveness
- Ensure counter-cyclical readiness for a major negative economic shock
- Ensure readiness for intergenerational pressure and the fiscal gap to reduce intergenerational inequity

Fiscal Policy Framework



TERMS OF TRADE AND THE RIGHT FISCAL FOUNDATIONS

The 2009–10 Budget assumed that the terms of trade would decline by around 15% over a ten year period from 2013–14. This was materially amended in the 2010–11 Budget and retained in the 2011–12 Mid Year Economic and Fiscal Outlook (MYEFO). In just a year, the terms of trade outlook was projected to decline by around 20% over a 15 year period, albeit from a higher starting point. This highlights the need for conservatism in how we project the terms of trade and the imperative for Government to diligently meet the fiscal rules even with the anticipated declining terms of trade. Clearly a conservative terms of trade judgement call is required by Government, to ensure that the fiscal projections upon which Government make fiscal framework decisions is reasonable.

Mercer views the current Budget forecast for the terms of trade as reasonable, albeit not conservative. While we would expect volatility around the terms of trade "trajectory" assumed in the forecasts, especially driven by short term supply side adjustments, we consider there has been a permanent structural increase in the underlying resources demand. It is equally important that such short term volatility does not erode confidence in the medium term forecasts imbedded in the Budget.

So if the terms of trade forecasts are accepted as reasonable, how should we integrate this "judgement" on the sustainability of the current terms of trade into the implementation of the fiscal rules?

Mercer believes that the current strong yet unsustainable terms of trade level, heightens the imperative for disciplined fiscal action today. Policy decisions today should be premised on the projected decline in the terms of trade. A future terms of trade decline can not justify any call to flex the limits and breach the fiscal policy rules. In saying this, Mercer acknowledges that should the terms of trade volatility induce a major economic shock, then there is a case to initiate a fiscal stimulus in the context of the fiscal rules.

FISCAL EFFECTIVENESS

Whilst the main architecture is in place, Mercer believes the government can and should "raise the bar" especially against the salient fiscal developments in the Eurozone and the US.

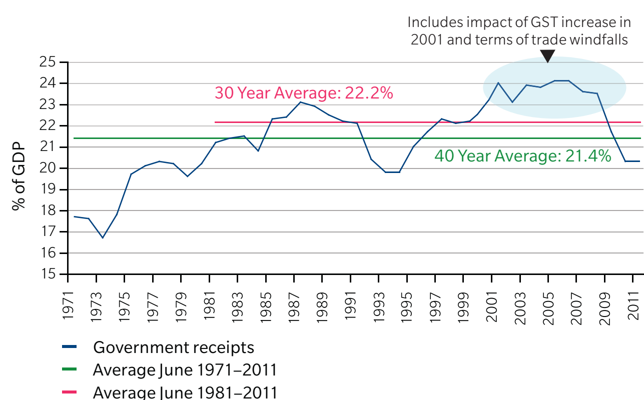
Mercer's fiscal policy framework will allow the Government to deliver on future fiscal policy objectives against the background of an economy in transition and growing intergenerational pressures with our ageing society.

SIZE OF GOVERNMENT

It is both appropriate and good fiscal practice to maintain an explicit cap for the level of tax revenue as a percentage of GDP — a discipline to the size of government. Unfortunately this fiscal rule has seen some slippage over the past 15 years. The current cap of 23.5% exceeds the 30 year average — which already includes the structural increase in the size of government from the 1970s. That said, we do need to allow for intergenerational pressures. It is important to retain transparency and credibility around the size of government to stop any future slippage. Given the starting point, Mercer believes that the current cap of 23.5% should be retained but should become a hard cap so future budgets do not see slippage.

Allowing the revenue cap to reside above the 30 year average allows for some size of government "headroom" in recognition of the intergenerational pressures faced by Government. Importantly, current tax receipts already incorporate some windfall revenues associated with Australia's record terms of trade as well as the one off structural increase in revenue with the introduction of the GST in 2000. Mercer therefore views this cap as achievable and reasonable. By imposing a hard cap discipline on the Government, productivity and economic growth enhancing policies (as identified) are the remaining "swing policy" to reduce intergenerational pressures. Whilst there is a broad range of consensus views on what is the optimal size of government for a developed country, like Australia, those studies do lend support to the Australian Government's current target of 23.5% of GDP being reasonable.

Government Tax Receipts



CYCLICAL READINESS

Mercer considers it reasonable that the Government will be required to make a 3% of GDP contribution to the economy in terms of counter cyclical stimulus on average, say, every 13 years. The sizing and frequency are informed by qualitative assessment of previous economic recessions in Australia requiring fiscal action. From this judgement call we can determine the level of surplus that needs to be "recharged" to satisfy the cyclical readiness rule.

The Government's current fiscal stimulus exit rules compel the return to surplus as soon as possible. Mercer believes the rules are appropriate and provide a suitable level of fiscal discipline. Mercer therefore supports the focus and imperative of returning to surplus by 2012–13. This not only supports the retention of international confidence in the Australian Government and economy should Government borrowing be needed for an earlier than anticipated economic shock, but also resumes the journey to restore medium term fiscal discipline.

The Government's current rule – to aim for surplus – is right but the imperative now is to shore up its integrity with hard targets informed by the objective – the readiness of fiscal policy for an economic shock. Mercer therefore believes the Government needs to specify a target percentage surplus in the fiscal policy rules based on "recharging" fiscal readiness in 13 years time for fiscal policy to be able to make a 3% of GDP contribution to the economy. That is to say, a series of small annual surpluses need to accumulate over 13 years to enable debt to be repaid and fiscal capacity to be recharged to be able to deploy a fiscal stimulus equivalent to 3% of GDP.

The Government's net debt position is inextricably linked to the notion of cyclical recharging through modest annual surplus. Should a major economic shock requiring fiscal action occur prior to the accumulated surplus being built up over this target period, the Government of the day should borrow in order to finance the fiscal stimulus, subject to international confidence and the terms. This is caveated with the requirement that such borrowing only be permitted with the Government undertaking to return to surplus as soon as practicable and thereby restore the net debt position to pre-stimulus levels. That is, there should be no permanent increase in net debt levels from the stimulus.

Cost effective borrowing rests on the retention of international confidence in the Australian economy, Mercer's preference is therefore to build up the cyclical "recharge" such that it could be deployed without the need to borrow and therefore satisfy the terms set by overseas lenders. That said Government net debt is currently 8.9% of GDP. Mercer concurs with the Government's priority to pay down the current net debt position to 0% by 2020–21. Reducing net debt supports confidence in the Government's fiscal integrity, thereby facilitating borrowing on relatively reasonable terms if required. Once net debt is removed, and in the absence of a premature major economic shock, the Government should accumulate surpluses to achieve cyclical readiness equivalent to 3% of GDP in the remaining 3 years by 2024.

As it is envisaged that this cyclical recharge will likely be deployed every 13 years, there is no need to establish a "reserve fund". Any required fiscal stimulus needs to be deployed expeditiously and there are no defined liabilities, in contrast to those of the Future Fund, Mercer therefore envisages that the accumulated surpluses reaching 3% of GDP would be invested in cash-like instruments and would be managed by the Australian Office of Financial Management (AOFM).

INTERGENERATIONAL EQUITY

For the fiscal policy rules to deliver on intergenerational equity we need an explicit target of a modest surplus to provision for the intergenerational fiscal gap. This would be in addition to the cyclical recharge rule.

We know the IGR's fiscal gap forecast is highly sensitive. We also know that any surplus provisioning requirement can be alleviated by supply side policies over time. Provisioning for intergenerational equity therefore needs to pursue action on two fronts:

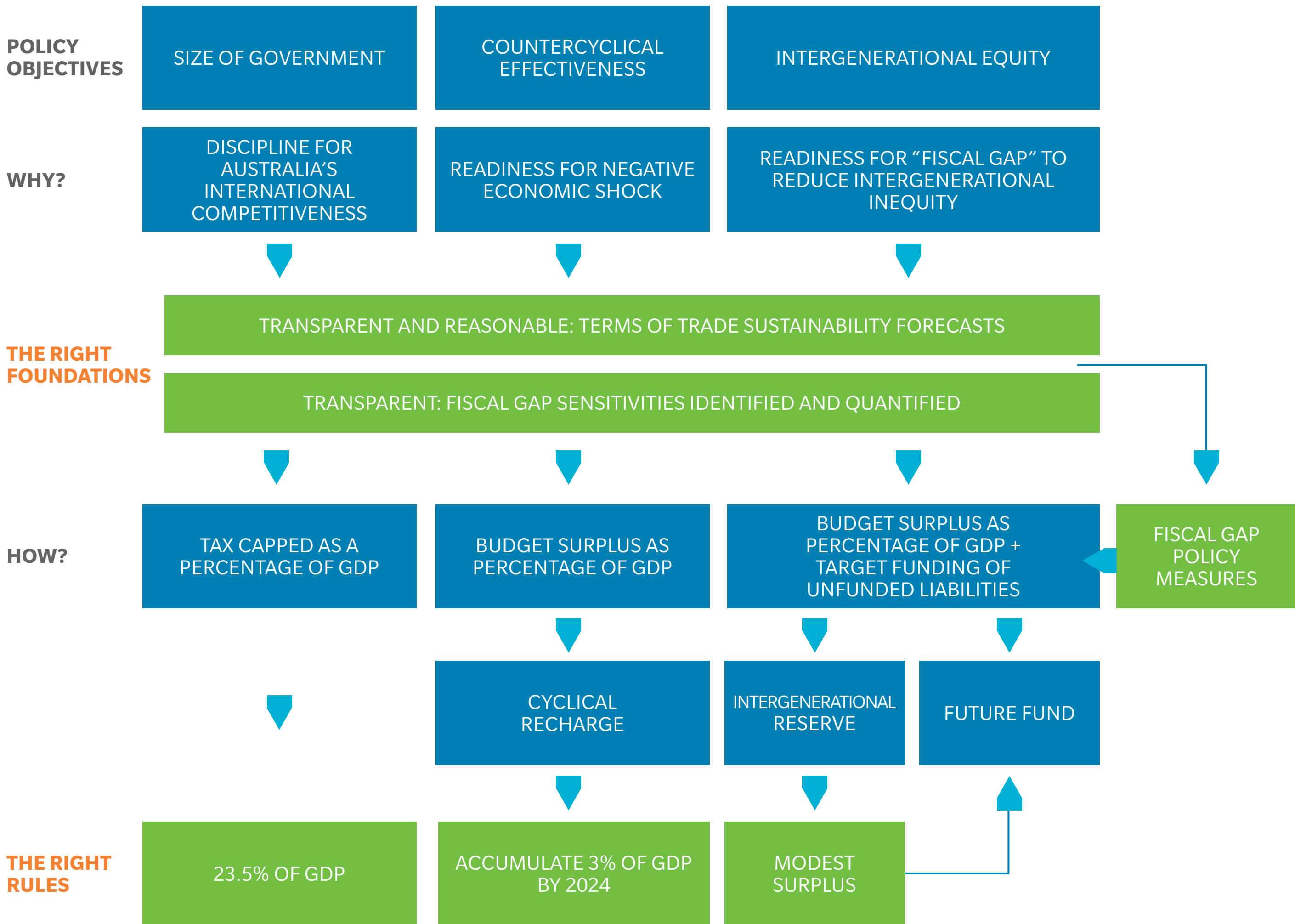
- First, target a modest "intergenerational" surplus to provision for the projected fiscal gap. Importantly, a medium term milestone by say 2024, should be set in terms of a reserving target to fund a percentage of the future fiscal gap, to ensure discipline with some flexibility. It is proposed that the surplus targets and medium term milestones be developed and announced by the Government in the forthcoming Budget.
- Second, policies on the supply side to negate the impact of an ageing population. This effectively reduces the fiscal gap that will need to be filled. Emphasis should be placed on policies that will have the largest impact on the overall gap i.e. productivity; mature labour force participation rate.

The intergenerational fiscal gap, across Commonwealth and state governments, is estimated to be 5% of GDP by 2050. Mercer's indicative estimates provide a sense of the order of magnitude of the required intergenerational surplus provisioning. Those estimates suggest that on average over the period a surplus of around 0.6% of GDP each year, by way of a collective contribution from Commonwealth and state governments, is required to provision for the fiscal gap by 2050. Given the ageing profile and the intergenerational principle of today's taxpayers provisioning for their retirement, Mercer proposes that reserving begins at a rate above the required reserving average and transition down to 0% by 2050. These estimates assume that the Government does implement meaningful supply side policies that reduce the 2050 fiscal gap by 25%.

Mercer proposes that the intergenerational reserving begins as soon as practicable – which we envisage as 2013–14. Whilst the Government would be paying down debt in parallel, the intergenerational reserve should earn a rate of return in excess of the cost of servicing Government debt. Further, there is a need to start the reserving now to ensure the future burden on Government budgets is met by today's taxpayers and does not become too great. The intergenerational reserve does need to be set aside to be invested and built up over a longer horizon.

Provisioning now through the fiscal rules compels Government to either begin to bear the pain of fiscal provisioning or embark on supply side policies to reduce the fiscal gap itself. Our proposed next steps for fiscal policy are summarised overleaf.

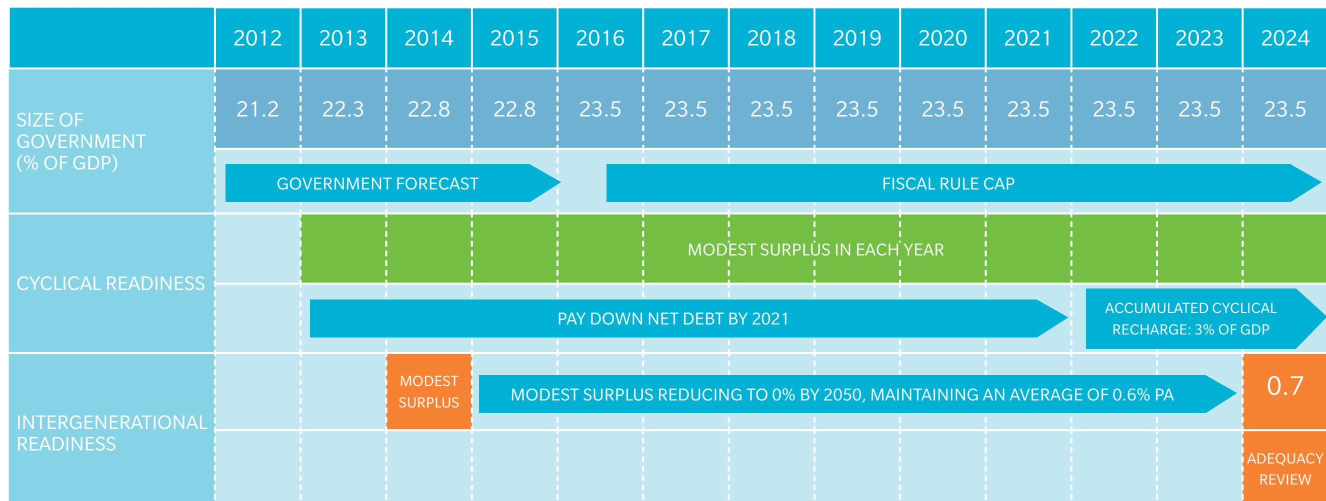
Fiscal Policy Framework — Next Steps



FISCAL RULES — IMPLEMENTATION

The Fiscal Policy Framework sets out the respective and revised fiscal rules for each of the 3 pillars — size of government, cyclical readiness and intergenerational equity. This Report provides indicative guidance on their proposed implementation. Building on the Government's current forecasts for the fiscal balance, the following chart below outline the implementation profile required to recharge cyclical readiness and reserve for intergenerational pressures. This is at all times constrained by the size of government rule, the sustainable level of terms of trade and the imperative of meeting the rules in each year.

Fiscal Policy Framework — Implementation Profile



DOES AUSTRALIA NEED A SOVEREIGN WEALTH FUND?

Mercer believes the primary policy imperative is to "raise the bar" on our fiscal policy framework and the ensuing rules. We propose that the Government target a cyclical readiness recharge and an intergenerational reserve.

What is done with the reserves is a second order issue, as long as they are earning interest for the Government and not being used for competing objectives. The primary issue is how our fiscal policy rules will deliver adequate reserving for the structural and intergenerational issues the Australian economy will face in the future.

CYCLICAL RECHARGE

The Australian Government was able to implement significant discretionary fiscal policy stimulus in response to the GFC. In this sense, and given the short term and unpredictable nature around the timing of any required fiscal stimulus, a separate sovereign wealth fund is not required to implement counter-cyclical fiscal policy. Mercer therefore proposes that the surpluses accumulated as the cyclical readiness recharge should be invested in cash-like instruments and would be managed by the AOFM.

INTERGENERATIONAL RESERVE

The intergenerational reserve funds need to be invested over a longer horizon than the cyclical readiness recharge and therefore require a different investment strategy. A new wealth fund does not need to be created today or in the near term. Both the fiscal gap and unfunded superannuation liabilities are projected liabilities of the Government. Although the liability profiles differ, the Future Fund already has the capacity to invest these funds and provides the simplest option. Given the Future Fund remains underfunded, this liability provisioning can simply be met earlier than previously targeted.

Once the Future Fund is fully funded, the intergenerational reserves could either be segregated within the Future Fund as an investment strategy designed to meet the long-term liability profile of the fiscal gap, or another fund vehicle could be established. This does not need to be resolved today and should not detract from the discussion on the appropriate provisioning through the fiscal rules proposed.

GOING BACK TO POLICY FUNDAMENTALS REQUIRES THE FOLLOWING ACTION FOR AUSTRALIA

ECONOMY IN TRANSITION

- Monetary policy integrity to be preserved and not formulated to cater for a patchwork economy
- Protectionist calls need to be resisted lest we erode the hard earned gains of reforms of the 1980s and 1990s
- Greater flexibility is needed in our wages system for resources to move as our economy transitions
- Further liberalisation and flexibility in our skilled migration policies is needed now to alleviate skills shortages

INFRASTRUCTURE

- Real action is required to encourage the broader adoption of user charging or direct government support where user charging is not possible to facilitate greater private sector financing of infrastructure
- The Commonwealth needs to coordinate an infrastructure audit with the states to undertake forward infrastructure planning (at least 10 years out) for financing the requisite infrastructure task for their respective jurisdictions. In essence, the "infrastructure task" should be incorporated in the much needed state IGRs
- There are a number of innovative risk sharing and financing models and the states need to be encouraged to adopt these in order to access private sector financing of infrastructure
- State Governments need to work with long term investors to agree on sustainable investment metrics for individual projects. They can defray bid costs by injecting common information and due diligence materials to facilitate greater discipline in the metrics and involvement of long term investors like superannuation funds

FISCAL POLICY

- Support the imperative for the Government to deliver on its pledge to return the Budget to surplus by 2012–13
- The size of government as measured by tax revenue should not increase above the current cap of 23.5% of GDP
- The Government should target an accumulated surplus of 3% of GDP by 2024 to ensure cyclical readiness for a major economic shock, and following prior year surpluses paying down net debt
- The Government should target a modest surplus in addition to the cyclical recharge to provision for the fiscal gap and ensure intergenerational equity
- Implementation of cyclical and intergenerational readiness — does not require the establishment of a new sovereign wealth fund
- All state and territory governments need to prepare an intergenerational report
- Mercer supports the BCA's call for an independent fiscal authority as the vehicle to introduce transparency around the sensitivities of the Budget and the IGR fiscal gap

FISCAL GAP ALLEVIATION

- Age pension eligibility age indexed to the rate of increase in life expectancy.
- Incentives to increase mature age workforce participation
- Review eligibility and entitlement for Disability Support Pension to encourage workforce participation where appropriate
- Income stream to form a larger proportion of the retirement mix
- Accommodating immigration policy, targeting specific skills (in the short term) and age profiles (for the medium to long term)

1.
INTRODUCTION: SETTING THE SCENE

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As the rest of the developed world teeters on the brink of renewed recession, Australia's growing integration with emerging Asia provides good reason to anticipate a more resilient economic outlook for Australia. In sharp contrast to the deep recessions recently experienced in most developed economies Australia also avoided recession when the developed world contracted following the "tech wreck" of 2000-2001. We also weathered the Asian crisis a few years earlier, despite our already heavy trade connections with the region.

Our last recession was "the recession we had to have" nearly 20 years ago. While using that byline may have been a political mistake at the time, with the benefit of hindsight it seems appropriate. The recession finally wrestled out of the system the great inflation that took hold in the 1970s. The move to enterprise bargaining in those years heralded the end of comparative wage justice and the primacy of awards. Together with a series of productivity and competition enhancing reforms, these developments (and some luck along the way) set us up for the long run of solid non-inflationary growth we have subsequently enjoyed.

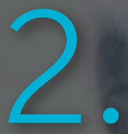
This is a great record but Australians are not celebrating. Consumer confidence and business confidence (both large and small) is weak. Consumers feel they are "doing it hard", manifesting itself in Australian household deleveraging and rising saving rates. Business worries about declining productivity, regulation, shortages of skilled labour, the difficult business conditions outside the mining related sectors, poor infrastructure and policy uncertainty. Economists and economic commentators share business concerns on productivity and infrastructure but also worry about the impact of an ageing population and the need for structural change in the economy.

This Report revisits the foundation of our public policy framework – monetary, fiscal, retirement income and structural policy. In doing so it articulates their genesis, objectives and prudential targets, and the respective roles these policies play in delivering sustainable economic growth. This provides the framework to examine the policy settings and reforms which contributed to two decades of strong performance. It also looks at external drivers such as the rapid development of the world's two most populous countries in our region and the implications for Australia's terms of trade and resources sectors. It then attempts to assess the validity of current widespread doubts and concerns about the economy and whether we need to make further changes if we are to enjoy continuing economic success.

Fiscal policy is the backbone of public policy

The backbone of our public policy architecture is fiscal policy. It determines the size of government and how governments raise and spend money. It is the primary vehicle for governments' macroeconomic interaction with private markets and perhaps a litmus test for how government identifies and addresses long term structural and demographic drivers. This Report's overarching objective is therefore to revisit and assess whether Australia's fiscal policy rules remain appropriate to contribute to sustainable economic growth. To this end Mercer also reviews in detail our national savings and investment track record. In doing so, a critical assessment is made as to whether we have the right fiscal policy settings and underlying assumptions, given the structural changes in our economy, for Government to contribute to the delivery of sustainable economic growth.

Finally a series of policy proposals are made – Back to Policy Fundamentals – to address the concerns that Mercer considers warrant action now.



2. AUSTRALIAN ECONOMIC POLICY BACKDROP

2. AUSTRALIAN ECONOMIC POLICY BACKDROP

To consider the future we first need to examine the past, and therefore in this section of the Report we return to policy basics. What are the primary objectives of economic policy? And what are the characteristics of good policy?

Mercer assesses the conduct and performance of policy — benchmarked against those objectives. Our focus is on the three arms of economic policy that arguably played an integral role in Australia's economic performance through the Global Financial Crisis (GFC); namely, monetary policy, fiscal policy and prudential supervision.

The high level overview of Australia's major economic policy developments over the last 50 years leads us to consider whether Australia suffers from a "vintage" concentration in Government policy efforts.

2.1. ECONOMIC POLICY: THE PURSUIT OF WELLBEING

The primary purpose of economic policy is to assist the growth and sustainability of the wellbeing of Australians. Wellbeing can only be maintained in an economy that delivers relatively stable growth and economic policy has an important role in contributing to output growth and macroeconomic stability. In particular, polices relating to population, participation and productivity will drive changes in output levels and economic growth rates.

Population drives output and growth in several ways. Firstly, the size of the working age population directly influences the potential level of labour inputs into production. Secondly, the non-working population — such as children and retirees — impose dependency costs (education, aged care, health services and social welfare) on families, the community and Government, reducing their capacity to save and invest. Public policy influencing population includes: encouraging (discouraging) fertility rates; migration programs; and initiatives to encourage longer workforce participation (e.g. varying pension and superannuation eligibility ages and health care).

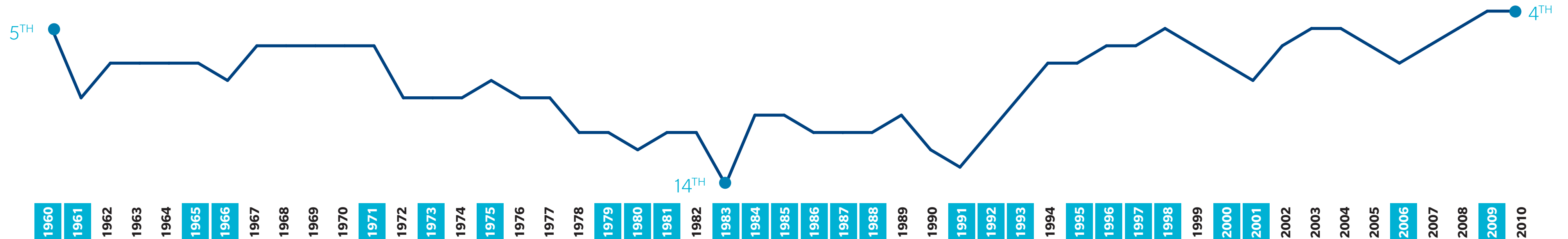
Participation is the proportion of the working age population actually employed and the number of hours they work. High participation rates are likely to occur with stable macroeconomic conditions which keep unemployment close to the minimal frictional levels consistent with the evolution of the economy. Retraining programs improve the participation rate by reducing the period for that the frictional unemployed are not participating. Carefully designed tax and welfare policies that minimise effective marginal tax/withdrawal rates are also important to encourage participation.

Productivity is the volume of output produced per unit of inputs. It is most commonly and simply measured as labour productivity — the value of output per hour worked. The productivity of labour is obviously affected by the quality of the work force — including levels of education and training and the levels of overall health. However, it is also affected by such things as the volume and quality of the tools and equipment labour is supplied with, the suitability of the work place for the purpose, the efficiency of the processes developed by management and the quality and reliability of essential infrastructure such as water, energy and transport. To capture the effectiveness of all these inputs (in addition to labour inputs) we need to calculate multi-factor productivity — the volume of output adjusted for the quantity of all factor inputs. While this is more difficult to calculate, it gives a clearer reading of how well the economy and the firms within it are converting our economy's inputs into products and services.

Economic policy should assist the growth and sustainability of the wellbeing of Australians

Figure 2.1a: 50 Years of Economic Policy

- **1960:** RBA ESTABLISHED
- **1961:** 30/20 RULE FOR LIFE OFFICES & SUPER FUNDS
- **1965:** BANK LENDING REGULATIONS EASED
- **1966:** DECIMAL CURRENCY; **WHITE AUSTRALIA POLICY DISMANTLED**
- **1971:** TARIFF REVIEW INITIATED
- **1973:** CERTIFICATES OF DEPOSITS CONTROL REMOVED; **TARIFF REFORM**
- **1975:** ASPREY (TAX) REVIEW
- **1979:** AUSTRALIAN FINANCIAL SYSTEM INQUIRY; **DEREGULATION ALLOWING MARKET DETERMINED INTEREST RATES**
- **1980:** **INTEREST RATE CEILING DISMANTLED**; BANK DEPOSIT RATE CONTROLS REMOVED
- **1981:** CAMPBELL COMMITTEE REPORT
- **1983:** FOREIGN BANK ENTRY
- **1984:** ALL REMAINING CONTROLS ON BANK DEPOSITS REMOVED; 30/20 RULE ABOLISHED; **EXPLICIT FISCAL POLICY RULES**
- **1985:** **WAGES ACCORD**; DRAFT (TAX) WHITE PAPER; **CGT INTRODUCED**; **COMPULSORY SUPER BEGINS**
- **1986:** FBT INTRODUCED; LOAN RATE CONTROLS REMOVED; AWARD BASED SUPER SCHEMES ESTABLISHED; SOCIAL SECURITY REFORM
- **1987:** **DIVIDEND IMPUTATION INTRODUCED**
- **1988:** NEW ARRANGEMENTS FOR SUPER; CAPITAL ADEQUACY RULES FOR BANKS; **TARIFF REFORM**
- **1991:** TWO-AIRLINE AGREEMENT ABOLISHED; CBA PRIVATISED
- **1992:** TELECOMMUNICATIONS DEREGULATION; FOREIGN BANK BRANCH ENTRY; **SUPERANNUATION GUARANTEE LEVY**; COAG ESTABLISHED
- **1993:** **RBA 2–3% INFLATION TARGET**
- **1995:** ACCC FORMED
- **1996:** WORKPLACE RELATIONS ACT; **INDEPENDENCE OF RBA**; **CHARTER OF BUDGET HONESTY**
- **1997:** PRIVATISATION OF TELSTRA COMMENCES
- **1998:** APRA AND ASIC ESTABLISHED
- **2000:** **GST AND TAXATION REFORM**
- **2001:** COMPANY TAX CUT TO 30%
- **2006:** COAG'S NATIONAL REFORM AGENDA
- **2009:** PENSION AGE INCREASE ANNOUNCED



* Ranked by GDP per capita

Public policy has a key role to play in promoting an environment in which productivity is maximised. A very broad range of Government policies and services affects productivity:

- Affordable access to high quality education and employment training leads to a skilled and adaptable workforce
- Health programs affect the health standards of the workforce
- Affordable access to medical and pharmaceutical services
- Reflecting history and natural monopoly characteristics, most essential infrastructure is provided or heavily regulated by Government. Assured supplies of water, energy and communications services contribute importantly to the efficiency of the workplace, while conversely, for example, congested transport infrastructure affects everything from journey to work and business travel through to delivery of inputs and despatch of outputs.

Policy that also successfully delivers a stable and predictable macroeconomic environment will also positively contribute to economic growth and output levels. A stable environment makes it easier for business to make investment decisions and reduces cyclical variations in capacity utilisation. Business investment is the primary vehicle through which new technologies are brought into play. In a stable environment, business is likely to spend more to ensure the equipment they install embodies the latest technologies to elevate productivity.

Fewer large swings in economic activity also reduce the impact of changes in unemployment. It results in fewer workers losing their jobs and potentially facing long periods unemployed. Long periods of unemployment erode work skills, workforce engagement and future productivity; unemployed older workers often lose touch with the labour market, moving permanently to the welfare system.

An open economy is integral to productivity growth. Open trading systems enable businesses to source the latest technologies and capital equipment from world markets rather than having to rely on what might be available domestically. They also provide competitive pressure to drive efficiency and innovation. Trade also brings scale opportunities for successful local industries. Accommodating migration policies facilitate management of critical skilled labour shortages and can bring new techniques as well as foreign market knowledge, language skills and trade connections. Openness of capital and investment markets has enabled Australia to invest more than it has saved almost throughout its modern history. Foreign investors have taken on or shared risks involved in major projects which would otherwise not have been developed or would only have been developed at much later dates.

2.2. POLICY DEVELOPMENTS: A CASE OF VINTAGE CONCENTRATION

Over the past 50 years Australian Governments have introduced numerous reforms intended to promote the country's prosperity. These policies ranged from improving participation and productivity to facilitating skilled migration, beginning with abolition of the White Australia policy in the 1960s. A sketch of the history of public policy reforms is given in Figure 2.1a and Boxes 1, 2 and 3 in this section. Whilst there may be debate about what constitutes major policy reform, Mercer has identified those that it considers earn this mantle. Importantly, whether complete or not, it is clear that the reforms were concentrated in the 1980s, fell away during the 1990s, and most recently have been quite sparse. It also highlights that the imperative for policy action is concentrated when our relative economic performance is at its lowest.

> Reforms concentrated in the 1980s, fell away in the 1990s, and today are quite sparse

BOX 1: POLICY REFORMS OF THE 1980s

The 1980s are characterised as a decade of extraordinary economic policy reform, across the financial sector, labour markets, social security, tariff and fiscal policy and superannuation.

BANKING

Whilst deregulation of banking operations started in the mid 1970s, most of the changes were made in the 1980s. Controls on interest rates were gradually removed starting with certificate of deposits (1973), bank deposits (1980) and loan rates (1986). The prescribed asset ratio, which required the purchase of government securities, was gradually reduced. A lower reserve asset ratio was introduced in 1982; the same year the RBA ceased quantitative lending guidance. Banks effectively became responsible for their own operations, setting interest rates and managing their deposit and loan books according to market demand.

SOCIAL SECURITY REFORM

1986 saw the establishment of the Social Security Review, tasked to come up with long-term policy programs to cover: income support for families, social security, and aged care. The review was very broad in its focus, covering access, equity, adequacy, simplicity redistribution and transition to work. In total, six major issues papers and 31 research and discussion papers were generated to support future government policies. By the end of 1991, significant policy changes had been implemented across a wide spectrum of social security issues. The Review resulted in a restructure of Australia's social security architecture, and a requirement that programs supporting social security and welfare delivery were subject to a comprehensive review every three or five years.

It has been argued that the Social Security Review established a culture that allowed policy makers to be responsive to change; many of the new programs that have been introduced since can claim to have their origins wholly or partly in the Social Security Review of 1986. In this decade, key programs included:

- Unemployment assistance focussing on re-employment (1986)
- Sole Parents allowance (1987)
- Family assistance (1987)
- Job Search allowance for 16-17 year olds (1989)
- Widowed persons allowance (1989)
- Newstart allowance (1991) designed to address problems of the long-term unemployed (1989)

LABOUR

The Prices and Incomes Accord operated from 1983 to 1996 and was introduced following the stagflation of the 1970s. Under the Accord, the ACTU agreed to restrict wages and the Government pledged to minimise inflation and improve the social security system, including the introduction of Medicare. After several years of centralised wage fixing, with only modest wage increases, the "real wage overhang" was narrowed considerably. In the early 1990s the Government and the ACTU agreed to wage determination through enterprise bargaining, replacing the traditional industry wide award system.

Award superannuation commenced in Australia in 1985 as part of the then Prices and Incomes Accord, with the introduction of superannuation as part of the award based system of wages in 1986.

TARIFF CUTS

Trade liberalisation gained momentum in the 1980s. Initially tariffs were reduced and import quotas removed on an ad hoc, industry by industry basis. The first of a series of phased reductions in tariffs across industry sectors was introduced in 1988, which eventually saw most tariffs fall to five percent or less by 1996. "Opening the borders" to foreign goods increased international price competition and supported the industrial relations reforms that followed.

INTEREST RATES

A tender system for the sale of bonds was introduced in 1982. Together with the tender for Treasury notes in 1979, this effectively allowed the market to determine interest rates, other than the cash rate.

EXCHANGE RATES

The Australian dollar was floated and exchange controls removed in December 1983. Prior to the float, the currency was set at a crawling peg to the Trade Weighted Index. The float improved the economy's ability to absorb external shocks such as changes in the terms of trade. For example, in the event of a negative terms of trade shock, the exchange rate would depreciate, thereby reducing the adjustment required by monetary and fiscal policies.

Under the fixed exchange rate regime, the RBA cleared the excess demand or supply for the Australian dollar. In effect, this meant that international trade and capital flows impacted upon domestic liquidity. Under a floating exchange rate system the market clears the excess demand or supply for the currency with the price rising or falling as needed. The float, combined with the tender system for Treasury notes and bonds, allowed monetary policy to be fully effective.

TAX

Equity and efficiency of the tax system received increased attention during the 1980s (a consequence of the Asprey Report in 1975 which recommended broadening the tax base.) The Draft White Paper in 1985 reiterated the broadening imperative and recommended the introduction of a broad based consumption tax, a capital gains tax and comprehensive taxation of fringe benefits. During this decade the following tax policies were initiated:

- CGT on realised gains from the sale of assets (1985)
- FBT levied on employers (1986)
- Cessation of double tax on company dividends and the introduction of the dividend imputation system (1986/87)

FISCAL

The Federal Government introduced Australia's first explicit fiscal policy rules in 1984. In its 1985/86 Budget the Government set out a "Trilogy" of commitments to:

- Not raise tax revenue as a proportion of GDP in 1985-86 and over the life of the Parliament
- Not raise government expenditure as a proportion of GDP in 1985-86 and over the life of the Parliament and
- Reduce the budget deficit in dollar terms in 1985-86 and as a proportion of GDP over the life of the Parliament

These commitments provided a medium term framework of fiscal discipline within which annual budgets were framed. The principles were broadly maintained through the rest of the decade as the Government continued to consolidate the Budgets.

The concentration of reform in the 1980s and early 1990s has been ascribed to the activism of the Hawke/Keating Governments. As illustrated in Figure 2.1a, it could alternatively be viewed as a product of the difficult economic conditions at the time — double digit inflation, high levels of unemployment, low levels of labour force participation and slow productivity growth. The need for reform was widely recognised by the community and by the major political opposition parties. This reduced the political cost of change and ensured smooth passage of relevant legislation.

Reform activism appears a product of difficult economic conditions

Through the course of the 1990s, the earlier reforms paid dividends in the form of improved inflation, participation, unemployment and growth outcomes. Arguably and perhaps perversely, these improvements contributed to the subsequent fall-off in reform activity. Australians felt they had done enough and did not need to suffer more structural change.

Australian participation, employment and inflation outcomes have remained generally satisfactory in the 2000s. Output growth, while slower on average than in the 1990s, remained positive during this period, despite the global "tech wreck" early in the decade and the GFC in 2008, which caused contraction and high unemployment levels in almost all advanced economies.

Australia's relative success during this period of global stress reflected judicious management of monetary and fiscal policy, as well as the steady rise to record levels of the terms of trade arising from sustained higher growth of the larger Asian economies. However, the unprecedented boost to national income from the improved terms of trade has masked, firstly, a slowdown in multi-factor productivity growth and more recently, an absolute decline. As the terms of trade level peak and eventually moderate, the adverse impact of falling productivity on the nation's economic welfare will become more readily apparent. Reform therefore needs to restart if current levels of wellbeing are to be protected now and into the future.

Adverse impact of falling productivity will be more apparent as our terms of trade moderate

The terms of trade shock has redefined Australia's comparative advantage and is likely to continue to do so in the decades ahead. Australia needs to adapt to the new pattern of opportunities. The early beneficiaries of this change are the energy and minerals sectors and the businesses serving them. While Australia is still in the early stages of an unprecedented energy and minerals investment boom, rising labour demand in these sectors is already highlighting shortages of skilled labour. They are also suffering from uncertain approval regimes, especially for the coal seam gas industry, and uncertain state[1] and Commonwealth tax arrangements. Developments in new regions require new infrastructure and upgrades are required in existing mining locations. As detailed further in Section 4, it is not clear that governments have the fiscal capacity to supply this sector with specific infrastructure at the same time as they wrestle with general shortages of vital capacity in the rest of the economy. There are also issues about ownership and access for privately built infrastructure.

Australia's comparative advantage being redefined by the terms of trade shock

There are opportunities and risks to be managed. Looking ahead, it is likely that other sectors of the economy will also benefit from the growing wealth and rapidly expanding middle classes of Asia, as further outlined in Section 3. At this point, potential candidates appear to be tourism, education and high protein food production. There is already conflict between the mining and gas sectors and the farming and tourism industries about land and water use and the environment. But there remains some reluctance to fully realise the opportunities. For example, there are popular campaigns seeking to ensure that foreign investment in the agricultural sector is kept low despite the probability that foreign market knowledge and connections and willingness to share risk are as vital to this sector as they were to mining in Australia's earlier history.

It is fundamental to the growth and sustainability of the wellbeing of Australians that we make progress on these questions to allow businesses to capture as much as possible of the new and expanding opportunities in what is possibly the 'Asian' century.

1 *References to state(s) is to mean state and territory governments in this Report.*

BOX 2: POLICY REFORM CONTINUES IN THE 1990s

Policy reform continued into the 1990s, but the pace and substance clearly decelerated during the second half of the decade.

FINANCIAL REGULATION

The Wallis Inquiry resulted in major changes to the oversight of Australia's financial system. Australia's regulatory framework was divided into four pillars. Under the streamlined framework:

- The Australian Competition and Consumer Commission (ACCC) was responsible for competition.
- The Insurance and Superannuation Commission and bank supervision area of the RBA (and several state regulators) were combined into a single prudential regulator, the Australian Prudential Regulation Authority (APRA). APRA became responsible for prudential regulation of deposit-taking, insurance superannuation and pensions.
- The Australian Securities Commission was renamed as the Australian Securities and Investments Commission (ASIC), and became responsible for market conduct (and thereby consumer protection) in insurance, superannuation and aspects of banking and the payments system.
- The RBA's responsibility became the maintenance of financial stability through its influence over monetary conditions and oversight of the payments system.

COMPETITION

The ACCC was formed in 1995 as an amalgamation of the Trade Practices Commission and Prices Surveillance Authority, with the role of promoting competition and fair trade for the benefit of consumers, business and the community. The independent commission administered the Trade Practices Act 1974 (TPA).

At this time, the responsibilities for the ACCC and the TPA were transferred to the Treasurer's portfolio, reinforcing the move to economic substance over black letter law application of the Act. Amendments to the TPA, including replacing the market dominance test with a substantial lessening of competition, better reflected Australia's transition to an open economy.

Constitutional limits on the application of the federal TPA created a need for nationally coordinated reforms across all jurisdictions. The framework and principles were devised in the Hilmer Review in October 1992 and lead to the formation of the National Competition Policy (NCP) in 1995 — a co-ordinated national program of reforms agreed to by state, territory and Commonwealth governments. The cornerstone principle of the NCP was that arrangements that inhibit competition should only be retained if they are shown to be in the public interest.

The program of NCP reforms included: extending anti-competitive conduct laws to previously exempt government enterprises; review of anti-competitive regulation; reforms to public monopolies including competitive neutrality mechanisms; and an access regime for network infrastructure. The National Competition Council was established in 1995 to monitor implementation of reforms across the jurisdictions. States and territories received "competition payments" from the Commonwealth Government depending on their progress in implementing agreed reforms.

SAVINGS

Recognising the decline in and importance of national savings, the Fitzgerald Report was commissioned in late 1992. The report, published in early 1993, set out a comprehensive fiscal and savings policy plan for the next decade, recognising that the current savings rate was not likely to be adequate going forward. Key to its findings were strengthening of fiscal consolidation and measures to encourage private savings.

The Superannuation Guarantee levy was introduced in 1992, which required employers to contribute to superannuation on behalf of their employees. The contribution rate was phased in to reach 9% by 2002.

PRODUCTIVITY

The Productivity Commission was established in 1998 with a remit to focus on ways of achieving a more efficient and productive economy. The Commission had various predecessors including the Industry Assistance Commission (1973) and an explicit function within the Industry Commission. The Productivity Commission was given responsibility for the widest range of reform issues with microeconomic dimensions, including not only impediments to improved economic performance in all sectors of the economy, but also areas of social, environmental and economic interaction.

PRIVATISATION

The Commonwealth government began a program of asset sales in 1987, which largely involved property. Significant privatisations of Commonwealth and State public trading enterprises (PTEs) followed in the early 1990s. The rationale for privatisation was that the businesses would be more efficiently run by the private sector, subject to arms length regulation where required. Privatisations were also promoted as a means to retiring government debt, which in the 1980s and 1990s was a major policy concern. While there was a similar trend to privatisation overseas, especially in the UK, Australia's program over the decade was one of the largest among the OECD countries.

The value of Commonwealth and State privatisations was roughly equal as at 1996. The proceeds were largely used to reduce or contain growth in government debt.

TAX

Concerted policy efforts were initiated in 1998 to broaden the indirect tax base, as work got underway on the design development and implementation of the goods and service tax (GST) in 2000.

LABOUR

In the 1990s, the Coalition Government sought to further decentralise and deregulate wage setting. The federal award system continued under the Workplace Relations Act 1996 although the matters that could be determined by the Australian Industrial Relations Commission were restricted. The Act included:

- The introduction of australian workplace agreements
- Greater flexibility to use of enterprise bargaining agreements
- Restrictions on union activity
- Prohibition of closed shops, where employers agree to only hire union members

FISCAL POLICY

The Coalition Government set out its fiscal policy framework under the Charter of Budget Honesty in 1996. The Charter was legislated in 1998 and continues to provide the framework for fiscal policy. The Charter requires the Government to prepare a Fiscal Strategy Statement each year that specifies its long term fiscal objectives; the budget's strategic priorities; key fiscal measures; the fiscal objectives, targets and outcomes for the next four years; and any fiscal policy actions that are temporary in nature.

The primary objective adopted by Governments under the Charter has been to maintain budget balance on average over the course of the economic cycle. The secondary objectives have varied between Budgets and include the counter-cyclical commitment to maintain fiscal surpluses while economic growth prospects remain sound.

2.3. POLICY CONDUCT AND PERFORMANCE THROUGH THE GFC

Whilst Figure 2.1a summarises the major policy reforms implemented over the past five decades, the remainder of this section discusses the key policy levers — namely fiscal, monetary and prudential policies — that proved critical to Australia's resilience throughout the GFC.

> The powder was dry in both fiscal and monetary policy barrels and the authorities were able to pull both triggers when it mattered

The GFC and its continuing aftermath have highlighted the pivotal roles of fiscal and monetary policy in responding to economic shocks. Australia's fiscal stimulus package was one of the largest in the world relative to GDP. It was implemented quickly and closely followed the guidelines developed by the IMF. The monetary response was also fast and bold. As cash rates were already high relative to other advanced economies, rate cuts were faster and larger than was possible in most other economies. Earlier reforms in monetary policy and the establishment of, and compliance with, a set of conservative fiscal rules positioned Australia well to respond to the GFC challenge; the powder was dry in both fiscal and monetary policy barrels and the authorities were able to pull both triggers at the time when it mattered.

2.3.1. MONETARY POLICY

Effective monetary policy was critical to Australia's resilience to the economic impact of the GFC. The Reserve Bank of Australia (RBA) is responsible for the development and implementation of monetary policy in Australia. The RBA's legislative charter charges it to contribute to the best of its ability to:

- Stability of the currency of Australia
- Maintenance of full employment in Australia
- The economic prosperity and welfare of the people of Australia

The stability of the currency objective is interpreted to mean domestic stability (or inflation control) rather than exchange rate stability. Since the independence of the RBA and inflation targeting having become more formalised, this objective has generally been given more overarching precedence. Maintaining low and stable inflation is now regarded as a necessary pre-condition to deliver full employment, economic prosperity and improving welfare (although rapid and large interest rate cuts in response to the GFC could be seen to focus on the full employment objective).

> RBA independence and inflation targeting has proved successful

Low and stable inflation is crucial for sustained economic growth; it assists business in making sound investment decisions, protects savings, and curbs incentives that might otherwise result in poor resource allocation. The significant reduction in Australian inflation that followed the 1990–91 recession provided a unique opportunity to permanently lock-in low inflation expectations in wages and price setting negotiations. Inflation targeting was initiated by the RBA in 1993, with the then Reserve Bank Governor announcing in a speech the objective of maintaining average inflation within a band of 2–3%.[2] This was reinforced by a series of research papers and subsequent releases from the Bank.

The RBA's inflation target is expressed over the medium term: maintaining consumer price inflation at an average of between 2–3% over the full course of the business cycle. The target allows for some cyclical fluctuation in inflation, but the benchmark keeps monetary policy disciplined and helps to anchor private sector inflation expectations.

A medium term horizon has been adopted to provide greater economic certainty, while also recognising the uncertain lags between policy action and actual inflation outcomes. The ensuing opportunity for pre-emptive policy action mitigates the risks of serious policy mistakes.

2 *Fraser (1993)*

BOX 3: POLICY REFORM SLOWS IN THE 2000s AND BEYOND

The 2000s has witnessed an emerging pattern of policy reform inertia.

TAX

A broad-based goods and services tax (GST) was introduced in July 2000. It replaced the narrow and inefficient wholesale sales tax and a range of state taxes. Revenue from the GST is paid to the states and territories, replacing financial assistance grants previously paid to them from the Federal budget. To compensate low income earners, the introduction of the GST was accompanied by social security payments and a reduction in the personal income tax rate.

COMPETITION

In 2006 the Council of Australian Governments agreed to the National Reform Agenda to build on the National Competition Policy which concluded in 2005-2006. The National Reform Agenda comprises three streams:

- A competition stream directed to enhance the operations and efficiency of infrastructure markets. The Productivity Commission believes that the performance of infrastructure improved greatly from the introduction of commercial disciplines and incentives that flowed from the National Competition Policy reforms. However, there is scope to achieve more competitive, nationally integrated markets in energy, transport and water.
- A regulatory reform programe to reduce the costs of compliance to business. This involves promoting "best practice" regulation making, including ensuring that regulations are well targeted and designed and the compliance costs considered. It also involves reducing the regulatory burden by harmonising regimes nationally, rather than having multiple regulations across jurisdictions.
- A human capital stream to enhance workforce and participation and productivity through policies to improve health, education and training, and incentives for work. The Productivity Commission believes there is scope to: increase workforce participation by up to 5% over the next 25 years and workforce productivity by up to 2%; and the quality of primary and secondary teaching could be improved by addressing income disparities with other professions, ensuring merit based appointments and performance related pay.

LABOUR

Work Choices was introduced in 2005. It significantly reduced the protection provided by unfair dismissal laws; removed the no disadvantage test; and imposed restrictions on allowable industrial action. However, the legislation was subsequently repealed in its entirety by the incoming Labor Government in 2007.

SOCIAL POLICY

The demographic issues facing Australia with an aging population continued to be reflected in public policy in the latter part of the 2000s. In 2009, the qualifying age for the pension was increased from 65 to 67, with a phased introduction over a number of years. The same year, changes were made to the compulsory preservation of super, with retirees required to wait until 60 to access preserved funds. The need to increase the amount of money being put aside for retirement was also recognised and it was generally agreed that compulsory super contributions should rise to 12%.

The framework was formalised in the Statement on the Conduct of Monetary Policy, as agreed by the then RBA Governor, Ian Macfarlane, and the Coalition Government in 1996.[3] The Statement also provided full independence to the RBA in setting monetary policy. Prior to independence, setting rates was problematic for Governments given their sensitivity to public response. This meant monetary policy was often ineffective in controlling inflation, as Government historically reacted too late and raised rates too slowly.

It is widely agreed that the growing credibility of the RBA's anti-inflation stance has resulted in further declines in Australian interest rate volatility in recent years, as well as affording RBA significant flexibility in the operation of monetary policy.

3 *The first Statement on the Conduct of Monetary Policy was released in August 1996, followed by releases in July 2003, September 2006, December 2007 and September 2010.*

Over the two years prior to the GFC, the RBA steadily increased its target interest rate from a broadly neutral level of 5.5% to 7.25% in response to tightness in the economy and steadily accelerating inflation. A year later the target rate had been reduced to 3.0% providing considerable support for recovery from the slowdown. By October 2009, the RBA had begun steadily to tighten again, lifting rates back to around neutral by November 2010. The independent RBA had managed rates in a way which gave it room to move when the GFC hit. It used that capacity quite boldly when it was needed. It has since re-established "head room" since domestic recovery emerged and moved recently (in both November and December 2011) to reduce rates.

> Past two decades of low inflation is unprecedented in Australia's economic history

The monetary policy framework of central bank independence and inflation targeting has proved to be successful in maintaining low inflation and inflationary expectations. Since 1993, actual inflation has averaged close to the mid-point of the RBA's target range. There is little doubt the RBA's monetary policy framework has contributed importantly to the unprecedented period of sustained economic growth since the early 1990s. Australia's inflation history over the past two decades and its ability to sustain steady growth over such a protracted period is unprecedented in our history.

The panoply of reforms of financial markets, the currency, independence of the Bank, and adoption of a target band approach to inflation control have proved a real success on this score.

2.3.2. FISCAL POLICY

As recent events in Europe have illustrated, appropriate and disciplined fiscal policy is also critical to promoting long term economic growth. Fiscal sustainability reduces economic vulnerabilities as well as uncertainty about future policy settings, thereby facilitating growth enhancing decisions. Australia's fiscal policy framework is set out in the Charter of Budget Honesty Act (1998). The Charter requires fiscal strategy to be set in a sustainable medium term framework based on the principles of sound fiscal management. These principles require policy to consider: financial risks including levels of government debt; the adequacy of national savings; cyclical economic fluctuations; stability and predictability of spending and tax policies; and equity between generations of Australians. The Charter requires the Government to provide a Fiscal Strategy Statement at the time of each budget setting out its long-term fiscal objectives, the strategic priorities for the budget, the key fiscal measures for the Government, the fiscal objectives and targets and expected outcomes, and any temporary measures and the process for their reversal.

> Today's eurozone demonstrates how disciplined fiscal policy is needed for sustainable economic growth

Earlier Australian Governments specified the primary fiscal policy objective as maintaining a balanced budget, on average, over the course of the economic cycle. The objective also adopts a medium term horizon — akin to Australia's monetary policy framework. Balancing the budget maintains fiscal discipline, while the "over the cycle" goal allows for automatic stabilisers to operate and the possibility for discretionary fiscal policy if circumstances warrant.

Monetary policy is accepted as the "swing" instrument and primary tool to manage short term demand. Policy makers should be and are prepared, however, to use fiscal policy to supplement monetary policy in sufficiently challenging circumstances such as the 1990s recession and the GFC.[4] In such extreme circumstances, monetary action may need fiscal support to provide sufficient counter-cyclical impetus. It is not envisaged that fiscal policy will be used often to stabilise macroeconomic conditions. Experience has shown that decision and implementation lags can result in pro-cyclical outcomes.

The current Government's fiscal strategy is to achieve budget surpluses on average over the medium term.[5] This has been a secondary objective in earlier fiscal strategy statements, to be achieved while economic growth prospects remain sound.

> Fiscal policy should not be used often to stabilise macroeconomic conditions

The current Government has also committed to:

- Keep taxation as a share of GDP below the level for 2007–08 (23.5%) on average
- Improve the Government's net financial worth over the medium term

In Section 5 of this Report, Mercer assesses in detail the ongoing relevance and adequacy of the fiscal policy rules.

Following the significant fiscal response to the GFC, the Government has committed to return the budget to surplus by a combination of allowing the level of tax receipts to recover naturally as the economy improves, and by constraining real growth in spending. The commitment has two elements. First, to hold real spending to 2% per year until the budget returns to surplus. Second, to restrain real spending growth to 2% on average once the budget has returned to surplus until surpluses are at least 1% of GDP and while the economy is growing at or above trend.

Australia's discretionary fiscal response to the GFC, as a share of GDP, was among the largest of advanced economies. According to Treasury estimates, growth would have been negative for three consecutive quarters without the fiscal stimulus. While some commentators have questioned its effectiveness, the fiscal response was endorsed by the IMF and OECD. The official institutions praised its quick implementation, its size and sustainable nature.[6]

4 *Henry (2009)*

5 *Commonwealth Government (2011–12b)*

6 *IMF (2008)*

Importantly, it was the fiscal framework followed by successive Governments that left the Commonwealth Government with positive net financial assets at the time of the onset of the GFC. This enabled the Government to introduce an aggressive fiscal package designed to maintain economic activity and prevent a large increase in unemployment.

2008 — The first time since 1990 that Australia applied significant counter-cyclical fiscal stimulus

During the GFC unemployment rose by around 2 percentage points, before recovering to half that increase quite quickly. The discretionary measures combined with the impact of the automatic stabilisers have since left Australia with a modest level of net debt — equivalent to around 9% of GDP. This is a very small proportion relative to almost any other advanced country. Australia still has capacity to apply stimulatory fiscal measures in the event they are needed in the future. The post-crisis commitments made on expenditure control and returning to surplus promise to strengthen this capacity further, but the question of whether this is enough is addressed in Section 5 of the Report.

2008 was the first occasion since 1990 that significant counter-cyclical fiscal stimulus has been applied in Australia. In 2008 the threat to the economy seemed much larger and the case for fiscal support of monetary policy was correspondingly stronger. In contrast to 1990, when action was too slow on projects that were too ambitious, the Government moved quickly and the measures taken were chosen largely on the basis that they could be implemented in a short space of time. The package has been criticised as not providing value for money, but the counter-factual would have resulted in a much greater increase in unemployment and more idle capacity. Large amounts of unused capacity and labour arguably add less value than even marginal investments.

From a macroeconomic policy perspective the fiscal policy reforms score well. The general approach of leaving demand management to monetary policy, with fiscal policy focused on ensuring Governments balance spending and taxation priorities in the medium term, is entirely consistent with the differing characteristics and effectiveness of the two policy tools. While Australia's experience with the GFC showed that in extreme circumstances fiscal stimulus can make a strong and useful contribution, nevertheless, countries have to ensure that they create the capacity to do this through prudent fiscal management in normal times. Lack of fiscal discipline and management is something so many countries in the North Atlantic are grappling with now.

Australia's disciplined fiscal framework enabled an aggressive fiscal stimulus to counter the GFC

It is less clear that the Australian Government's spending priorities have been managed as well as the overall macroeconomic management framework. While it is always difficult to say how much infrastructure is enough, there does seem to be a pervasive view that Commonwealth and state governments have under spent over the past few decades. Although the states are constrained in the revenue they can raise, for many years they have enjoyed ample capacity to borrow from public markets. Clearly, Australia's fiscal framework needs to ensure we make room over time for such borrowing and investment, and this may require revisiting the current fiscal policy rules and how they are applied. There is a strong case that governments need to work harder on defining sound approaches to the private provision of infrastructure. These issues are addressed in Sections 4 and 5 of this Report.

From a macroeconomic perspective — Australia's fiscal policy reforms scored well

It is also difficult to balance fair and adequate levels of income support to the economically disadvantaged with the national imperative to lift labour force participation rates and the level of national saving. Australia's compulsory superannuation system was introduced, among other objectives, to help ensure retirees sustain a reasonable living standard without overly burdening the diminishing number of taxpayers relative to pensioners. While it was originally intended by one of the primary architects that at least 15% of income would flow into superannuation, the initial legislation (introduced in 2002) provided only for 9%. Legislation has only now been introduced to increase compulsory employer contributions to 12%. In the meantime concern about retirees' living standards has led to an increase in pension rates. Perhaps the strain on future budgets would have been contained had the superannuation change been considered and implemented first.

2.3.3. PRUDENTIAL SUPERVISION

Australian banks were in a healthy state at the onset of the GFC and weathered it well. No major Australian bank failed during the crisis. During the worst of the liquidity freeze the system needed support from the RBA, as well as Government guarantees of deposits and wholesale debt issuance. However, Australia was one of only two advanced G20 countries (Canada was the other) where the Government did not need to inject capital into the domestic banking system. Just why Australian banks proved so resilient is a complex issue, but it is clear that reform of prudential supervision and its energetic application made a significant contribution.

As the RBA has pointed out, one of the reasons our banks fared better than most during the GFC is that our economy performed better than most.[7] This meant that our banks were not subject to as much stress from loan write-offs.

> Australia — one of only two G20 countries where government did not need to inject capital into banks

Longstanding features of the Australian credit markets also helped strengthen banks' risk profiles. Housing loans in Australia are full recourse, unlike the US, so the system is not open to borrowers posting the keys off to RBA and walking out.

Since 1996 the Uniform Consumer Credit Code has put responsibility on lenders to avoid putting borrowers in a position of overcommitment. Nevertheless, the earlier strength of home lending was hugely profitable for the Australian banks, in turn curbing the need to venture into new markets to sustain healthy earnings growth.

History may also have helped. In the early 1990s recession and associated property correction several Australian banks, including some of the majors, found themselves in difficulty. Banks subsequently adopted a more cautious approach to their balance sheets and non-traditional activities. As the RBA notes, Australian banks were much more circumspect about the use of special purpose vehicles and other devices to transfer operations off balance sheets. No doubt the prudential authorities remained aware of the earlier episode and were also cautious.

The major institutional development in regulatory supervision of the finance sector was the implementation in 1998 of the "twin peaks" approach recommended by the Wallis Inquiry. This included the establishment of a specialist prudential supervisor by amalgamating the Insurance and Superannuation Commission and RBA supervision area of the RBA; and several state regulators to form the Australian Prudential Regulation Authority (APRA). The other peak body was the Australian Securities and Investments Commission (ASIC) with responsibility for market conduct and consumer protection. The failure of HIH Insurance in 2001 was a major embarrassment to APRA and led to the strengthening of its prudential supervision across the board and to increase its resources.

Part of this was the implementation in 2002-03 of bottom-up stress testing of the housing loan portfolios of all Authorised Deposit-taking Institutions with more than $20 million in housing loans outstanding. The stress test included a 30% real reduction in housing prices and a substantial increase in mortgage defaults. The results were comforting in that no institution was judged likely to fail or come close to failing under the scenario. APRA discussed the results with individual institutions to show them where they stood relative to peers.

APRA's second stress test was a joint macro-economic exercise with the IMF, Treasury and the RBA in 2005 and 2006 involving the five largest Australian banks. The scenario included a 30% fall in house prices, a domestic recession with unemployment rising from 5% to 9% and a depreciation of the Australian dollar. The banks showed considerable resilience. Subsequent stress tests have incorporated New Zealand (where Australian banks have significant operations), a global recession (including China) and a large fall in commercial property values in addition to housing.

Through exercises like these, the regulator made sure that it understood the risk positions of the institutions it was supervising and that the institutions themselves did too. To add further to risk controls, APRA took steps to increase capital requirements on riskier types of mortgages in its implementation of Basel II. The risk-weighting for a residential mortgage depends upon its loan to valuation ratio, whether it is standard or non-standard loan and whether there is acceptable mortgage insurance. The concessional risk weight is 35%, while riskier loans are weighted at 50, 75 or 100%.

7 *Edey (2009)*

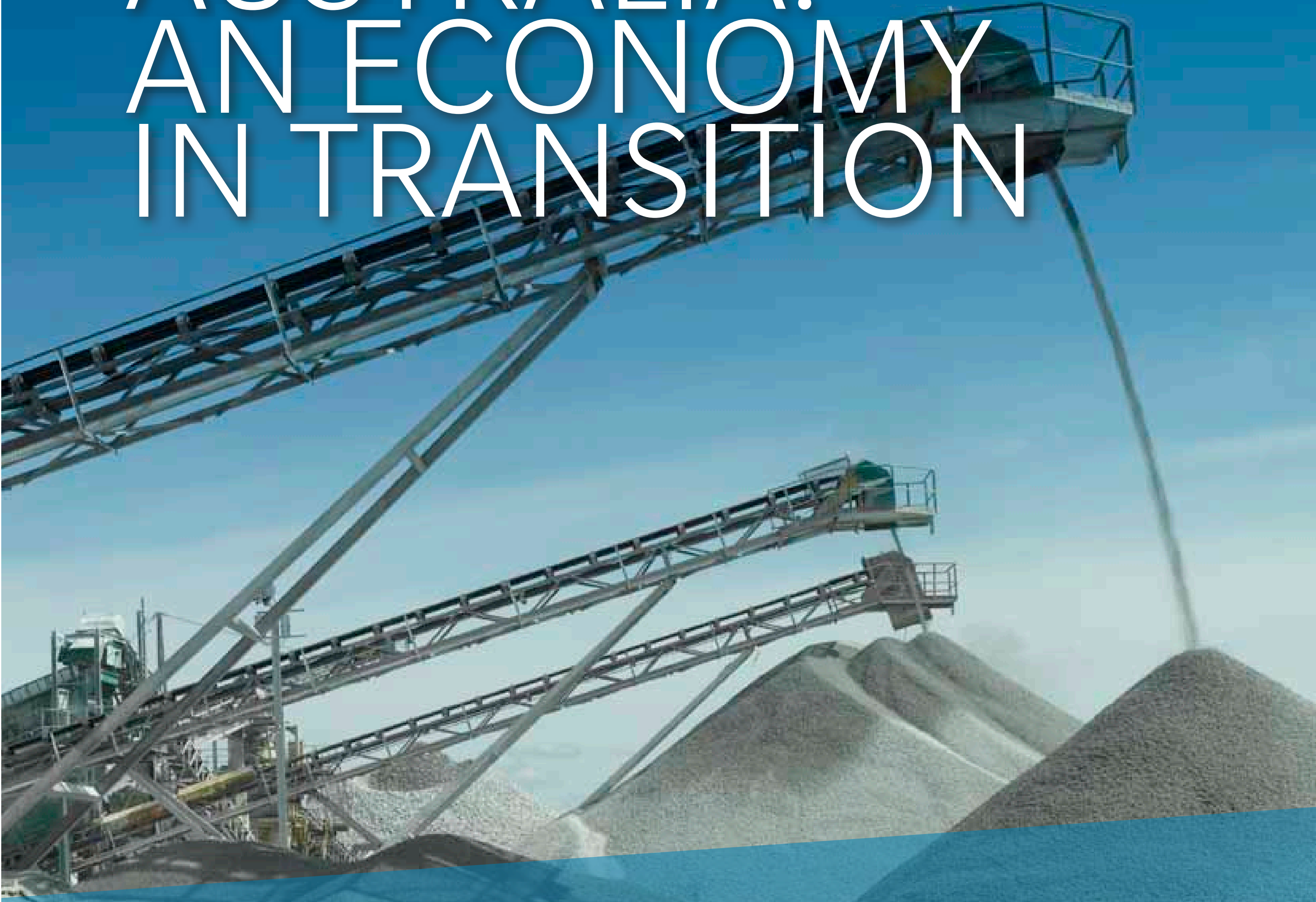
> Deregulation is widely derided as a cause of the GFC

While the Australian banking system may not have had to live through quite as stressed a period as institutions in the North Atlantic countries they certainly withstood testing times very well. As the Australian financial system in the late 1980s grappled with rapid growth and a wealth of new competitors in a deregulated environment some institutions overreached and got into difficulties. The sector learnt some hard lessons from this and by the end of the 1990s prudential regulation had been reshaped to better fit the new environment.

Deregulation is widely derided as a cause of the GFC. Australia's experience suggests that with highly competent and well resourced prudential regulators, it is possible to have the benefits of deregulation without the agony seen elsewhere in the developed world.

> Australia's experience suggests you can have benefits of deregulation without the agony experienced by others

3. AUSTRALIA: AN ECONOMY IN TRANSITION



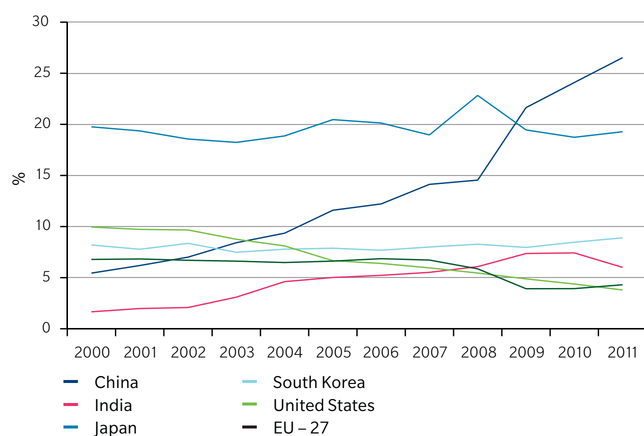
Australia is an economy in transition. In this section of the Report Mercer examines the factors driving this transition — both external (principally Asia's demand for our commodities) and internal (ageing and productivity) — and their impact on the outlook, opportunities and risks for Australia's economy. The section concludes with an exploration of the implications and challenges an economy in transition poses for Australia's policy makers.

3.1. COMMODITY-DRIVEN CHANGES TO THE AUSTRALIAN ECONOMY

3.1.1. ASIAN GROWTH AND THE DEMAND FOR COMMODITIES

A critical factor for the current Australian economy is the rise in the importance of commodities. While commodity exports and mining have always represented a material part of Australia's output, the rapid industrialisation and urbanisation of China, India and a number of other developing economies have resulted in a large increase in demand for Australia's commodities. Australia has been fortunate to find itself with the right raw materials and in the right geographical location.

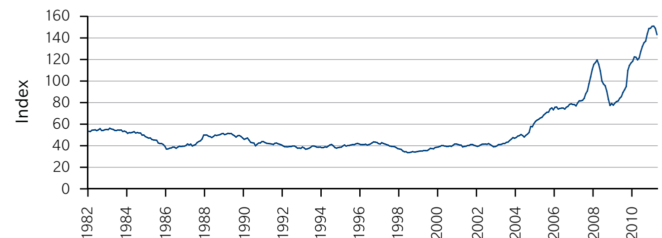
Figure 3.1a
Exports by Destination (Annual, Share of Total)



Source: ABS Catalogue No. 5368.0

Australia's iron ore and coking coal exports have increased as steel production doubled in India and quadrupled in China, as reflected in the trends in export destinations (Figure 3.1a). Emerging Asia's demand for other energy products has similarly increased, resulting also in a significant rise in Australia's thermal coal exports and a pipeline of LNG projects. Indeed, demand has easily outpaced supply across all of Australia's major bulk commodity exports, and consequently prices have risen sharply.

Figure 3.1b
RBA Index of Commodity Prices (SDR, 2008/09=100)



Source: RBA

Mercer believes the increase in Asian demand for natural resources is structural in nature, rather than a business cycle development. Incomes in the developing economies will continue to rise and living standards will continue to improve. The demand for Australia's commodities will therefore also continue to grow.

> Mercer views increased Asian demand for natural resources to be structural in nature

3.1.2. STRUCTURAL CHANGES TO THE AUSTRALIAN ECONOMY

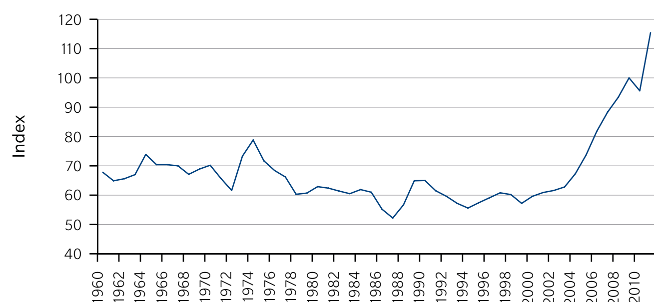
The mining boom is having a significant impact on the Australian economy.

The rise in prices for Australia's key exports — iron ore and coal — has resulted in a sharp rise in Australia's terms of trade. The terms of trade are at 140 year highs and around 85% above their 20th century average.[8]

8 Stevens (2011 a)

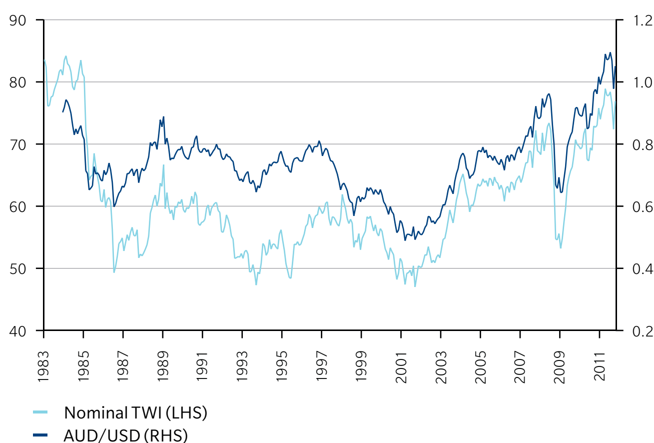
The rise in the terms of trade has in turn resulted in a large boost to Australia's national income and a strong appreciation in the Australian dollar, as illustrated respectively in Figures 3.1c and 3.1d.

Figure 3.1c
Terms of Trade Index



Source: ABS Catalogue No. 5206.0

Figure 3.1d
Australian Exchange Rate

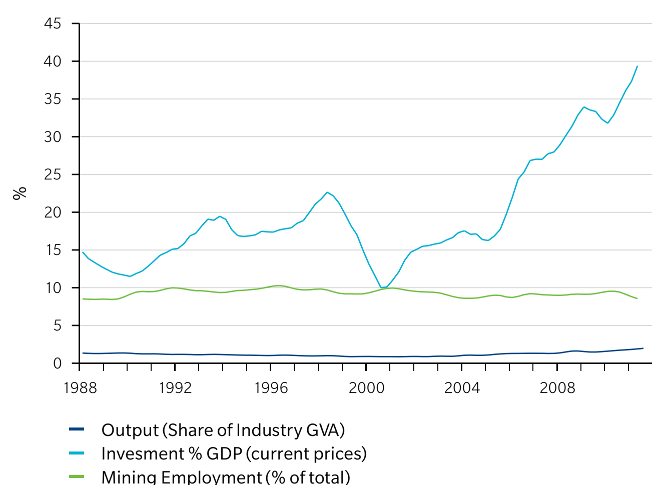


Source: RBA

Australia's mining contribution to national output has risen significantly during the boom. As well as an increase in exports, mining investment has increased sharply in response to the high commodity prices. Capital investment in the mining sector has now risen to about 4% of Australia's GDP compared to its averages of around 2% of GDP over the past 25 years. The RBA estimates this could rise by a further 1 to 2 percentage points over the next couple of years given the large pipeline of projects. New capital expenditure in the mining industry is estimated to be $55.5 billion in 2010–11, 53% more than in 2009–10. ABARES expects a further increase to $73.7 billion in 2011–12.

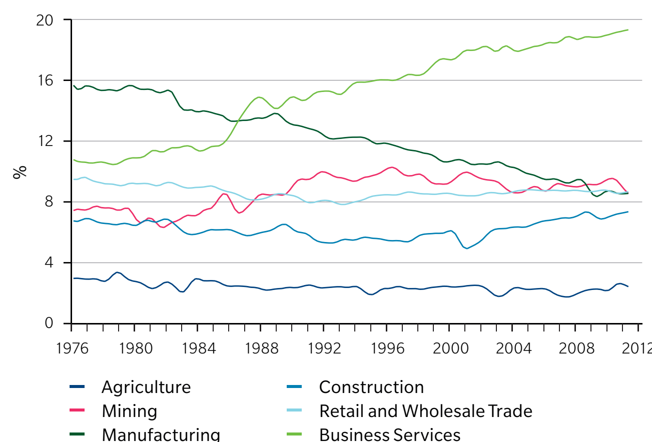
A significant share of the physical investment will be imported and is evident in the rise in the ratio of capital goods imports to private equipment investment. Nonetheless, the RBA believes that a large spend on domestically sourced inputs is also likely.

Figure 3.1e
Mining Sector Activity Share of Total



Source: ABS Catalogue No. 6291.0, 5625.0 & 5206.0

Figure 3.1f
Industry Share of Output (% Real GDP)



Source: ABS Catalogue 5206.0

Mining is capital intensive and despite strong growth in employment during the boom it still only accounts for less than 2% of the Australian workforce as at August 2011, as illustrated in Figure 3.1e. Even so, the resource expansion has had a positive "spill over" to the broader economy:

- To begin with, there has been a significant increase in construction activity associated with mining
- Business services, such as exploration, engineering, accounting and legal services have demonstrably benefitted from the resources boom and associated investment activity
- Mining also creates a need for non labour intermediate inputs. There has been an increased demand for utilities and transport;
- As well as the demand effect, there is an income effect. As further examined in Section 5, Commonwealth Government taxes and state royalties have risen along with mining profits and the volume extracted
- Lastly, profits of the miners are either distributed to shareholders via dividends or retained as earnings. The latter may be used to fund construction, about half of which is filled locally[9]

Of course, not all industries are benefiting from the resources boom. The accompanying appreciation of the Australian dollar has reduced the competitiveness of the tradable, non-resource sectors. This includes import-competing industries, such as manufacturing, education and tourism. Manufacturing peaked in the 1970s and its share of Australia's output and employment has steadily declined, as shown in figure 3.1f. Nevertheless, manufacturing exports continued to grow strongly during the 1990s but more slowly from the turn of the 21st century. Growth in recent years has been particularly weak and the higher Australian dollar is certainly part of the reason for this. Domestic tourism has also suffered with Australians choosing to travel overseas rather than within Australia given the change in relative prices resulting from the higher Australian dollar. The currency has also deterred foreign tourists from visiting Australia.

It is both costly and ineffective to oppose the transformative forces

The booming resource sector has also introduced pressures into the economy. Australia's previous mining booms highlight this and the challenges they create for policy makers. In prior booms, the sharp rise in commodity prices led to a surge in investment and miners paying high prices to attract labour and other inputs. The economy encountered capacity constraints, the pay increases spread to the rest of the economy and inflation resulted. The commodity boom often came to an end with a sharp slowdown in global demand — namely, the stagflation of the 1970s and the global recession of the early 1990s — and miners were left with excess capacity and sharply falling share prices.

Importantly, the economy is now better placed to deal with terms of trade shocks following the reforms of the 1980s and 1990s.

- The floating exchange rate allows the currency to rise and help to disperse inflationary pressures
- Labour markets are now much more flexible than the centralised systems in previous booms that spread the rise in wages to the broader economy
- Fiscal and monetary frameworks are now more soundly based on medium term targets

Policy makers have studied and learned from the previous boom-bust cycles. At the same time, they believe the current situation is very different. Treasury and RBA believe that Asian urbanisation and industrialisation will result in the continuation of strong growth in demand for commodities and that this episode is likely to be much longer lasting than past terms of trade shift. The terms of trade are expected to remain high relative to historical standards for quite some time. Treasury forecasts are for a slow retractment in the terms of trade, falling by 20% over the next 15 years.[10]

The Treasury and RBA seem determined that Australia makes the most of this very different, very large, and likely long-lasting terms of trade shift. They recognise that the economy has to adjust to this persistent change with capital, labour and business focus shifting towards the mining and other sectors that benefit from the boom. With an economy already near full employment, they recognise that the rest of the economy must be slowed down to allow for the very rapid growth occurring in the mining, minerals development and associated infrastructure sectors.

9 *Deloitte Access Economics (forthcoming)*

10 *Commonwealth (2011-12a)*

Restricting the overall growth in the economy to around its trend level of about 3% to 3.5%, manages inflationary pressures and assists in the movement of productive resources from the lagging sectors to where they are most needed.

That adjustment process is seeing a change in the industry make-up of the Australian economy. Job losses and declining investment opportunities in the non-booming, tradable goods and services sectors are needed to free up labour and capital to move into mining and mineral exporting services. We are all very aware that firm closures and relocation of workers is a painful process. However, and perhaps more importantly, it is costly and ineffective to oppose the transformative forces.

Flexible and accommodative immigration policies, in the short to medium term and targeting the desired skills profile, will alleviate the pressures on the wider economy and help manage the "boom".

> Flexible and accommodative immigration policies will alleviate pressure and help manage the "boom"

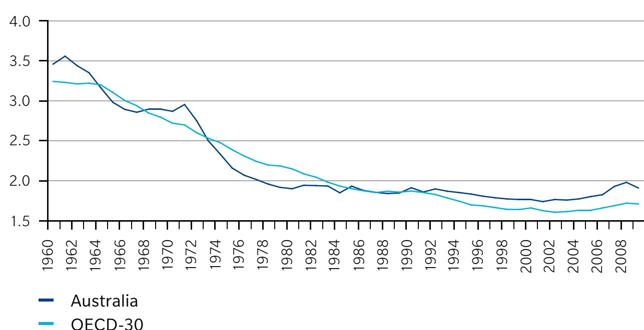
3.2. DEMOGRAPHIC DEVELOPMENTS

3.2.1. AGEING

Like many other developed economies, Australia faces policy challenges as a result of its ageing population. There are three main drivers of the increase in average age of the population.

Firstly, Australians are having fewer children. Figure 3.2a below shows that the fertility rate has been declining since the mid 1960s with the rate dropping below the replacement rate — the rate required to keep the population stable — in the mid 1970s.

Figure 3.2a
Total Fertility Rate for Australia and OECD

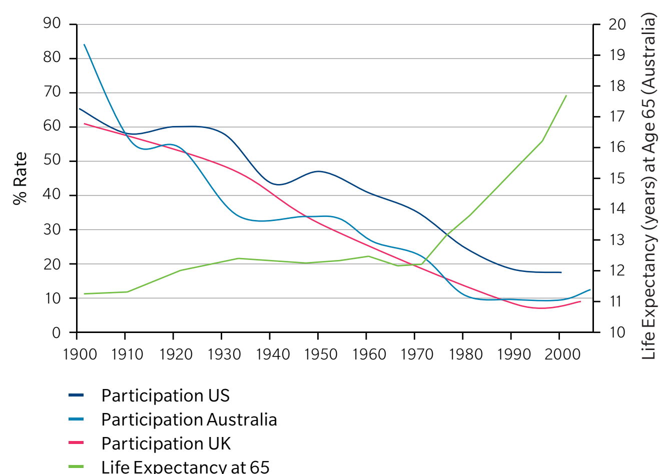


Source ABS 3301.0 Births (2010)

The fertility rate reached a low in 2001 with 1.7 babies per woman; since then there has been an upward trend with the fertility rate falling just short of 2.0 – a 30 year high of 1.96 – in 2008. This recent upward swing in fertility has been attributed to cohorts of women having delayed or foregone having children only to catch up in subsequent years. The increasing age of first time mothers is evidence of this. However, it is also noted that our total fertility rate has been higher than the OECD average since 1990, which is welcome.

Secondly, Australians are living longer. Over the past 150 years, life expectancy has been improving. Initially the greatest gains in expectancy were due to improvements in infant and child mortality. However more recently, life expectancy has had its greatest improvements at older ages, with a pronounced trend from 1970 onwards. This is shown in Figure 3.2b below where male life expectancy has increased steeply from 77 in 1970 to above 82 in 2000. Notably this increase in life expectancy has not been translated to an increase in mature age workforce participation.

Figure 3.2b
Changes in Labour Force Participation in Males Aged 65+ and Life Expectancy at 65



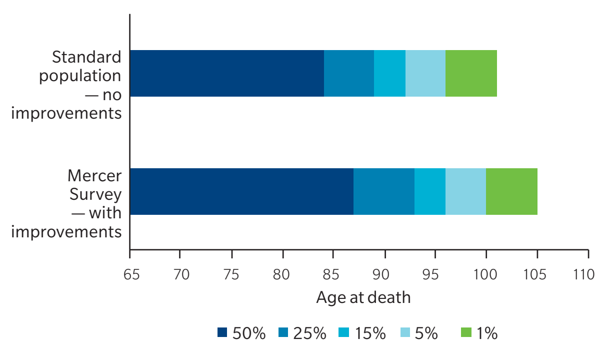
Source: ABS Catalogue 6291.0 and respective national censuses

Thirdly, the population is experiencing the demographic bulge attributed to the baby boom after the post war period. The post war boom produced a large cohort of people that are now starting to retire.

Research on longevity suggests that the ageing trend is likely to continue.[11] The very latest data on improvements in longevity comes from Mercer's public sector pensioner mortality database. While this is only a subset of the Australian population, this database is one of the largest collections of mortality data outside the Australian Bureau of Statistics (ABS) / Census and has the benefit of being updated more frequently.

Estimating the speed with which the Australian population will age depends critically upon the assumptions used for future improvements in mortality. If we assume that the improvements that have occurred over the past 25 years apply in the future (and apply this to the results of Mercer's mortality database), then we can expect outcomes as illustrated in Figure 3.2c below.

Figure 3.2c
Survival Proportions Males Aged 65



Based on standard population data and not allowing for any improvements, 50% of men aged 65 can expect to live to age 84 (with 25% living to 89). However using the Mercer survey data and allowing for mortality improvements observed over the past 25 years, life expectancy figures are much higher with, 50% of men aged 65 can expect to live to age 87 (with 25% living to 93).

Longevity research suggests ageing trend to continue

However, if we apply the even more recent trends in mortality improvement then we see a substantial increase in life expectancy. Under some scenarios a 65 year old man may have a 50% probability of living to 93 and a 25% probability of living to over 100.

Critical to Government spending projections is improvement in life expectancy those aged between 70 and 80 as they require greater support to cover expensive health and aged care needs. These issues are discussed further in Section 5.

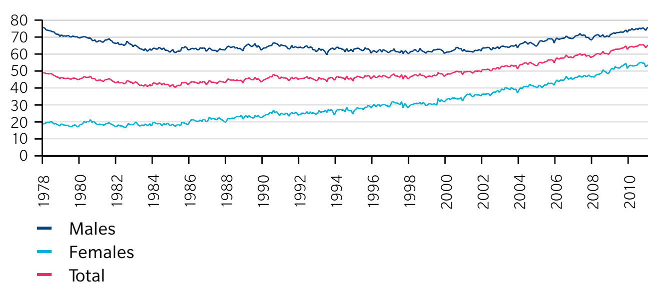
Recent mortality improvements see a substantial lift in life expectancy — critical to future government spending

The impact of the ageing population on the economy is significant for a number of reasons. Slowing growth in labour supply will continue to put pressure on skills shortages in the economy. The Productivity Commission estimated that the number of workers is projected to grow by over one million in the 21 years from 2023-24 to 2044-45. By comparison the number of workers increased by around one million in only five years between 2006 and 2011.[12]

Employers will have to compete for fewer young employees and are likely to realise that retaining and recruiting older workers will be cost effective.

We are already seeing the impact of the increasing number of mature age workers. The graph below illustrates the upward trend in mature age workforce participation.

Figure 3.2d
Participation Rate (%) — Age 55–64



Source: ABS Catalogue 6291.0

11 *In Australia, life expectancy statistics are produced by the ABS in conjunction with the Australian Government Actuary using data collected from Census – providing the official life expectancy forecasts*

12 *ABS (2011)*

Barriers remain to mature age workforce participation

While this trend is likely to reflect the ageing population, there are other contributing factors. Mature age participation is sensitive to economic growth, and a relatively strong economy will encourage participation. Improving health at mature ages also enables workforce participation. In addition:

- Legislative changes have encouraged workforce participation[13]
- Finally, inadequate retirement savings coupled with recent balance volatility delays retirement

The Government has also increased the long term Age Pension eligibility age providing a powerful signal about the expectations of continued workforce participation. Further policy action is warranted and this is addressed in Section 5.

This is an area of ongoing policy development. The BCA has been a participant in the Government's "Consultative Forum on Mature Age Participation". At a state level, the Victorian Government is currently holding an inquiry into the Opportunities for Participation of Victorian Seniors. That said, Mercer considers below the barriers to mature age workforce participation.

Very high numbers of mature age Disability Support Pension recipients result in a reduction in mature age participation in the workforce. In 2001, 30% of all Australians between the ages 55 to 65 were receiving disability support pension. Using updated statistics (including updated methodologies around age bands), in 2010 the proportion of all males aged 60 to 64 on the Disability Support Pension was around 16%. While a decline relative to the earlier period, nevertheless it still represents a very large portion of the population. This still remains a barrier to the extent that it can form an early retirement pathway to Age Pension, reducing the likelihood of ongoing workforce participation. Supporting early intervention and increased support for younger recipients could reduce the reliance on the Disability Support Pension over time. This is further discussed in Section 3.3.4 below on labour market flexibility.

Other obstacles to mature age workforce participation include:

- Pension withdrawal rates and tax combine to create high effective marginal tax rates
- Limited services through Job Service Australia Providers
- Lack of funded care arrangements for disabled partners

Other barriers are workplace based. The BCA's 2008 paper, "Engaging our Potential: A Checklist to Reduce Barriers to Workforce Participation" addressed the issue for the broader population. Further to this Report, Mercer would also identify employer reluctance to hire and retain older workers (based on perceptions about lack of ability), lack of flexibility in the workplace (to permit more flexible working hours), workplace structure built around ongoing forward promotion and recruitment agency bias.

Australia's ageing population remains the dominant longer term structural threat to Australia's economic growth and fiscal position. Clearly a holistic approach is needed to comprehensively address the related issues including employment, pensions, health, housing and aged care. This is further examined in Section 5 of the Report.

In the short term flexible and accommodative immigration policy allows the Government to alleviate the shortage of skilled labour in specific sectors. Given the historic levels of investment in the mining sector this also allows the Government to address skills shortages and provide timely access to skilled labour.

In the medium to longer term, a more accommodating immigration policy is required to support sustainable economic growth. Such a policy stance would alleviate the pressures of an ageing population whilst mitigating in the short to medium term the disparate performances across different sectors of our patchwork economy.

Australia's ageing population remains the dominant structural threat to our long term economic growth and fiscal health

13 Transition to Retirement superannuation arrangements. Changes to Age Pension means test to allow some working income to be exempt from the income test. Increasing age limits for superannuation contributions. Increased age pension age for women.

The Productivity Commission[14] undertook analysis to assess the economic impact of a large increase in Australia's skilled migration policy – modelling the effects of a 50% increase in Australia's skilled immigrant intake. Whilst the modelling made several material simplifying assumptions related to the impacts on environmental, urban and social amenity, it yielded the following results:

- By 2024-2025, real GDP was projected to be around 4% higher than would otherwise have been the case
- Annual average income per head of the population was projected to be $383 higher. Most of this increase derived from increased labour force participation

A well designed and targeted immigration policy over the long term can also have an impact on the Australia's population age profile over the medium to longer term. Net overseas migration (NOM) peaked at 315,700 in the year ending 2008 before declining more recently to 167,100 in the year ending 2011.[15] In contrast, the 2010 Commonwealth IGR assumed NOM of 180,000 per annum over the projection period.

A more accommodating immigration policy would alleviate the pressures of an ageing population whilst mitigating our patchwork economy

The impact on the dependency ratio (a measure of population ageing) can be seen below.[16] Increasing NOM from 0 to 300,000 reduces the dependency ratio in 2045 from 75.3% to 61.2%[16]. This also highlights the sensitivities in the IGR around the assumed level of immigration going forward.

Figure 3.2e
Population Age Structure Projections for 2044-45 with Varied Levels of NOM

Long Term net overseas migration	Proportion of the population aged 65 and over	Proportion of the population aged 14 and under	Total dependency ratio
0	28.1	14.9	75.3
150,000	23.6	16.3	66.3
300,000	20.8	17.1	61.2

Source: Productivity Commission (2005).

14 Productivity Commission (2006)

15 Department of Immigration and Citizenship (2011)

16 Projections assume a base year of 2005. The NOM level is assumed to reach the long-term value after ten years. The total fertility rate is assumed to be 1.8 over the projection period

Mercer acknowledges that the scope for alleviating ageing pressures through immigration alone is limited. A flexible and accommodative immigration policy is however part of a broader suite of policies to mitigate pressures of an ageing population.

3.3. PRODUCTIVITY

Productivity growth is the key driver of output growth over the long run and is particularly important for an economy with an ageing population. In a more immediate way, the impact of slowing productivity is most obvious when the terms of trade peaks and the economy loses the windfall of income rising faster than output growth.

Below productivity measures are defined and Australia's disappointing productivity performance over the past decade is outlined. There is also some discussion as to the possible reasons for that decline. The role that policy can play in promoting productivity enhancements is discussed, and Mercer provides details on the need for infrastructure investment and flexibility in the labour market.

Australia's productivity performance over the past decade has been poor — with mining, utilities and agriculture the major detractors

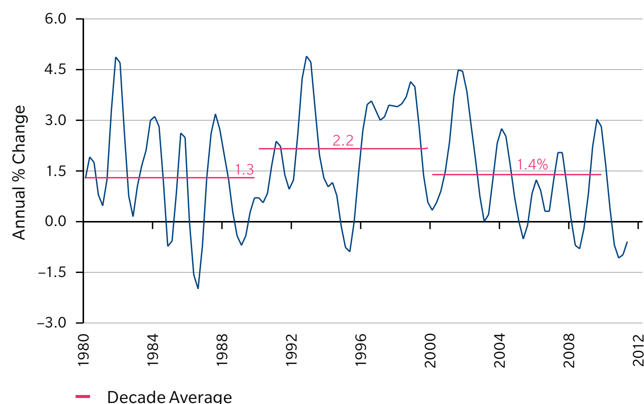
3.3.1. DECLINING PRODUCTIVITY

Productivity represents the efficiency with which an economy transforms inputs, such as labour, capital and raw materials, into outputs. The two main measures are labour productivity (output per hours worked) and multi-factor productivity (MFP or output per unit of labour and capital). The latter is a better measure of efficiency in the sense that it controls for increases in output associated with capital deepening. MFP reflects technological changes, economies of scale and cyclical effects.

Australia's productivity growth over the past decade has been poor, as highlighted in Figure 3.3a. This followed strong growth in the mid to late1990s, which has been empirically linked to the economic reforms of the 1980s and 1990s. The forthcoming Deloitte Access Economics report to the BCA shows that Australia's total factor productivity growth peaked in 2003–04 and that, on average, productivity growth has made a falling contribution to Australia's economic growth since 2001–02.[17] There are a number of possible explanations for the recent weakness in productivity performance.

17 Deloitte Access Economics (forthcoming)

Figure 3.3a
GDP per Hour-Worked



Source: ABS Catalogue 5206.0

Industry level analysis of MFP shows that three sectors — mining, utilities (electricity, gas and water) and agriculture — have significantly contributed to the deterioration in national productivity growth.

The fall in mining productivity is to be expected. Australia is in the construction stage of a mining boom and there are considerable lags between investment and production. In this sense, the increase in inputs should eventually be reflected in an increase in outputs. But resource depletion has also played a role and may act as a more persistent drag on productivity growth. High commodity prices mean that lower quality mineral yields have become economically viable to be mined. Productivity measures do not control for the quality of inputs and therefore fall, while income and profits rise.

There has also been a trend decline in the productivity growth of the electricity, gas and water sector. This followed substantial gains in the 1990s associated with the National Competition Policy's reforms of the State Governments. This decline has been attributed to large scale investment over the past decade.[18] Heavy investment in electricity and gas responded to the continued growth in demand, the need to replace ageing infrastructure, and the need to satisfy renewable energy targets. There has also been considerable investment in water infrastructure, including the building of desalination plants to cope with drought. The investment coincided with restrictions during the drought on water usage (i.e. output) so a decline in productivity is far from surprising. Lastly, according to Treasury (2008), agricultural MFP had fallen at an average annual rate of around 1% from 2000.

The weakness in agriculture is attributed to the drought during this period.

The fall in mining productivity is to be expected

It seems that a good part of the declines in productivity in these sectors were unavoidable. Estimates of their impact on aggregate productivity growth vary. They may account for as much as half of the decline in productivity growth over the past decade.[19] What is clear is that the "unavoidable" declines are not the only reason for the overall decline in productivity growth in the 2000s and that there is considerable scope for improvement.

It is fair to say that there have been few policy reforms introduced over the last decade that would likely facilitate marked improvements in productivity. Arguably the "low hanging fruit" had been picked in the 1980s and 1990s, aided by a political environment that was more conducive to reform. The recessions of the early 1980s and 1990s provided the political will and electoral preparedness for the discomfort that major reforms bring. There is a tendency to rest on one's laurels during the good times. This may have been the case for Australia over the last decade.

There are signs that the environment is becoming more conducive to reform. Policy makers appear to be making a concerted effort to raise public awareness of the decline in productivity and its implications for Australia's growth and living standards. They are careful to explain that over the long run productivity growth is the key determinant of living standards. A public of cautious consumers, which is coping with the "patchwork" economy, pronounced global economic uncertainty and market volatility, may be ready to accept changes, particularly if they are seen as bringing more economic stability.

The "unavoidable" declines are not the only reasons for the decline in productivity growth in the 2000s

18 Eslake (2011)

19 Productivity Commission (2008)

3.3.2. PUBLIC POLICY OBJECTIVES AND PRODUCTIVITY GROWTH

Ultimately productivity improvements come from decisions and actions by business and workplaces. Governments' role in this context is to provide a sound framework to facilitate productivity enhancing decisions.

Macroeconomic stability is one of the best ways that governments can enhance productivity growth. Stability increases the level of certainty for individuals and firms and the medium term targets of the RBA and Treasury help provide that outcome. Providing a microeconomic framework that encourages competition can also facilitate private sector decisions that efficiently allocate resources. Again, the deregulation of product and labour markets during the 1980s and 1990s increased competition and improved productivity.

It is particularly important for policy to provide an environment that facilitates smooth adjustments for an economy undergoing the sort of structural change — transition — that Australia currently is undergoing. Public policy can facilitate labour market flexibility so that some workers can more easily relocate to high growth sectors and regions. A national approach can help to ensure there is world class infrastructure, removing the bottlenecks currently affecting high growth areas. Infrastructure investment and labour market policy are covered in the following sections. Tax policy and regulation are other areas where governments can decisively influence productivity. These four — tax policy, labour market flexibility, infrastructure delivery and better regulation — are identified as the "four policy pillars" that underlie productivity.[20]

Tax and regulation are outside the scope this Report. Mercer notes the BCA's submission to the Australian Government's 2011 tax forum, which recommends a 10-year plan for comprehensive reforms to Australia's tax system.[21] Further, Deloitte's productivity report to the BCA focuses on the effect of regulation on productivity.[22] Below the remaining two contributors, infrastructure and labour market mobility, are discussed.

20 Bradley (2011)

21 Business Council of Australia (2011)

22 Deloitte Access Economics (forthcoming)

> Labour market flexibility — integral to improving Australia's productivity

3.3.3. INFRASTRUCTURE

Economic infrastructure is an important driver of competitiveness and contributes to economic growth by increasing productivity.

The infrastructure requirements of OECD countries and larger non-OECD countries, like China, India and Brazil, are growing. This is largely a function of economic growth, a general underinvestment in the past and new challenges such as climate change.[23] In terms of the outlook, the OECD estimates the global annual infrastructure requirement[24] to be 3.5% of world GDP, translating to USD2 trillion p.a.[25]

There has been much commentary on the purported under spend on infrastructure in Australia. A recent report by the Grattan Institute argued that a lack of infrastructure spending has detracted from Australia's productivity performance.[26]

Over the last few decades, in OECD countries, as the share of government investment in infrastructure has declined, the private sector share has increased. Over this period, the OECD average ratio of capital spent on fixed investment (primarily infrastructure) to GDP fell from above 4% in 1980 to 3% in 2005, reflecting a fall in public capital investment.[27]

Over the last 30 years, Australia's investment in infrastructure related industries has been largely correlated with population growth. Australian infrastructure spending has trended upwards over the last decade, increasing from 4.1% of GDP in 2000-01 to almost 6.0% in 2008-09 and declining more recently. The infrastructure project pipeline has also skewed towards much larger projects. Section 4 of this Report provides a detailed explanation of infrastructure investment and the role governments do and should play.

23 OECD (2011), p28

24 Infrastructure defined as electricity transmission and distribution, road and rail transport and telecommunications and water

25 OECD (2007)

26 Eslake and Welch (2011)

27 OECD (2011), p16

3.3.4. LABOUR MARKET FLEXIBILITY

Flexibility in the labour market is integral to improving productivity. This includes flexible and responsive education and training programmes to ensure we have the right skills to meet future job opportunities. We know that individuals respond to wage signals; the education and training institutions in turn need to respond to changes in demand.

Labour market rigidity and skills shortages are ongoing problems that have become more critical with the need for structural change as the Australian economy works through economic transition. The immediate challenge we face is dealing with the increase in demand for labour in the resources and construction sectors that comes with the mining boom. Labour and skill shortages potentially endanger the pipeline of resource and infrastructure projects. Displaced workers from lagging industries are to be encouraged to move to the faster growing sectors of the economy. Training will be required — city workers will not have the skills for the construction phase of mining and minerals processing or for infrastructure development. Lagging industries or those more exposed to international competitiveness (e.g. airlines) need a labour market that facilitates transition.

> A lagging and trade exposed sectors need a labour market that facilitates, not fights, transition

Opportunities for Australian workers must be maximised but, in the short term, skilled overseas workers are needed to address labour shortages. Immigration policy must allow the flow of temporary skilled workers in these circumstances. Skilled migration under Section 457 visas is helping to alleviate some of the pressure and needs to be maintained. As at June 2010–11 there were over 72,000 skilled migration visa holders. Applications in the calendar year strengthened again following a slowdown during the GFC. The Enterprise Migration Scheme has recently been introduced to cater for big resource and associated infrastructure projects. These are negotiated by the Government and each company on a case by case basis. Eligible projects are restricted to those with a peak workforce of more than 1500 workers and capital expenditure of more than $2 billion. The applicant also needs to show that local labour sources are insufficient and make commitments to invest in the training and up-skilling of Australian workers. If granted, the scheme covers the duration of the project and individual visas are fast tracked. Mercer believes that the minimum project size and workforce do constrain its relevance and hence should be lowered to cover a wider section of the economy. Furthermore, access to Section 457 visas remains essential in increasing both the absolute level of immigration and targeting the specific immigration skills profile needed.

Labour mobility between Australia's states and territories is also essential during the transition and any barriers stopping workers from moving between regions need to be removed. Licensing of occupations is a State and Territory function falling outside of the Commonwealth's constitutional power. Licensees in one jurisdiction were required to apply for a licence to work in another region. While these applicants were not required to undergo a skills assessment (by virtue of the Mutual Recognition Act, 1992), the process was hindered by inconsistencies between the State and Territory systems. The prospect of multiple license fees and dealing with overlapping and inconsistent regulations deterred trades people and technicians from working in multiple jurisdictions.

To address this and allow for a more mobile workforce, the Council of Australian Governments (COAG) agreed to introduce a national occupational licensing system. The objective of the new system is to provide a single national licence, which enables the holder to work anywhere in Australia, making it easier to deal with skills shortages. The national licensing system is being introduced in phases.[28] A new national licensing authority has been created to deal with policy and maintain a public register of licensees. The existing regulatory authorities will continue to deal with operational matters such as issuing licenses.

> Labour market rigidity and skills shortages are now more critical and endanger the investment projects pipeline

The national licensing system is an improvement but it has failed to achieve national coverage. The ACT and, surprisingly, given its relative skills shortages, Western Australia have not passed the relevant law and remain outside the national system. Deloitte Access Economics also rightly expresses the concern that the reforms do not simplify the regulatory framework but impose an additional regulatory layer — creating a national regulator but delegating authority to the existing bodies.[29]

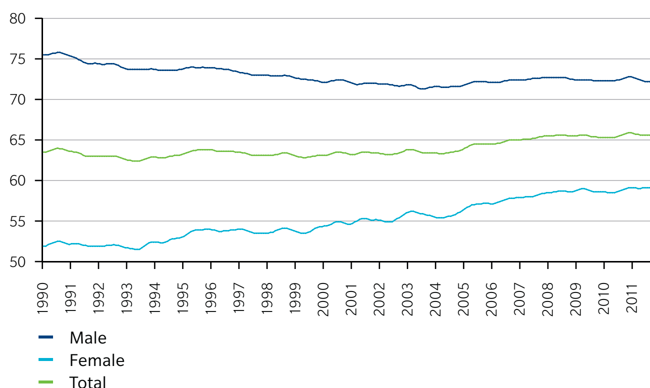
28 *Plumbers, gas-fitters, property agents and refrigeration and air-conditioning mechanics will be the first occupations to move to the national system in mid 2012, followed by builders, conveyancers and valuers, land transport and maritime occupations in mid 2013.*

29 *Deloitte Access Economics (forthcoming)*

Skilled migration remains constrained

There are also opportunities to build on the steady rise in Australia's workforce participation rates since the 1990s. As Figure 3.3b shows the increase in Australian labour force participation has been driven by higher participation by females. Australia's participation rates still trail other developed economies for a number of groups and scope remains for improvement.

Figure 3.3b
Labour Force Participation Rates



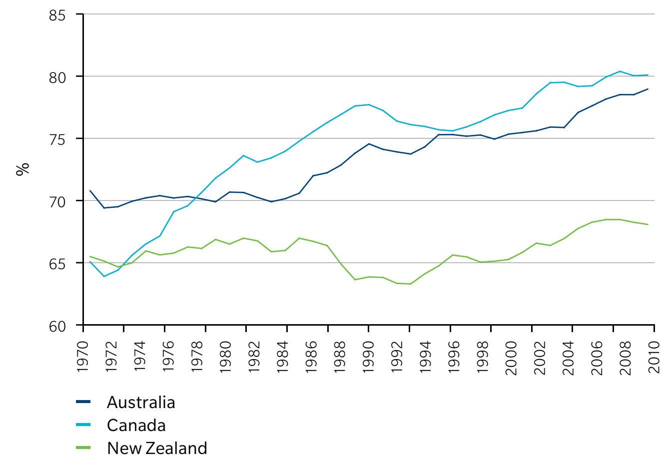
Source: ABS Cat. No. 6202.0

- Australia's Disability Support Pension is likely to discourage labour participation, contributing to Australia's lower participation rates for prime-aged males (25–54 years old).[30] Steps could be taken to review and potentially tighten eligibility and encourage recipients to seek employment, as well as improve their employment prospects
- Participation rates of females of child-bearing age (25–44 years old) are also low relative to other OECD countries. Policies have already been introduced to increase child care support and a paid parental leave scheme was introduced in 2011. The financial disincentives of working are also being addressed, including increasing the Low Income Tax Offset and removal of the Dependent Spouse Tax Offset
- Participation rates of Australian's near retirement age (55–64 years old) are also low when compared to some developed countries. Tax rates and the Disability Support Pension are again likely to be acting as a disincentive as discussed in section 3.2.1 above

30 IMF (2011)

The IMF notes that tax and transfer reforms have enhanced work incentives and raised labour force participation in Canada and New Zealand and sees scope for similar improvements in Australia.[31] These issues are further examined in Section 5 of the Report when the focus is on intergenerational equity and Australia's widening fiscal gap.

Figure 3.3c
Labour Force Participation



Source: OECD: Economic Outlook 89 — June 2011

3.4. AUSTRALIA'S ECONOMIC OUTLOOK

The structural shifts in the Australian economy must be considered alongside the broader cyclical outlook. The past few years, notable for the worst global financial crisis since the Great Depression have been turbulent for Australia and other world economies. And in early 2012 the outlook appears clouded once more. Despite the factors behind Australia's success in navigating through the GFC, described in some detail in Section 2, there is no guarantee of a similar performance in the event of renewed global financial stress and recession.

3.4.1. FORECASTS FOR AUSTRALIA AND THE WORLD ECONOMIES

The deteriorating economic outlook is firmly anchored in the European Union and the United States. The cause of much weaker growth for both regions has been government and market responses to unsustainable public sector deficits and debt levels.

31 IMF (2011)

The IMF forecast economic growth of below 2.0% in both regions in both years, foreshadowing renewed rises in unemployment. In late 2011 large parts of peripheral Europe appear to already have slipped back into recession.

As has been the case since early 2010 with previous efforts to contain the sovereign debt crisis, originally emanating from Greece in late 2009, further intensification of contagion pressures continues. Bond yields in Italy, the third largest member of the European Monetary Union, subsequently rose to over 7.0% jeopardising Italy's efforts to stabilise government debt.

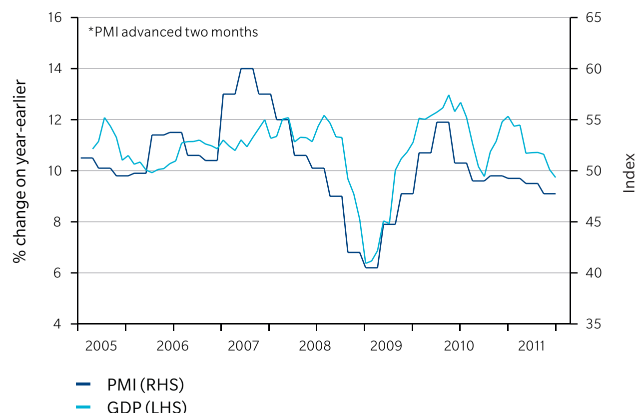
Despite in principle agreement to expand the European Financial Stability Facility, widespread scepticism remains over the capacity of the fund to provide adequate refinancing support. Markets are likely to continue to discount for some time the risk of a disorderly fragmentation.

Fiscal austerity and the preclusion of a significant exchange rate adjustment (in the context of a global slowdown) mean that the floor to the downturn requires a credible stabilisation plan, which ring-fences the problems to peripheral Eurozone nations. A roadmap towards stronger fiscal union also needs to be agreed.

Fiscal consolidation was also a source of the sharp slowdown in the US in early 2011, along with the impact of the Japanese tsunami. The US economy is in somewhat better shape than its European counterparts. In the US, GDP growth strengthened moderately in the second half of 2011, but remains weak. Fiscal policy has acted as a major drag on US growth in the first half of 2011 and will continue to do so in 2012. The US recovery is in a fragile state and there are fears that GDP growth may slump again. Indeed, various leading indicators continue to send mixed signals, and consensus forecasts continue to imply a significant probability (30%–50%) of the US returning to recession in early 2012. Despite the projected fiscal consolidation in 2012, and with new measures to be implemented from 2013, it is still unclear whether US public finances are moving to a more sustainable footing.

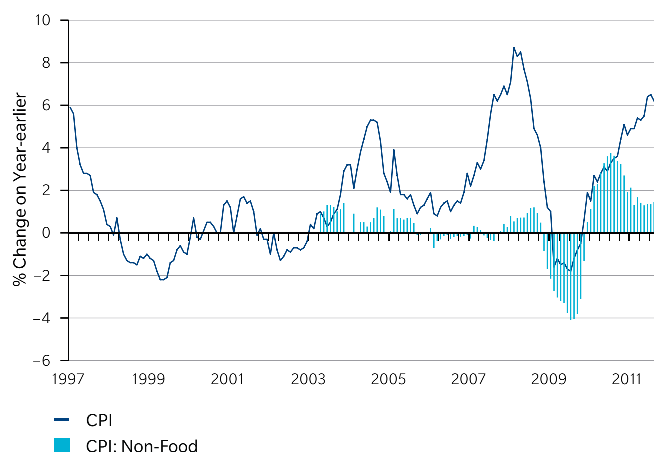
In contrast, inflation pressure remains the key policy challenge in China and most other large developing economies.

Figure 3.4a
China — Manufacturing PMI* and GDP



Source: DataStream and Consensus Economics.

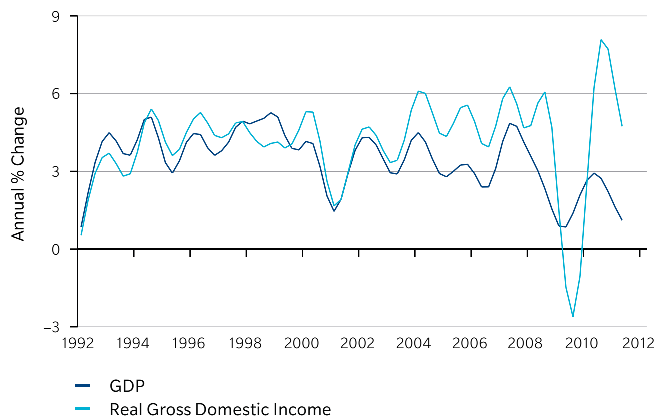
Figure 3.4b
China: Consumer Price Inflation



Source: DataStream

It is accepted that the fate of the global economy rests to some extent on the prosperity of China. While Chinese growth has moderated, economic growth remains strong, with the most recent reading at 9.1% and expected to slow to 8.5% in 2012 (the slowest in over a decade). Inflation pressures have proved somewhat stubborn, and remain the key policy challenge. Nevertheless it is expected China's authorities will soon embark on a process of policy easing. While it seems likely China's growth will continue to ease into 2012, and the new 5-year plan is targeting lower growth than in the past decade, China is expected to remain the major source of global growth over the next few years.

Figure 3.4c
Australia: Domestic Production and Real Income



Source: ABS Catalogue 5206.0

Correspondingly, the otherwise positive medium-term outlook for Australian growth dimmed over 2011. Rebounding rural and minerals production, following the floods, coupled with surging resources investment, have continued to deliver. However, the strength of the exchange rate is taking an increasing toll on non-commodity-related sectors of the economy.

Consensus growth forecasts for Australia for 2012 stood at 3.25% (in November 2011), down from 4.0% only several months earlier. It remains unclear whether this process of downward revisions has concluded.

The household sector now faces the prospect of slowing employment growth and continued large price rises for certain non-discretionary expenditures, most notably electricity, gas and water. The prospective weakening in household income growth will continue to lean against a renewed upswing in residential investment, which essentially has been flat over the past year.

At this point, there is little reason to doubt the pipeline of committed resource development projects, other than the potential for various capacity constraints to delay work in progress. Conversely, and more disconcertingly, however, it is clear the strength of the exchange rate has taken a large toll on other trade-exposed (and even traditionally trade-sheltered) sectors of the economy.

Purported loss of market share has been accompanied by a growing (although erroneous) impression of consumers under financial distress. Nevertheless it appears households may confront a much more uncomfortable squeeze. Following the more recent sharp deterioration in business confidence, labour demand is likely to moderate further over the remainder of 2011 and into 2012. At the same time, however, this would likely allow the RBA to consider bringing monetary policy back to a more neutral level.

3.4.2. ALTERNATIVE ECONOMIC SCENARIOS

Mercer's central economic outlook over the medium-term is for below-trend growth in Europe and the US and material risk of renewed recession in some countries. While a prolonged period of weak growth in the North Atlantic is unlikely to leave emerging Asia and Australia unscathed, counter-cyclical policy action could be expected to cushion any ensuing downturn. In both Australia and emerging Asia, Government and other public policy makers have the flexibility to use both monetary and fiscal policy to support their economies.

> Mercer's medium term economic outlook — below-trend growth in the US and Europe, with material risk of renewed recession in some countries

It is clear both emerging Asia and Australia would struggle to avoid a more significant downturn in the event the weakening in global growth was accompanied by a renewed financial crisis, possibly emanating out of Europe. IMF modelling of this scenario estimates that China's GDP growth would be 3% less than the baseline forecast over one year and nearly 4% less over two years. The Australian economy would be next hardest hit given its exposure to a sharp fall in the demand for and prices of commodities. From the IMF's baseline forecasts of 1.8% growth in 2011 and 3.3% growth in 2012, Australia's GDP growth would fall more than 2 percentage points over one year and more than 3 percentage points over 2 years. Note that the IMF's modelling does not account for policy responses, which played a very important role in limiting the impact of the GFC on the region. While Australia has scope for monetary policy easing, any fiscal policy stimulus is likely to be more constrained. China's policy response may also be more restrained, subject to the outlook for inflation.

There is also a risk that a deeper emerging market slowdown could result from domestic macro-economic policy errors, independent of the outlook for advanced economies. Rapid economic and income growth in the developing world since 2009 has been accompanied by a steady strengthening in commodities prices and domestic inflationary pressures. Overheating has been further compounded in a number of developing economies by the slow withdrawal of fiscal stimulus implemented at the depths of the GFC. Despite the more recent evidence of slower growth in many larger emerging regions, including China, however, inflation pressures remain stubborn (reflecting the contribution of food and other commodities prices). With central banks reluctant to ease policy, there are now growing fears in some economies of significant declines in housing and other asset prices, and pressures on excessively leveraged balance sheets.

In China, this process could be compounded by banking system difficulties, where heavily indebted State Owned Enterprises and local governments are clearly vulnerable to significant declines in commercial property prices. Some commentators suggest that the household sector could also add to banking system problems, as the "bubble" in housing prices succumbs to over-building. A "hard landing" in China – i.e. growth of 6% or less - would have a significant impact on commodity prices and Australia's export volumes. In past episodes of excessive tightening, however, China has been able to react quite quickly, especially in generating a recovery in investment.

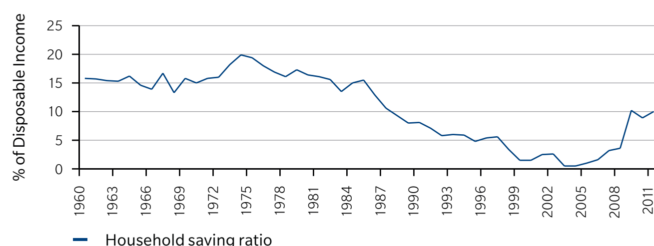
3.4.3. AUSTRALIA'S CAUTIOUS CONSUMER SECTOR

The cautious approach Australian consumers have adopted in the post GFC environment, has complicated the jobs of policy makers in the past few years.

Uncertainty and risk aversion is reflected in consumer sentiment in Australia which has been subject to a stream of negative headlines from offshore, including the European sovereign debt crisis, the US debt ceiling standoff, the general deterioration in the global growth outlook, fears of a hard landing in China, and the accompanying extreme volatility in financial markets. News of local job losses in manufacturing and service sectors have further detracted from confidence.

Australian households feel they are "doing it hard" despite strong income growth, low unemployment and inflation generally within the target range. This is not purely due to the negative news flow. There have been very visible price increases for water, electricity and gas as well as petrol. Wealth effects are also weighing on consumer sentiment. While there hasn't been a substantial fall in house prices, there has been a substantial moderation from the rapid increases that occurred between 1995 and 2005, coupled with downward volatility in superannuation balances.[32]

Figure 3.4d
Household Saving Ratio



Source: ABS Catalogue No. 5204.0

With real consumption flat over the past few years and disposable income growing with the terms of trade boom, household saving rates have increased significantly as illustrated in Figure 3.4d. The current saving rate is thought by policy makers to be closer to "normal" than that recorded in the 10 year period that preceded the GFC. The boom of the mid 1990s to mid 2000s was considered a one off, where the Australian economy adjusted to lower inflation and the easy access to credit, resulting in households becoming more confident about taking on large loans. The situation was unsustainable as spending rose faster than income. With the onset of the GFC — which centred on housing and excessive debt and resulted in sharp falls in house prices offshore — Australian households became more cautious and local property prices eased.

Australia's "cautious consumers" complicate the policy making task

32 *Stevens (2011b)*

Household saving seems to have stabilised at around 10% of household disposable income. If this continues, consumption should pick-up and grow at the same rate as income.

The drivers of household saving are further examined in Section 4 of this Report.

3.5. POLICY CHALLENGES

Given the structural changes occurring in the Australian economy — namely an increase in the exposure to the resources sector, an ageing population, slowing productivity growth – what response is required from public policymakers?

3.5.1. PERSISTENCE OF HIGHER TERMS OF TRADE

Given Mercer's expectation for continued commodity intensive growth in Asia, are we entering the second leg of a commodity super cycle?

The run up in commodity prices before the GFC simply resulted from demand growing faster than new supply. Speculation may have impacted at the margin but the sheer weight of emerging Asia's demand for resources was the main driver. This view is supported by the relatively quick return of commodity prices to their peaks after the crisis.

Mercer believes that scale and capital requirements were the major reasons why the supply response to growing demand was so slow at the turn of the century. Australia's key exports, iron ore and coal, are not scarce resources, although quality and accessibility vary. Producing and shipping them requires scale and massive capital spending. Gas is also an abundant resource which is becoming even more so as a result of technological advances in recovery techniques. However, the scale issues in extracting, processing and shipping gas are even greater than for coal and iron ore. Gas, in all its forms, has also faced more regulatory uncertainties and delays. For producers to commit to the capital spending, commodity prices needed to rise and producers needed to become confident that the increase in demand was likely to last.

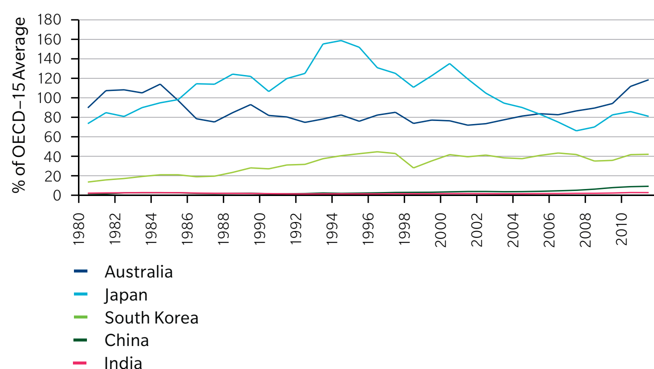
High prices and record profits gave producers that confidence, which is clearly evident in their capital expenditure programs. As current projects come on line over the next three to five years, Mercer expects supply will grow faster than demand, putting downward pressure on prices. But demand will still be growing (especially if the developed economy recovery gathers some strength) which should cushion any price fall. This means that Mercer expects Australia's terms of trade will remain elevated relative to historical levels. Low cost producers that take maximum advantage of scale economies are likely to remain very profitable.

Naturally there are risks to the Mercer view. Medium term risks to our assessment include:

- China and India transitioning to a more moderate growth path far sooner than expected
- Significant overinvestment resulting in greater than expected falls in commodity prices
- Government controls on carbon emissions significantly detracting from demand for our key commodities

The first factor relates to the period of high, commodity-intensive growth experienced when developing economies "catch up" to advanced economies. It is widely accepted that China and India have a number of years — perhaps even decades of such growth ahead of them. Despite improving in recent years, their current standard of living as measured by GDP per capita remains far below that of advanced economies. Urbanisation levels also remain below those of advanced economies. There is a risk, however, that the recent episode is more cyclical than structural and that the economies shift to a more moderate growth path much sooner than expected. In the event their growth to slows to, say 5-6% within the next few years, growth in commodity demand would fall markedly. Given that both countries are major producers of coal and iron ore as well as consumers, their imports (i.e. Australia's exports) would bear the weight of the reduced demand. Mercer considers this unlikely, but it is a risk worth noting.

Figure 3.5a
GDP per Capita



Source: International Monetary Fund, World Economic Outlook Database, September 2011

The second factor — over-exuberant investment by producers in response to high prices - is part of every commodity boom-bust cycle. It is certainly possible that the private sector extrapolates current prices too far into the future and significantly over-invests. This could even be the case if the demand from Asia remains strong as we expect.

The third factor relates to Government measures to control for carbon emissions. Government regulation always presents a risk but Mercer does not believe this will significantly impact Australia's key commodity markets over the longer term. Asian urbanisation will continue. In most of its uses there is no commercially practical substitute for steel. That creates a degree of certainty about future demand for iron ore and coking coal, our two largest exports.

There are alternatives to steaming coal — sustainable options for electricity (hydro, wind, solar, geothermal) and gas. At this point, however, coal has a considerable price advantage. It is difficult to see how growing world energy demand can be met without further growth in coal generation capacity. More efficient use of better quality coal and progress with carbon capture technology may be the way the world tackles this issue.

Gas can make a significant contribution to lower greenhouse impacts because of its greater efficiency as a fuel relative to coal. Currently gas projects do not generally proceed unless future prices and quantities have been agreed with buyers. The prices required to make projects viable restrict the attraction of gas for electricity generation. Carbon taxes might change this balance over time, creating an additional opportunity for Australia's LNG industry.

Mercer expects Australia's terms of trade will remain elevated relative to historical levels — but there are risks to this view

To conclude, Mercer believes that the terms of trade will remain high relative to its historical average but there are risks to this view. We have noted that there is a huge supply response underway, especially in coal (both thermal and coking) and iron ore. This is likely to come onto the market a bit more slowly than planned as labour and other resource constraints are encountered. As it does come on stream, however, supply will start to grow faster than demand and prices will tend to slide. Mercer believes that miners have already got their most attractive projects under way or at least in the development pipeline. After the massive surge in investment is completed they will have to move on to lower quality and/or less accessible projects. With price weakness they are unlikely to take these projects on at the quickstep speed we are seeing now. In the meantime, demand from China, India and other developing countries will still be growing. By this stage developed world economies should also be showing some recovery. This should be enough for prices to firm or at least stabilise.

To summarise, Mercer expects price falls over the next five years to be greater than that implied in Treasury's long-term assumption of a 20% decline in the terms of trade, but acknowledging this may be sensitive to construction delays. Prices will then recover somewhat and perhaps end the 15 year forecast period at around the level suggested by Treasury.

3.5.2. THE "COMMODITY CURSE" AND "DUTCH DISEASE"

The expectation that the current demand-supply imbalance will be addressed over the medium term as supply comes online, has been set out, although commodity prices are likely to remain elevated relative to their historical levels. Mercer expects Australia to continue to be a large exporter of iron ore, coal and gas and that mining investment will continue to significantly contribute to Australia's national output.

Natural resource endowments bring with them material benefits in the form of higher incomes. Yet there is a strain of thinking among some economists that there is some sort of "commodity curse". This stems from the observation that countries rich in non renewable resources on average tend to have lower economic growth and income levels than countries that are commodity poor. Upon closer inspection, that statistical relationship is fairly weak and is driven by the failure of developing countries to manage commodity wealth properly; for example with despotic leaders, armed conflicts and weak property rights being common problems. Such considerations do not apply to advanced countries rich in resources, such as Australia, Canada and Norway.

At the same time, advanced economies face some challenges common to other commodity-based economies. "Dutch disease" was a term coined by The Economist in 1977, when referring to the decline in the Netherlands' manufacturing sector after the discovery of large natural gas deposits in the North Sea. The Dutch guilder significantly appreciated and non resource exports suffered a loss of competitiveness. This concept was modelled to show the loss of competitiveness of an economy's non-booming tradable sector's exports, as well as the movement of capital and labour into the booming sector and non-tradable sectors (e.g. services) at the expense of the lagging sectors.[33]

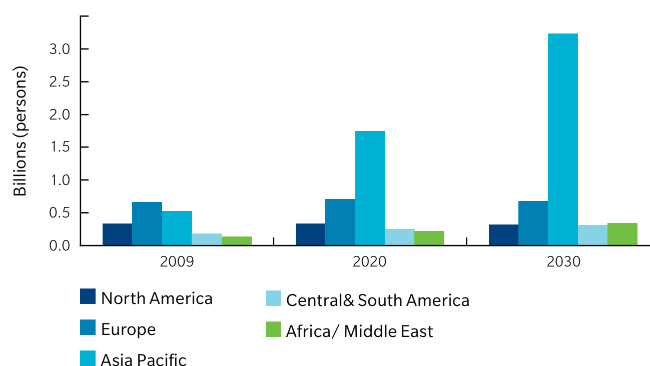
> Resource boom is a blessing, not a curse, but needs to be carefully managed

It is clear from section 3.1 that the Australian economy has experienced symptoms common to the "Dutch disease" during the course of the mineral resources boom. Our real exchange rate has strengthened thereby reducing the competitiveness of non-mining exports and import competing industries such as manufacturing. Capital and labour have moved to the booming mining sector and there has been strong growth in the services sector. As section 3.5.4 sets out, these changes are symptomatic of the structural change associated with the commodity boom. The resource boom is a blessing rather than a curse but one which needs to be carefully managed.

3.5.3. OPPORTUNITIES FOR OTHER SECTORS

The opportunities from Asia's urbanisation are not limited to the increase in demand for coal, iron ore and other hard commodities. There is a rapidly growing middle class in emerging Asia and with that comes consumption. By 2020 there are expected to be 1.75 billion middle class people in Asia Pacific and close to twice that number by 2030.[34] They will significantly increase the demand for other exports, including for example high protein food as well as services such as education and external tourism. These are things that Australia can supply and we need to respond to and capture these opportunities.

Figure 3.5b
Projections of the Middle Class by Region



Source: Kharas, H and Gertz G (2010)

33 Corden W.M., Neary J.P. (1982), pp 829-831

34 Kharas, H and Gertz G (2010)

Soft commodities in particular provide a valuable opportunity. There is already pressure on food prices, evident in elevated headline inflation in developing economies. At this point Mercer has seen little response from Australian suppliers or suppliers elsewhere. This investment opportunity will continue to become more attractive as demand grows and prices trend up around a critical level.

> 1.75 billion middle class people in APAC by 2020, and doubling by 2030

3.5.4. POLICY MAKERS' RESPONSE

Australia's policy makers clearly believe that the country's natural resource endowments are a blessing rather than curse. In fact, the RBA Governor, described the increase in the terms of trade and national income as potentially "the biggest gift the global economy has handed Australia since the gold rush of the 1850s".[35]

But we are all cognisant of the challenges that significant commodity exports present to the economy. Commodity prices are extremely volatile and uncertain. Prices are volatile in the short run because of extremely low demand and supply elasticities i.e. demand is not responsive in the short run to price changes and supply takes time to come online. Big movements in commodity prices are common. The impact on Australia's bulk exports was mitigated under the traditional system where prices were negotiated annually. However, quarterly contracts became the norm in 2010 and the move more recently to monthly contracts has further increased the exposure to market volatility.

> Policy makers can only dampen the effect of commodity price volatility on the economy. But to do this requires monetary and fiscal policy discipline, and structural reform

35 Stenens (2011b)

Policy makers cannot eliminate the volatility in commodity prices but can dampen their effect on the economy by:

- Strengthening the economy's fiscal position during the boom and avoiding pro-cyclical fiscal policies
- Maintaining disciplined monetary policy. For an inflation targeting country such as Australia, that involves focusing on price stability and not resisting movements in the exchange rate
- Undertaking productivity-improving structural reforms

These steps should help the economy deal with the commodity cycle.[36]

As well as short run volatility, the price for commodities in the longer run is uncertain. As discussed earlier, new supply will come on line when prices are expected to remain high; in addition, consumers will seek to economise on their use of the commodity and find substitutes to the extent they are available. Over the very long run, the average real price of most commodities has been stable; that is, commodity prices tend to mean revert.[37] The scale and structural aspects of the current demand surge may challenge history, but we should not ignore its lessons.

The private sector has to forecast commodity prices when making decisions on whether to invest in a new project. Policymakers also need to consider sustainability. It would be costly for an economy to undertake structural change were it to be reversed quickly. Some believe that where policymakers expect a boom to be temporary and likely to be reversed, they should protect the vulnerable sectors by taking steps to limit the appreciation in the exchange rate. In some respects, this involves policy makers second-guessing the market and industry experts. In the current situation both the RBA and Treasury believe that the terms of trade are likely to remain elevated for some time and consider the structural changes to be a necessary part of the adjustment process. As noted, Treasury's estimate in the 2011-12 budget papers is that the terms of trade will lose 20% over the next 15 years.[38] At the same time they note that we cannot be sure and that the best way to cope with that uncertainty is to maintain and, where possible, enhance the flexibility of the Australian economy to cope with changes.

36 *Murray (2010)*
37 *Ibid*
38 *Commonwealth (2011-12)*

Calls for monetary policy to support lagging sectors need to be resisted

3.5.5. INITIAL IMPLICATIONS FOR POLICY

The challenge for Australia's macroeconomic policy makers is to allow restructuring of the economy to take place without generating the inflation that has accompanied earlier terms of trade shocks.

The RBA and Treasury seem to be dealing with this cautiously, which is appropriate given the history. With the rapid growth in mining and related sectors, their aim of keeping the total economy growing around its trend is resulting in only modest growth in the rest of the economy. The RBA is also carefully monitoring wages for signs that pressures in mining and the related faster growing sectors are not spreading to the broader economy. Treasury continues to push the Government to deliver on its return to budget surplus and build on that when growth is above trend. These macroeconomic policies are facilitating a reallocation of capital and labour to the faster growing segments of the economy.

Special assistance programs will obstruct economic transformation

Loss of jobs in the slow growth or contracting areas has to occur to allow structural change to the economy. The Government needs to continue to firmly resist calls for protectionist reversion. Special assistance programs to prevent these job losses will obstruct economic transformation. More appropriate policies would be directed at the displaced workers and include relocation assistance and training. Equally calls for monetary policy to provide support to the lesser performing parts of our "patchwork" economy, need to be resisted. To do so would severely compromise the hard earned integrity and effectiveness of monetary policy for years to come.

The challenges to economic management are considerable. If macroeconomic policy is too restrictive, job losses and unemployment will generate pressure to sustain contracting industries through industry assistance policies and plans. Some of the labour freed up through contraction of other sectors will not be able to take up the mining related jobs because of family commitments or skills mismatches.

Initiatives to help transformation will be frustrated in the absence of a flexible wages system

The authorities also need to consider challenges outside the resources sector. Mercer has mentioned elsewhere in this Report the economy-wide strains on infrastructure. Mercer has also flagged the growing opportunities in Asia for food and fibre, tourism and education services. Housing supply also seems to be lagging long term demand. Overly tight monetary and fiscal policy could constrain activity in all these areas.

A key priority related to an economy in transition is for the Government to facilitate labour resources moving to where they are most needed. There are two important levers here. First, ensuring the skills of the workforce meet the changing needs of business. In the near term this requires further liberalising of Australia's skilled migration programs. Over the medium term it is facilitating movement within our existing workforce through retraining and facilitating relocation. Critical to all of these initiatives is a flexible wages system. The other initiatives will simply be frustrated, as resources cannot and will not move in the absence of a flexible wages system.

Productivity improvements can improve the economy's ability to cope with the transition. A well educated and well trained workforce is a more adaptable workforce. Australia has fewer skilled workers than are needed, particularly in the construction phase of the transition. We need to ramp up training and retraining of Australian workers. While this will help in the medium term, the need for more trained workers exists now. Skilled migration under Section 457 visas is easing the problem. Although there are conditions on issuing these visas, the rapid increase in numbers suggests the system is working well. The new Enterprise Migration Scheme is intended to make it easier for major project owners to access overseas skilled workers. The minimum project size ($2 billion) and workforce (1,500) will limit its relevance. The greater our success in meeting skills shortages the easier it will be to capture the benefit of our high terms of trade and grow our economy sustainably.

Mercer expects Asia's urbanisation to continue and the Australian economy will continue to benefit from the demand for resources. At the same time, the economy has become more exposed to the volatility in commodity prices and the economic cycles in emerging Asia. China's transition from an export-driven economy to a consumer-driven one presents challenges for its policy makers. There appear to be a number of disequilibria that need to be addressed for this transition to take place, increasing the risk of policy errors.

Australia's existing macroeconomic framework will respond to a slowdown in Asia – the RBA would ease monetary policy, the dollar would depreciate and improve competitiveness, and automatic fiscal stabilisers would support growth. However, if the slowdown in emerging Asia was severe, Mercer believes that discretionary fiscal policy stimulus may be appropriate as occurred during the GFC. In this respect, we believe there is a need for the budget balance to improve during periods of moderate to strong growth so as to be in a position to take countercyclical fiscal policy in the event of a material shock.

4. NATIONAL SAVING AND INVESTMENT

4.1. WHY IS NATIONAL SAVING IMPORTANT?

Australia's investment and savings are inextricably linked. This section of the Report examines the level, composition and drivers of Australia's national savings and investment.

We do not live in a global economy that exhibits perfect capital mobility. As such, domestic investment and savings are highly correlated and the level of saving is of great importance for driving strong, sustainable economic growth.

The level of national savings provides the capital for investment. If deployed efficiently this should deliver productivity growth and hence sustainable economic growth. Historically, Australia has tended to rely on foreign savings to partly fund investment as the level of national savings has not been sufficient.

Savings rate has begun to recover but remains historically low

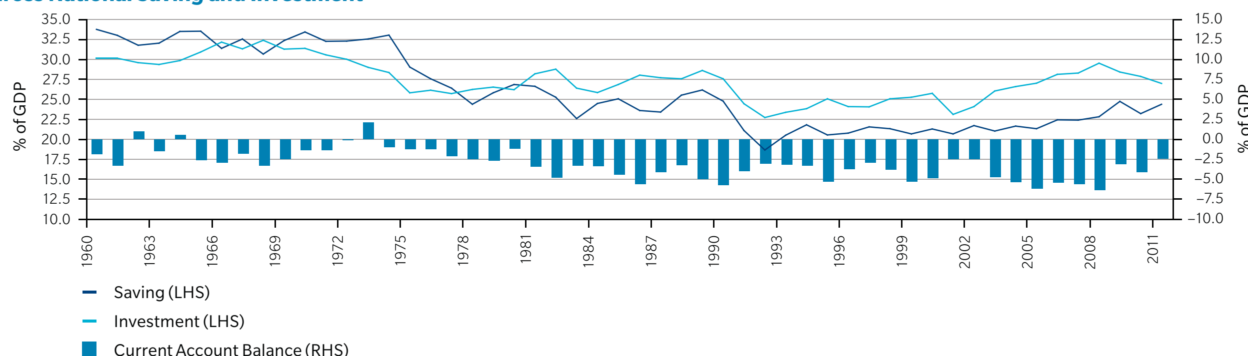
Given its importance, the respective drivers of savings and investment are revisited in this section. This provides the backdrop for the subsequent discussion on Australia's fiscal policy rules — the primary lever for governments to contribute to national savings and therefore investment.

National saving becomes all the more important in an economy with an ageing population as issues of intergenerational equity demand that any fiscal framework encourages efficient levels of savings and investment.

4.1.1. AUSTRALIA'S HISTORICAL NATIONAL SAVINGS

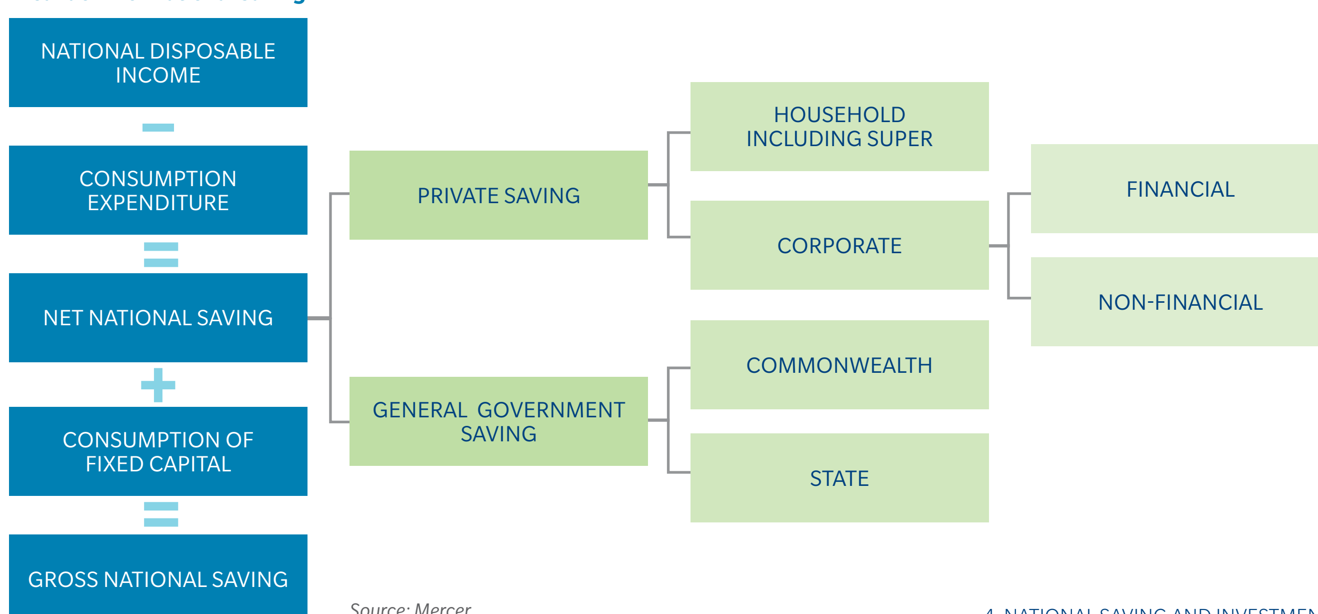
In its simplest form national saving is a residual of income after expenditure (Figure 4.1a).

Figure 4.0a
Gross National Saving and Investment



Source: ABS Catalogue 5204.0 & 5302.0

Figure 4.1a
Breakdown of National Saving



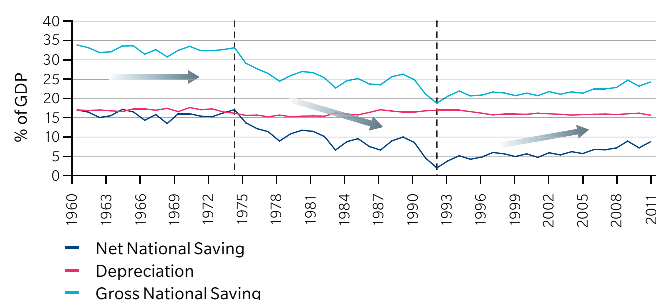
Source: Mercer

Household savings is the driver of overall savings

The level and composition of Australia's national savings has changed over time. During much of the 1960s and 1970s, gross national savings as a percentage of GDP hovered around 30%, before declining over two decades to historic lows of 18.6% in 1992. In recent years the gross savings rate has recovered somewhat to reach 24.1% in 2011.

Net savings, which adjusts for depreciation, has stayed relatively constant. Although the depreciation rate has stayed relatively constant at around 16%, net savings fell to a low of 1.8% in 1992 before recovering to levels of 8.6% in 2011.

Figure 4.1b
Savings Rate



Source: ABS Catalogue 5204.0

WHAT IS BEHIND THE TREND DECLINE AND RECENT PICK-UP IN NET NATIONAL SAVINGS?

Movement in household saving has traditionally been the driver of the overall savings rate (Figure 4.1c). The collapse in household saving after 1975 to a historical low in 2003 and 2004 drove the overall decline in national savings.[39]

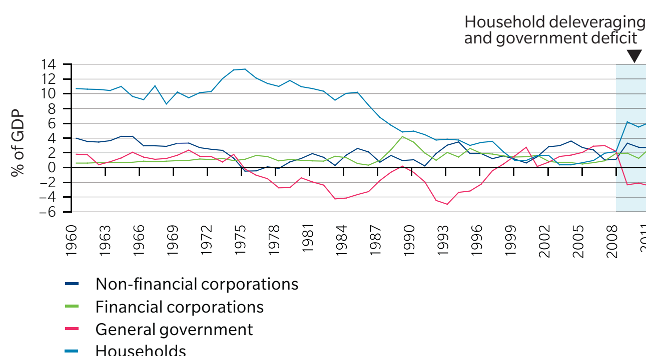
More recently, the household sector has gone through rapid deleveraging, increasing savings to levels last seen in the late 1980s. Household saving still remains well short of levels achieved prior to the early 1980s but is more in line with the 50 year average.[40]

Fiscal discipline of the 1990s has seen Government saving, which spent much of the previous two decades in negative territory, enjoy a steady increase to be in a position to allow the Government's fiscal stimulus in response to the GFC.

Despite recent deleveraging, household savings fall short of historical levels

The level of corporate saving became more important to national saving as household saving declined. Increased corporate profitability and hence retained earnings has resulted in corporations' saving rebounding strongly post GFC to 2.5%–2.6% (albeit partly related to the high terms of trade).

Figure 4.1c
Net Savings



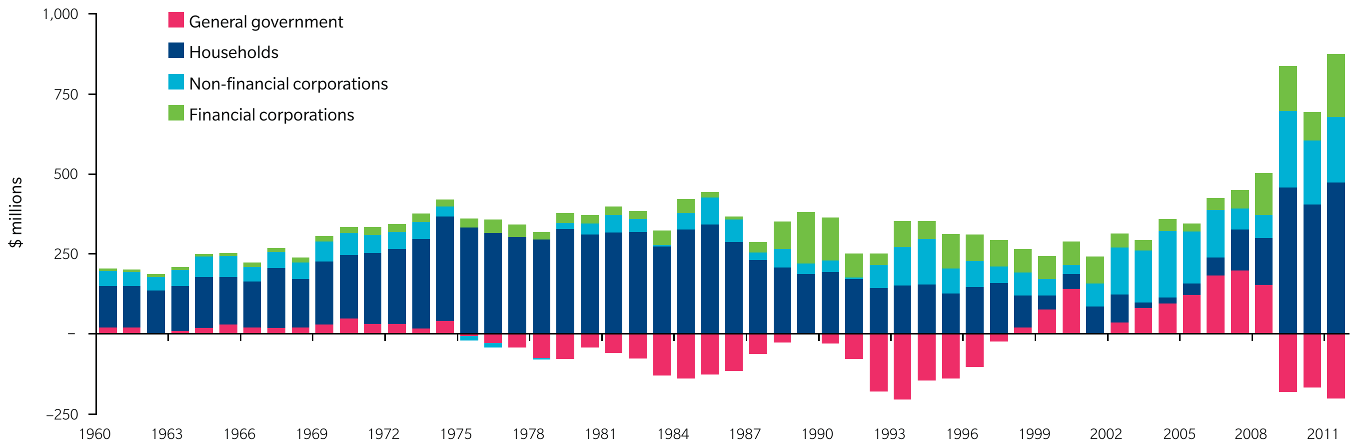
Source: ABS Catalogue 5204.0.

The contribution of corporate savings and the partial recovery in household saving can be seen clearly when the expressed as real dollar amounts (Figure 4.1d).

39 *Note that based on ABS 2009-10 figures the household savings ratio was shown to be negative, however following amendments to the methodology used to calculate Household Final Consumption Expenditure this has been revised.*

40 *High levels of net worth, due mainly to house price inflation and asset returns outperforming CPI over the decade to 2007, have acted as an incentive to consume and hence disincentive to save. As asset prices (especially shares and therefore superannuation balances) fell sharply during GFC, households reverted to historical savings rates.*

Figure 4.1d
Real Savings ($m)



Source: ABS Catalogue 5204.0

In short household deleveraging and private corporate savings have recently been partially offset by the unavoidable return of government deficits. The deleveraging of the household sector is also a welcome development. Household deleveraging is not so pronounced to pose a barrier to growth in Australia, given the Government's fiscal position coupled with the relatively low leverage in the Australian corporate sector. Given that movement in household saving is historically the key driver of the savings rate in the economy it is discussed further in Section 4.2.

> Recent government deficits have partially offset household deleveraging and corporate savings

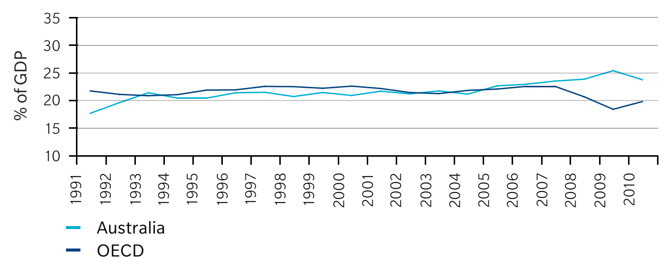
4.1.2. INTERNATIONAL COMPARISONS

As discussed in Section 3, the developed world (OECD) can be characterised by high levels of pre-GFC leverage in household, government and financial corporate sectors. In contrast, Asia is uniformly characterised by low levels of pre-GFC leverage.

Relative to OECD nations, Australian gross national saving has been "middle of the pack". Over the past two decades Australia's gross national savings rate has been in the bottom half of OECD countries (19th out of 33), but on average better than the larger OECD economies of the US, UK and France.[41]

In recent years, the savings rate has risen as an expected response by households to the GFC. Australia's savings performance is largely due to disciplined fiscal positions of Australian Government in the decade preceding the GFC, itself allowing Australian fiscal resilience through the GFC and thereby improving Australia's relative performance.

Figure 4.1e
Gross National Savings

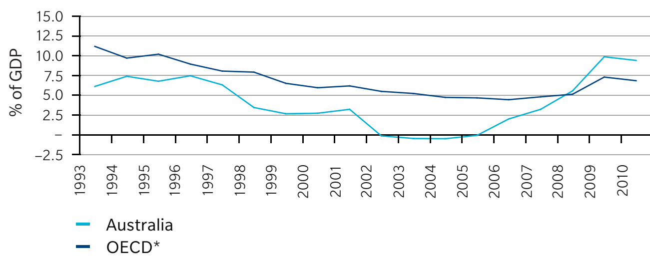


Source: National accounts of OECD countries database.

Australia's recent recovery in national savings has really been driven by households. When looking at the net household savings rate in comparable OECD nations (Figure 4.1f), we see that historically Australia's rate has been relatively low. As discussed earlier, however, Australia has seen a period of household deleveraging. This has also been the case across comparable OECD countries.

41 OECD (2010b)

Figure 4.1f
Net Household Saving



Source: National accounts of OECD countries database.

Historically Australia has been compared to its developed world counterparts, and for good reason given comparable welfare, pension and health provisioning. Given the growing importance of developing and eastern Asia to the Australian economy, it is also important to compare Australia to the national savings patterns in those countries.

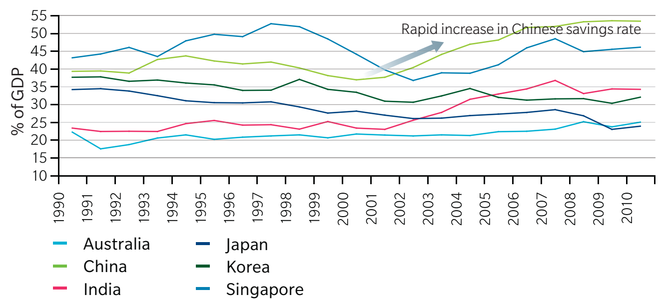
Australia's savings resides in the middle of the OECD pack

Over the last 30 years the national savings rates of the majority of our largest Asian trading partners has significantly outstripped the Australian rate. The more developed nations of Singapore, Japan and Korea saw a fall in their savings rate after the 1997 Asian financial crisis but savings have broadly recovered to pre-1997 levels.

The largest change has been the meteoric rise of the savings rates in both India and China. Since 2000 the savings rates have increased 44.9% and 46.6% respectively compared to 15.3% in Australia. This, coupled with record level of investment, has underpinned the large expansion in their GDP.

Saving rates of our major Asian trading partners has outstripped Australia's rate over the past 30 years

Figure 4.1g
Gross National Savings Rate



Source: IMF: World Economic Outlook 2011

Largest shift — meteoric rise of savings in India and China

Of the three components of national savings, public and household saving have driven changes in savings rates. Corporate saving is cyclical in nature. Public saving is critical to allow fiscal policy to be effective in times of economic shock and is dealt with in Section 5. Household saving is discussed further below.

4.2. HOUSEHOLD SAVING

Australian household saving has undergone the greatest relative change in recent years. As discussed in section 4.1, Australian households have recently deleveraged and increased saving reflecting a general risk aversion. This is arguably attributable to uncertainty surrounding the wider economic outlook, initially stemming from the "tech-wreck" of 2001, high house prices, the volatility in superannuation "nest egg" balances and continued market volatility.

In Australia, Government tax policy continues to encourage household consumption of housing. This bias is perversely further reinforced, by the ability of households to access retirement income as a lump sum, thereby allowing a one off deleverage at retirement. Whilst this bias has been in existence for decades, its manifestation is more important as superannuation balances increase over time.

* *OECD average excludes UK, France, Portugal and Spain who only release gross savings data.*
OECD data is not updated for recent ABS changes to household savings data and hence has not been revised to near zero (rather than negative) saving in the years between 2002–2005.

Even so, a large part of the savings story in Australia is down to compulsory retirement contributions, a policy used to boost private saving and to provision for retirement.

Household deleveraging reveals risk aversion due to volatility on several fronts

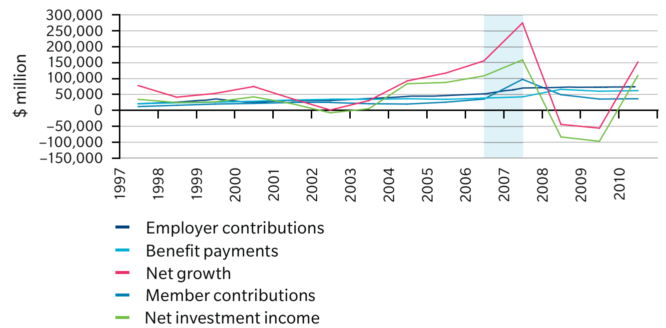
4.2.1. SUPERANNUATION

The importance of superannuation is on the rise. Reserves that have been accumulating over 25 years now form a substantial pool of savings within the economy. Superannuation policy is the primary lever for Government to influence household saving.

The three drivers of new superannuation growth are: contributions (both employer and member); benefit payments; and investment returns. Contributions have grown at an average rate of 13.6% from 1997 to 2010 (Figure 4.2b). Benefits have also grown at average rate of 10.5% each year.

Investment returns dominate current and future superannuation savings

Figure 4.2b
Superannuation Drivers



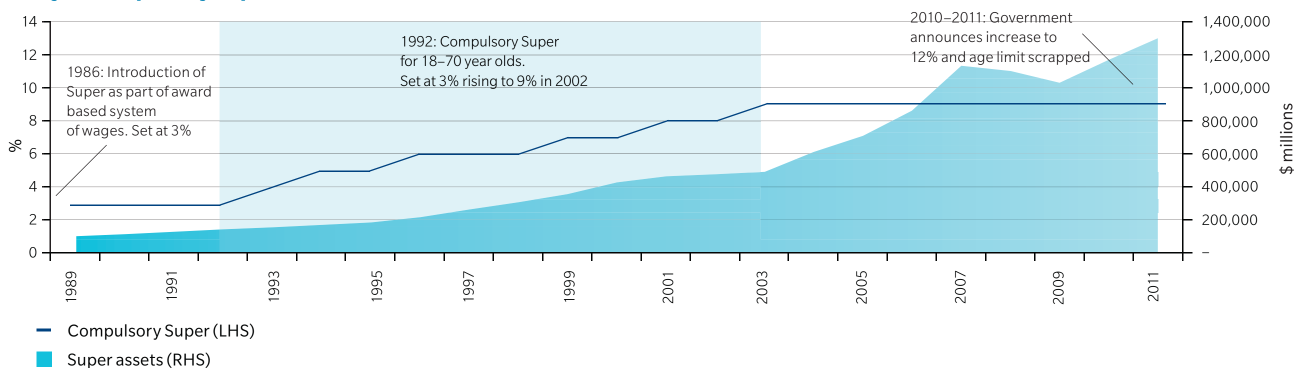
Source: APRA Annual Superannuation Bulletin, June 2010.

Drivers of growth in superannuation assets are shown in Figure 4.2b. During the establishment phase of superannuation saving, the growth of the pool of assets was strongly influenced by contribution rates. The spike in member contributions in 2007 was a result of transitional arrangement to a new taxation regime for superannuation contributions.[42]

The current asset pool is of a size where investment returns now dominate the aggregate level of superannuation savings and will dominate its future growth. The average superannuation fund has 50-60% invested in equities. This allocation to growth assets — the highest across OECD countries — drove gains in net growth in the years to June 2007 with the strong returns to equity.

Australian super funds allocate more to growth assets than other OECD countries — translating to greater volatility

Figure 4.2a
History of Compulsory Superannuation

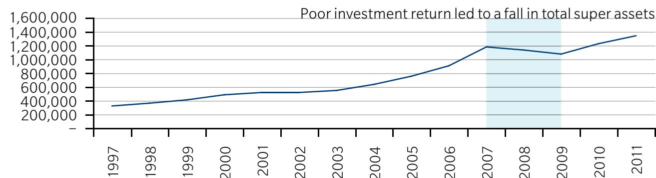


Source: Mercer and ASFA

42 *The new regime involved the introduction of an annual limit of $150,000 on undeducted contributions and harsher limits on employer contributions . The transitional arrangement allowed a once of $1 million to be paid into superannuation prior to 30 June 2007 which delivered a 186.0% increase in member contributions in that year.*

In 2007, member contributions were not sufficient to offset the market impact of the GFC. Ongoing volatility in superannuation returns and therefore balances reflecting volatility in equities markets, has remained a stubborn feature. Balances have recovered since - as of June 2011, Australians had $1.34 trillion invested for retirement provisions.[43]

Figure 4.2c
Superannuation Balance ($m) at Financial Year End



Source: APRA Annual Superannuation Bulletin, June 2010 and APRA Quarterly Update.

4.2.2. DRIVERS OF HOUSEHOLD SAVING

There have been four primary drivers of declining household saving[44] up to 2005.

- Strong capital gains in housing (caused by low interest rates, low unemployment, tax system incentives) increased household net worth at the same time as easier access to home equity[45]
- Banking deregulation allowed easier access to credit and thereby allowed "smoothing" of consumption
- A likely substitution effect has occurred with superannuation (households believe that they have a nest egg, so can leverage and spend now). Along similar lines there is some evidence that superannuation is being used to pay off debt at retirement,[46] which is discussed further below
- A statistical "switching" explanation, with the increasing trend of corporatisation of unincorporated enterprises (e.g. self employed) resulting in savings that had previously been attributed to household savings is now attributed to corporate savings[47]

43 APRA (2011)

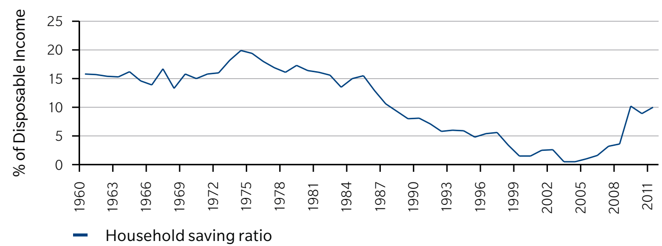
44 The ABS defines the Household savings ratio as: Gross (or Net) Disposable Income – Final Consumption expenditure / gross (or net) Disposable Income

45 Note capital gains are not counted as income from a National accounts perspective

46 AMP / NATSEM (2008)

47 Thorne, S and Cropp, J (2008)

Figure 4.2d
Household Saving Ratio



Source: ABS Catalogue 5204.0

Since 2005, however, household savings have increased. There are a number of factors that have been identified as contributing to the recent increase, perhaps better described as a welcome deleveraging by households when viewed historically.

- The ageing population may be showing up in household savings — an increase in savings by way of shoring up the "nest egg" before retirement (e.g. paying off the mortgage) peak savings occurring in the period leading up to retirement when earnings are highest
- Strong real wage growth (due to strong terms of trade) since 2004 has increased disposable income (with only a modest increase in consumption) thereby leading to higher savings
- Households have perceived their higher income to be temporary and therefore increased saving rather than consumption
- Rising interest rates over the period 2005 to 2008
- Precautionary savings behaviour from 2008 onwards, reflecting uncertainty around employment security and home values, coupled with a view that the boom (rise in incomes) is transitory
- The unwinding of the wealth effect given the fall in house and equity prices since 2008 and the inability to fund consumption from capital gains on these assets

Australian households may be returning to a period of thrift and frugality. However, the rebound in saving may not be a permanent phenomenon as the underlying drivers may not persist. In the US, where similar patterns of personal savings have been observed, saving rates have recently started to decline. Like Australia, the US household savings rate fell to lows in 2005 and increased substantially in 2008. However, since 2010, savings rates have been falling with increased consumer spending and sluggish

growth in disposable income.[48] However, this behaviour may reflect US specific factors associated with recession (with low income growth and savings being called upon).

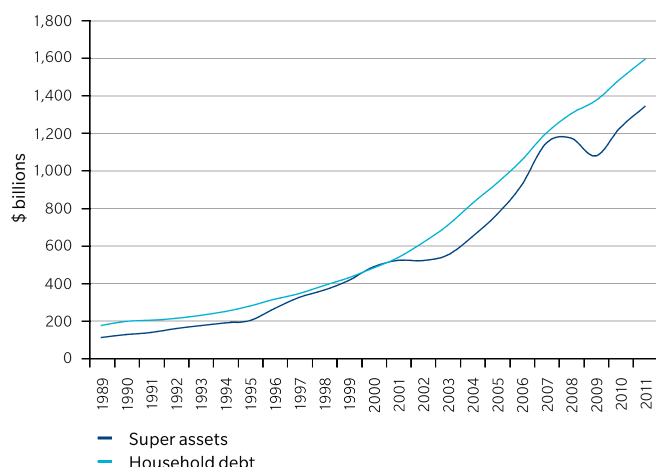
Australian households may be returning to a period of thrift — but this may not be permanent

4.2.3. SUPERANNUATION GUARANTEE (SG) IMPACT ON PRIVATE SAVINGS

Superannuation contributions (including SG and salary sacrifice) are considered part of disposable income (for the purposes of the National Accounts) and therefore included in the household savings ratio even though they cannot be accessed. However, compulsory superannuation will only increase savings to the extent it is not offset by a fall in other savings. A recent paper[49] by Treasury suggested that for low income earners there was very little of this type of substitution, but for higher income earners this was more substantial. Overall the impact of compulsory superannuation is estimated to be positive, with the current contribution to private saving estimated at 1.5% of GDP[49] and rising sharply to 3% of GDP in 2040[49] following the proposed mandatory increase in SG to 12%. These estimates are net of the assumed offsetting impacts on saving more broadly; including, a 30% offset in other private saving with any increase in superannuation contributions and lower tax revenues as a consequence of the concessional 15% flat rate tax on superannuation contributions.

Since the introduction of the SG (and its predecessor award based superannuation) there has been a substantial rise in the level of household debt.

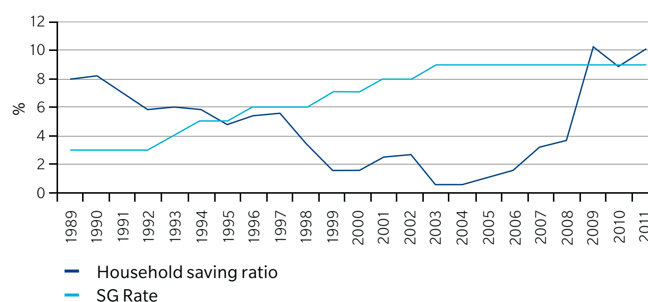
Figure 4.2e
Household Debt v Superannuation Assets



Source: ABS Catalogue 5232.0 and APRA Superannuation Annual Bulletin

While the rise in household debt can be attributed to some of the factors above (in relation to general savings trends), another possible factor is that people may have felt it was less necessary to save because they now have a superannuation "nest egg". The corollary is that recent volatility in, and therefore household uncertainty with respect to, the "nest egg" balance may have then contributed to the recent increase in household saving.

Figure 4.2f
Household Saving Ratio (% Disposable Income) and Superannuation Guarantee Rate



Source: ABS Catalogue 5204.0

This view is supported by a study[50] which shows a large difference in superannuation balances pre retirement and post retirement. It is possible that a large portion of superannuation is now used for purposes other than funding retirement income. Unrestricted access to a superannuation lump sum allows a "deleverage" event upon retirement and thereby households are able to accumulate larger debt during their working career and then pay of these debts with superannuation assets upon retirement.

Placing some restrictions on the access to a superannuation lump sum and greater utilisation of income streams[51] would discourage household leveraging and arguably increase the level of household savings. The reduced opportunity of relying on superannuation to repay debt would force households to primarily fund the debt from working life income.

48 US Department of Commerce (2011)
49 Gruen, D and Soding, L (2011)
50 AMP / Natsem (2004)
51 To apply to balances greater than $100,000

4.2.4. RETIREMENT INCOME ADEQUACY

The level of household savings is intrinsically linked to how people view the adequacy of their retirement incomes. There are a number of different approaches that have been taken when considering the all important benchmark question of retirement income adequacy. These include:

- "Budget" approach: ASFA / Westpac Retirement Standard[52] is a budget approach (building up adequacy from a standard of living based on items consumed). This approach suggests that a "comfortable income" requires an annual income of $40,412 (including the age pension) for a single person
- Net replacement ratio: the Melbourne Mercer Global Pension index uses a net replacement ratio approach comparing first year net retirement with net pre retirement salary. The index uses OECD methodology and adopts an ideal target of 70% net pre retirement salary
- Replacement ratio: the Financial Services Council (previously IFSA) suggests a replacement ratio of 62.5% of (gross) pre-retirement earnings

Restrictions on super lump sum access are needed to reduce the reliance on super to delever

ASFA has continued to advocate for higher superannuation contributions, believing that the level of superannuation savings remains quite low.[53]

Data released in the third quarter of 2011 showed that:

- The average superannuation balances (for all ages) in 2009/10 were $71,645 for men and $40,475 for women
- The average superannuation payout at retirement in 2009/10 was $198,000 for men and only $112,600 for women

The FSC has also suggested that current retirement savings are way too low relative to expectations. The FSC has suggested the "savings gap", the shortfall in assets to fund an adequate retirement income was in the order of $695 billion as at 30 June 2008.

Figure 4.2g
Retirement Savings Gap ($m) by Income and Sex

ANNUAL INCOME	MALES	FEMALES
Under 28,400	0	0
28,401 – 35,500	0	1,670
35,501 – 42,600	6,824	16,266
42,601 – 49,700	19,089	38,474
49,701 , 56,900	43,804	62,840
56,901 – 71,100	113,080	114,132
71,101 – 106,600	131,448	87,776
Over 106,600	40,854	16,241
Total	**358,099**	**337,400**

Source: IFSA superannuation Savings Gap 2008.

Many including ASFA and FSC have advocated gradually increasing compulsory superannuation from 9% to ensure retirement incomes will be adequate in the future. The Government has recently introduced legislation to increase the SG to 12% by 2019–20. Mercer supports this increase, subject to the SG increase being associated with some wages moderation.

The Melbourne Mercer Global Pension index ranks countries on a number of criteria including the adequacy of future retirement incomes. While Australia's ranking has recently improved, primarily due to improvements in the age pension and increased household saving, its increasing superannuation is required to further improve Australia's ranking in the index.

Australia's improved country ranking on retirement income adequacy is primarily due to improved age pensions. Further improvement needs to come from increased super

This view is not universally shared. The Henry Tax Review concluded that an increase in the SG was not necessary, albeit this conclusion formed part of a much broader policy suite including a proposed reduction in taxes pre-retirement. The Review's retirement income consultation paper[54] included forecasts of future retirement income (age pension and 9% SG) for different income groups, assuming a continuous 35 year period of contributing to superannuation.

52 ASFA (2011a)
53 ASFA (2011b)
54 Australian Treasury (2008)

Figure 4.2h: Replacement Rates Based on Income — Using Wages Discount[(a)]

INCOME AS A PROPORTION OF AWOTE[(b)]	REPLACEMENT RATE (%)
0.75	65
1.00	56
1.50	47
2.20	40

Source: Australian Treasury projections

While the methodology has been questioned, the primary concern for the baby boom cohort about to retire is that they have not had the benefit of 35 years of compulsory superannuation.

Aside from issues of meeting future income expectations, from a public policy perspective, increased superannuation savings is also important to reducing future reliance on the age pension, which is explored further in Section 5.

Current retirement savings fall short of retirement income expectations

4.2.5. IMPLICATIONS FOR POLICY

The taxation treatment of superannuation contributions, balances and benefits is an important driver of household superannuation savings patterns. Earnings paid as SG contributions are taxed at a flat rate of 15% compared with earnings paid as ordinary salary or wages which are taxed at progressive marginal rates. Also investment earnings on superannuation balances are taxed at flat rates and not marginal rates. For higher income earners with marginal rates above 15% this means that superannuation contributions are taxed concessionally compared with ordinary income.

From a fiscal policy perspective, concessional tax arrangements in superannuation represent an opportunity cost (or tax expenditure) in forgone tax revenue from ordinary income (substituted with lower superannuation tax revenue). The measurement of the level of these concessions is subject to some debate and was examined in the Henry Tax Review. Treasury estimates these expenditures to be in the order of $27 billion in the 2011–12 year. However, one particular criticism of the methodology used by Treasury in this calculation does not take into account the impact of superannuation savings on the future age pension outlays.

The difficulty in the calculation of the tax concession becomes more important as with the proposed increase of the SG rate. Under the current superannuation tax arrangements, the proposed increase in the SG rate to 12% has a negative impact on the forward fiscal balances due to the concessional tax treatment. It is for this reason the Government has linked the SG legislation to the passage of the Minerals Resource Rent Tax legislation to "fund" the increased tax expenditure.

Given the associated costs of encouraging superannuation savings to provide for adequate retirement incomes, the Government needs to ensure its policy objective — adequate retirement incomes — is delivered. The form in which retirement income is delivered will be important in meeting this objective. Currently, the ability of retirees to access a lump sum on retirement may be promoting savings for purposes other than retirement income, in particular, a future deleveraging event. This mixed incentive for household superannuation savings needs to be addressed.

There have been some signs that the superannuation industry is looking at income, rather than a lump sum, as a retirement solution. Some data shows encouraging trends in the take up of income streams (over lump sums). However, caution is required in interpreting these statistics as the introduction of transition to retirement pensions (primarily used for tax purposes with little overall increase in savings) may explain some of the increase.

(a) Increases deflated by wages

(b) AWOTE is average weekly ordinary time earnings and is approximately $1,150 a week

Figure 4.2i
Income Stream Utilisation

YEAR ENDED 30 JUNE	TOTAL BENEFIT PAYMENTS (% LUMP SUM)
2004	$34.5 billion (62% lump sum)
2007	$40.8 billion (56% lump sum)
2010	$60.4 billion (49.8% lump sum)

Source: APRA annual stats, Benefits payments – Table 7

4.3. NATIONAL INVESTMENT

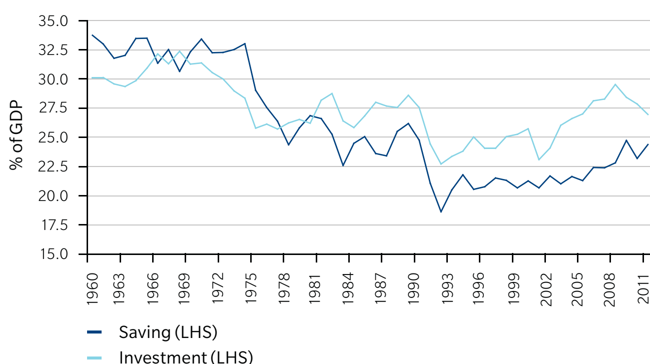
As previously discussed, national investment is largely financed through the availability of domestic savings — from government, corporations and households.

The interaction between Australia's rates of saving and investment is fundamental to supporting economic growth. Below the structure of Australia's investment and whether there are any likely impediments to future growth, are discussed.

4.3.1. TRENDS IN INVESTMENT

Over the past 3 decades, Australia has invested more than it has saved. Investment has outpaced savings since 1981— reaching 29.5% of GDP in 2008 (Figure 4.3a).

Figure 4.3a
Gross National Saving and Investment



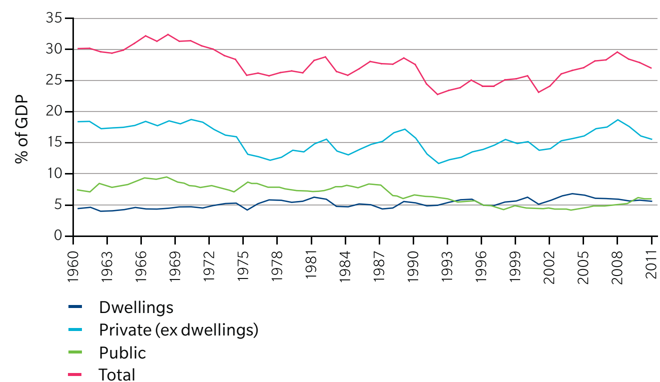
Source: ABS Catalogue 5204.0 & 5302.0

High levels of investment have been financed through a consistent current account deficit - the gap between national investment and national savings. This is discussed further in Section 4.4.

> Investment has outpaced savings since 1981— financed throughout our current account deficit

The private sector has historically driven and continues to drive national investment – accounting for 63% of total investment in 2008 (Figure 4.3b).[55]

Figure 4.3b
Gross Investment by Sector



Source: ABS Catalogue 5206.0

The remainder of investment is made up of household and public investment. Household investment has remained constant at or around 5% of GDP. Public sector investment has accounted for a falling share of total investment. Although the Government contribution to investment is small it is often deployed to projects that, although limited in commercial value, have economic merit, such as arterial infrastructure.

Given the dominant nature of private sector investment, Government policy should focus on facilitating efficient private investment and ensuring public investment targets projects with economic merit.

Efficient investment in infrastructure directly impacts productivity in the wider economy. The adequacy of infrastructure investment and the role of governments is therefore examined overleaf.

> The private sector drives national investment — accounting for 63% of investment in 2008

55 *The increase in private investment during the 2000s has outstripped GDP growth, reflecting the increase in mining related investment. The related forecasts reveal a surge of mining related investment in the next two years. Deloitte Access Economics (forthcoming)*

4.3.2. INFRASTRUCTURE INVESTMENT

> "...There is a sense that our infrastructure networks are barely adequate for current needs, and that they are beginning to impose significant long term costs... There is a powerful need for change, especially in the way we fund our infrastructure..."[56]

Economic infrastructure is an important driver of competitiveness and contributes to economic growth by indirectly facilitating increased productivity. The OECD broadly defines infrastructure as the "system of public works in a country, state or region, including roads, utility lines and public buildings." [57]

The infrastructure requirements of OECD countries and larger non-OECD countries (i.e. China, India and Brazil) are growing. This is largely a function of economic growth, a general underinvestment in the past and new challenges such as climate change.[58] In terms of the outlook, the OECD estimate the global annual infrastructure requirement[59] to be 3.5% of world GDP translating to USD2 trillion p.a.[60]

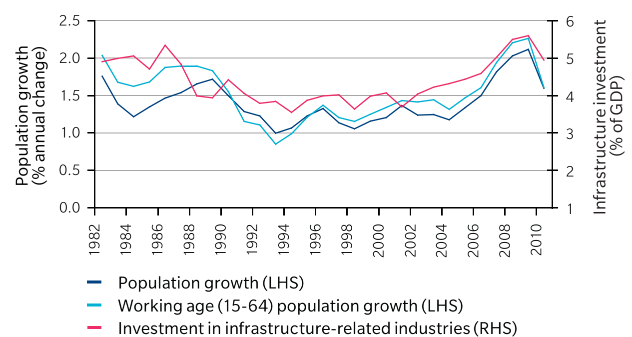
Economic infrastructure is an important driver of competitiveness and productivity

There has been much commentary on the purported under spend on infrastructure in Australia and in OECD countries more broadly. A recent report by the Grattan Institute argued that a lack of infrastructure spending has detracted from Australia's productivity performance.[61]

Over the last few decades, in OECD countries, as the share of government investment in infrastructure has declined, the private sector share has increased. Over this period, the OECD average ratio of capital spent on fixed investment (primarily infrastructure) to GDP fell from above 4% in 1980 to 3% in 2005, reflecting a fall in public capital investment.[62]

Over the last 30 years, Australia's investment in infrastructure related industries has been largely correlated with population growth.

Figure 4.3c
Infrastructure investment and Population Growth



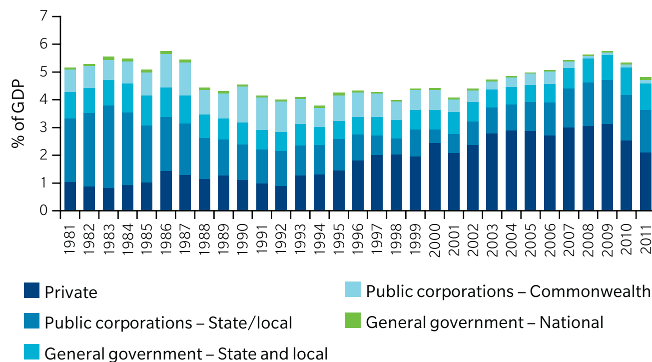
Source: ABS cat. No. 3201.0 and 5204.0 Note: excludes inventory investment.

Australian infrastructure spending has trended upwards over the last decade, as outlined in Figure 4.3d overleaf, increasing from 4.1% of GDP in 2000–01 to almost 6.0% in 2008-09 and declining more recently.

Australia's infrastructure investment has tracked population growth over the last 30 years

56 *Infrastructure Australia (2011), p7*
57 *OECD (2011), p15*
58 *OECD, opcit (2011), p28*
59 *Infrastructure defined as electricity transmission and distribution, road and rail transport and telecommunications and water*
60 *OECD 2007*
61 *Eslake and Welch (2011)*
62 *OECD, opcit (2011), p16*

Figure 4.3d
Composition of infrastructure investment



Source: ABS Catalogue 5204.0 Tables 52,53,54.

There is a large range of estimates on Australia's future infrastructure investment task from $450 billion to $770 billion in the next 10 years. Importantly, in the absence of a meaningful and authoritative audit, the jury remains out on the magnitude of Australia's "infrastructure gap", although intuitively given broader economic developments an infrastructure gap is not unanticipated. The National Infrastructure Priority List prepared by Infrastructure Australia comprises reset $86 billion in projects. From that list, $19 billion worth of projects are assessed as residing in the "Ready to Proceed" category and include 11 transport related projects that are assessed as having economic merit. Importantly, and from an investor's perspective, this listing does not allow an assessment of commercial feasibility.

In the absence of the meaningful infrastructure audit, the jury remains out on Australia's "infrastructure gap"

The current infrastructure "pipeline" comprises projects in transport (accounting for the majority of projects), utilities and communications. Notably, the communications infrastructure investment is dominated by the Government's $41 billion National Broadband Network project, which itself is the largest single infrastructure project currently under construction in the "pipeline". Importantly, the "pipeline" does suggest high levels of investment in infrastructure for some time which is potentially consistent with some redressing of the infrastructure backlog over time.

Current "pipeline" suggests high levels of infrastructure investment which may over time redress some of the backlog

There remain competing and growing demands on Government funds, as detailed in Section 5 of the Report. The current infrastructure "pipeline" also reveals a skew towards much larger projects over time, including several projects that are unprecedented in scale. The cost of providing infrastructure has and is anticipated to continue to rise above the rate of general inflation. A key risk therefore remains whether the Australian economy is able to deliver these projects on time and on cost. These developments coupled with the mining sector's infrastructure needs, brings into question the Australian economy's capacity to meet current infrastructure needs.

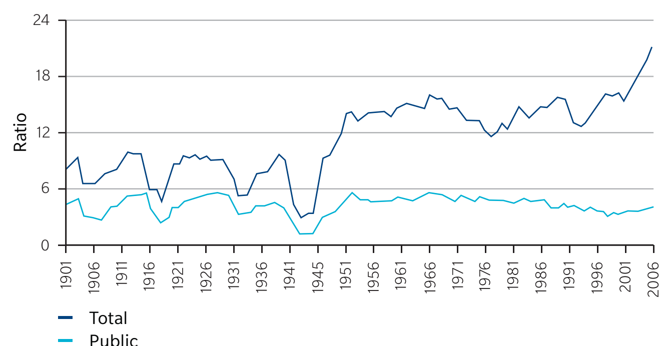
These developments coupled with the mining sector's infrastructure needs, brings into question the Australian economy's capacity to meet current infrastructure needs.

But questions abound on Australia's ability to efficiently deliver the infrastructure spend

PUBLIC VERSUS PRIVATE SECTOR INFRASTRUCTURE INVESTMENT

The role of private capital formation in providing Australia's infrastructure has grown since 1945. Figure 4.3e below outlines that public capital expenditure, with the exception of the First and Second World Wars and the Great Depression, has remained broadly constant.

Figure 4.3e
Historical Investment in Australian Infrastructure (Private & Public Funds)

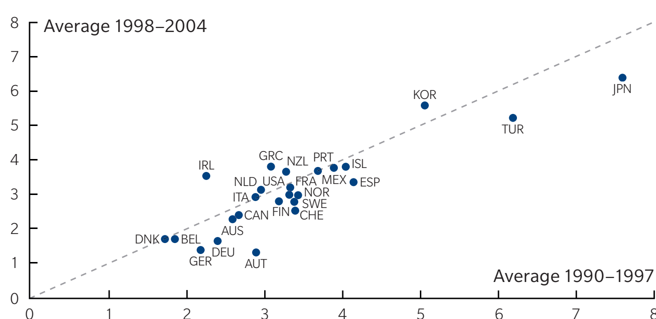


Source: Maddock & McLean (1997) for data from 1901–1991, ABS for data 1992–2005 & Treasury calculations from Infrastructure Partnerships Australia (2007) Australia's Infrastructure Priorities: Securing our Prosperity

Historically, infrastructure projects were built and maintained by governments, with infrastructure viewed primarily as a public good. During the 1980s and early 1990s, growing constraints on public finances stemming from increasing demand for social expenditure delayed new investment and maintenance of existing public infrastructure. This prompted countries, such as Australia and the UK, to initiate privatisation programs and commercialisation of Government Business Enterprises – many being infrastructure providers.

Except for very recently, Australia's public investment in infrastructure declined over the past two decades. As outlined in Figure 4.3f below, over the period 1990-2004, Australian Governments invested less than most OECD countries.

Figure 4.3f
Public investment as a percentage of GDP 1990–2004

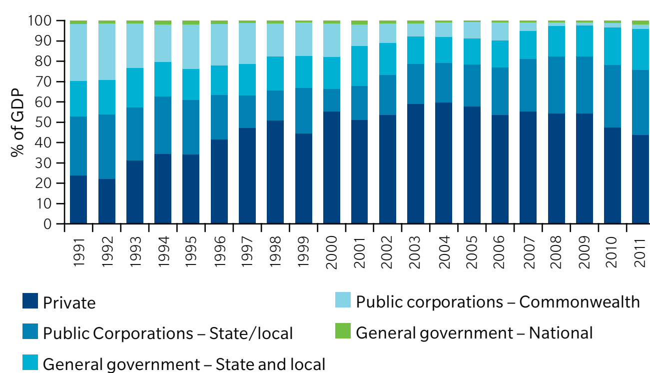


Source : OECD (2006a), data for 25 OECD countries.

The private sector was responsible for 54% of economic infrastructure investment in 2007-08. More recently, state governments were responsible for a steadily increasing proportion of economic infrastructure investment — reaching 28% in 2011. The Commonwealth Government's share has fallen to low levels over the last decade.

> Early private sector involvement, can deliver cost savings of around 30%

Figure 4.3g
Composition of Infrastructure Investment



Source : ABS Catalogue 5204.0 Tables 52,53,54.

This earlier structural shift in responsibility largely reflects the transfers from the corresponding program of corporatisations and privatisations.

Australian superannuation funds have also proved global leaders, along with Canadian peers, in investing in infrastructure. Superannuation has become an important source of finance for infrastructure projects.

Further to alleviating public finance pressures, private sector involvement in the provision of infrastructure brings cost saving benefits. Studies indicate that private sector involvement in the provision of infrastructure, under the Public Private Partnership (PPP) model for example, delivers lifecycle savings of around 30%.[63] Notably, 75% of these savings are the design and build phase and 25% in the operational phase. So to secure most of the cost saving benefits, private sector involvement is required early on and during the project's greenfield stage.

PUBLIC SECTOR: COMMONWEALTH VERSUS STATE RESPONSIBILITIES

The Commonwealth Government influences the provision of infrastructure in the following ways:

- Specific purpose payments (SPPs) to the states to provide infrastructure
- Microeconomic and "framework" policies
- Limited direct spending role (detailed below)
- Tax and regulatory policies

63 GHD (2011)

Superannuation has become an important source for infrastructure financing

Most publically provided infrastructure involves a blend of Commonwealth and state financing responsibilities. The Commonwealth Government's responsibilities in infrastructure is imbedded in regulatory powers and in the Constitution – directly with respect to functions such as telecommunications and postal and indirectly, and more fundamentally, with financing capacity due to taxing powers.

The Commonwealth remains the primary source of public sector infrastructure financing by way of SPPs to the states and territories for capital purposes. The Commonwealth Government finances social infrastructure (e.g. hospitals and schools) by SPPs to the states and by some individual programs (e.g. Building the Education Revolution). Economic infrastructure is financed by the Commonwealth through several national partnership programs (i.e. National Building Program, Roads to Recovery Program, Blackspot Program, Building Australia Fund, Regional Infrastructure Fund).

Government infrastructure spending saw a record increase — peaking in 2009

Infrastructure investment and maintenance priorities are set out by the states in their Annual Budget Papers and respective State Infrastructure Strategies.

State governments finance infrastructure investment from government debt, user charges, state taxes, producer levies and Commonwealth Government transfers. The primary sources of states' general government capital expenditures are operating surpluses (including Commonwealth transfers) and debt.

The states' Commercial Private Trading Enterprises (PTE) (e.g. water and electricity) finance their capital programs from debt and internally generated cash (user charging). Non-commercial PTEs (e.g. public transport) rely primarily on state budget grants and debt to finance their capital programs.

The States and Commonwealth have seen a large recent increase in infrastructure spending, albeit forecast to decline in most cases from the peak in 2009. The states are chiefly responsible for the recent increase. The BCA-commissioned analysis by Port Jackson Partners (PJPL) attributes the "uptick" in state spending to action to offset past under spend in infrastructure.[64]

This analysis highlighted that the recent increase in expenditure on economic infrastructure by the Commonwealth Government comprised 14% of the GFC prompted fiscal stimulus between October 2008 and May 2009. That is, $10.9 billion of the $76.2 billion fiscal stimulus across this period was allocated to ports, road and rail.[65]

The economic infrastructure projects targeted were informed by recommendations from Infrastructure Australia. However, given the primary objective of timely fiscal stimulus, this necessitated priority and funding afforded to projects based on their "shovel ready" status as opposed to their relative economic merit.

Importantly, the PJPL report concluded that the states are unlikely to continue financing infrastructure investment at recent levels. New South Wales and Queensland in particular are focussed on fiscal restraint with high levels of debt coupled with the articulated desire to preserve credit ratings. In short, the states remain fiscally hamstrung to increase investment in infrastructure.

Clearly the restructuring of the financing relationship between the Commonwealth and the States — addressing vertical fiscal imbalance (VFI) — is a missing piece in the puzzle of resolving the adequacy of public sector investment in Australia's infrastructure.

Whilst potentially difficult, failing to adopt more infrastructure user charging is at the expense of more private sector financing

64 PJPL (2009) p35
65 PJPL (2009) p35

FUNDING VERSUS FINANCING: AN IMPORTANT DISTINCTION

From a policy perspective, it is important to distinguish between the funding and financing of infrastructure.

The four funding models for public infrastructure are government debt, taxes, user charges and producer levies — who ultimately pays.

Financing is the source of the upfront capital for the investment itself.

The scope for funding through user charging or levies on users, and therefore potential for commercial return, is the responsibility of Government. Whilst at times politically difficult, a failure to adopt a greater utilisation of user funding mechanisms is at the ultimate expense of being able to tap into private sector financing for infrastructure projects.

Financing can be provided by the public sector or the private sector (corporate, institutional investors or superannuation funds).

Governments have traditionally financed infrastructure with debt. An often cited advantage of using public debt to finance infrastructure is the lower cost of capital. From a fiscal policy framework standpoint, public infrastructure that produces a commercial return can and should be funded by debt. State governments should do so without trepidation of rating agency consequences, subject to rigorous analysis to support the commercial merit of the investment. For public infrastructure that has economic merit but does not produce a commercial return funding needs to come from taxes. Given the size and lumpiness of these investments, this requires a small budget surplus when such spending is moderate to produce a buffer or reserve to fund large investments when they are needed.

Most public infrastructure does not have the commercial opportunities to be fully self funding. This reflects the following factors, taken in isolation or combined:

- External economic benefits / public good characteristics
- Forward planning translates to non-commercial patronage over the economic life
- Limited or absence of user charging
- Absence of forward planning (i.e. land corridor access; retro-fitting costs)

The reality remains that Government faces a financing "zero sum game". Importantly and, in contrast, Government does not face a funding "zero sum game". Government action to initiate funding opportunities through user charging and related microeconomic reform means that projects that can be funded by users correspondingly frees up finances for infrastructure where pricing or user charging is not viable. Further, such policy action can also result in projects becoming commercially viable (self funding) and thereby opening a role for private sector financing. There are also innovative financing models developed and adopted by some states (e.g. availability PPPs) that can allow access to private sector financing even for social infrastructure projects where a commercial return from end user charging is unattainable. These models are addressed further below.

GOVERNMENT VERSUS PRIVATE SECTOR FINANCING

Both the government and the private sector are important to infrastructure financing.

For infrastructure projects which are commercially viable and provide returns to appropriately compensate for the risk involved, and where a government concession right is non-required, the private sector will invest with minimal government involvement. Examples include the mining sectors at times self-funding investment in rail and ports. The only potential role for Government is to ensure minimal regulatory and sovereign risk. These issues and policy direction are detailed in the BCA commissioned report *Groundwork for Growth Building the Infrastructure that Australia Needs* by PJPL.

> Availability of "bankable" projects is the chief constraint for super funds investing more in infrastructure

Infrastructure is an asset class that can provide attractive risk adjusted returns for Australian superannuation funds. The potentially defensive qualities of unlisted infrastructure investment also align well with the post GFC shift in investor risk appetite and the greater focus on "real preservation" as a greater percentage of superannuants transition from pre retirement accumulation to post retirement.

BOX 4: COMMONWEALTH GOVERNMENT BUDGET 2011–12: A CASE OF LIMITED LEVERS?

The five measures announced in the 2011–12 Budget to increase private investment in infrastructure represent small steps in the right direction towards creating a more constructive and transparent environment for private investment in infrastructure.

These initiatives are summarised below.

- The expansion of Infrastructure Australia's[66] (IA) role and funding increase of nearly 40% (to $36 million) over four years. IA is tasked with establishing a National Infrastructure Construction Schedule that will identify and prioritise infrastructure projects (over $100 million) across all levels of government. This is designed to provide a transparent and deeper pipeline of infrastructure projects, thereby improving investor certainty and guiding private investment in projects prioritised through IA's cost benefit analysis.
- IA will establish an Infrastructure Financing Group comprising key private and public sector players to further identify obstacles to private financing of infrastructure.
- Tax incentives in the form of enhanced treatment of tax losses to mitigate wastage and preserve their real value for certain infrastructure projects. Investors in "designated" projects will continue to access tax losses after any change in project ownership and / or business structures. These projects will be exempt from the current tax loss tests (of "continuity of ownership" and the "same business"). The value of the project's tax losses will also be preserved over the project life by indexing at the Government bond rate. Project designation is subject to a global cap of $25 billion of projects and eligibility until 30 June 2017.
- The Government will continue to lengthen the Commonwealth Government Securities yield curve, when prudent to do so, which should facilitate the financing of long term infrastructure projects.
- Additional direct funding for roads and regional infrastructure projects with a further $36 billion to be invested by the Government in developing new and existing roads, railways and ports; and a further $6 billion allocation to the Regional Infrastructure Fund over the eleven years to 2020–21.

66 *IA is a statutory body, established in 2008, to assist Australian governments "to develop a strategic blueprint for unlocking infrastructure bottlenecks and to modernise the nation's economic infrastructure". IA reports to the Council of Australian Governments through the Federal Minister for Infrastructure and Transport.*

The ultimate success of the Government initiatives will be largely dependant on the extent to which IA is able to proactively engage with the State and Territory Governments and private sector investors to identify and address the fundamental obstacles to private and superannuation fund investment in infrastructure.

While the changes are constructive and lend transparency, the reality remains that the Commonwealth Government has limited policy levers with respect to infrastructure projects. Moreover, the overriding fiscal imperative appears to have constrained the time period of project eligibility for the proposed tax concessions.

The tax incentives, whilst welcomed by the private sector, are modest in supporting investment returns from infrastructure and are quarantined to "designated" infrastructure projects and eligibility will only be available until 2017.

Importantly, the proposed tax loss changes do not fundamentally change the economics and risk profile of investing in greenfield infrastructure projects. The tax loss wastage measure does not necessarily advantage investors with "buy and hold" strategies typically employed by Australian superannuation investors. Instead it would tend to favour early investors who seek to exit post-greenfield risk, such as investment banks and construction companies with early stage balance sheet exposure to infrastructure projects.

Whilst tax incentives may improve returns for some investors in the development of greenfield infrastructure projects, long term investment decisions are not driven by tax considerations of this form.

Importantly, unlisted infrastructure is relatively illiquid. Superannuation funds will make an assessment of the appropriate exposure to illiquid assets in their portfolio as part of their strategic asset allocation. This is based on an assessment of their optimal portfolio which reflects their liability matching needs coupled with the risk return assumptions for respective asset classes. Collectively this assessment has seen an allocation of 5% on average to infrastructure by Australian superannuation funds — which translates to Australian superannuation funds currently investing around $65 billion which when leverage is taken into account represents around $190 billion of infrastructure assets. Forecasts suggest that this may reach $120 billion of equity in $340 billion worth of infrastructure assets by 2023[67]. From our experience, coupled with anecdotal reports from Australian superannuation funds, the constraint to investing in infrastructure is not a product of illiquidity considerations by Australian superannuation funds but rather the availability of "bankable" projects.

The reality remains that the Commonwealth Government has relatively limited policy levers which is perhaps best reflected in the recent budget's modest tax loss changes, as outlined in Box 4 above. The states remain ultimately responsible for the implementation of most infrastructure projects. It is they who hold the primary levers to attract private investment into greenfield and patronage-based infrastructure on a sustained basis.

Reality remains that the states hold the primary levers for attracting more private financing of infrastructure

There are five broad challenges to infrastructure investing in Australia, some of which represent market conditions following the onset of the GFC.

The first challenge — the debt financing dichotomy — reflects credit market conditions and we can therefore hope it is a stubborn but not permanent fixture. While Australian Government funding costs are at historically low levels, reflecting a flight to quality or away from risk, the cost of private finance remains elevated. This manifests in higher debt margins; constrained debt availability for economic infrastructure projects by the domestic banks with little risk differentiation and most importantly shorter tenors, thereby introducing material refinance risk for long life projects which imposes a higher risk profile.

That said, and more recently, improved debt terms and tenor are being secured by private investors from international banking sources.

The second and more fundamental challenge — getting the funding economics right is really about pricing and charging for using economic infrastructure.

> "Experience over Infrastructure Australia's first three years confirms that governments are reluctant to use the discipline of pricing to manage demand and encourage efficient new investment."[68]

The reality is that while many of these projects have net economic benefits (that is they pass Infrastructure Australia's benefit cost ratio threshold) they are not commercially feasible because we cannot or do not price for the positive externalities they bring to the economy. There are new and innovative ways of approaching user charging or cost recovery; for example, the hypothecation of distinct council charges in the Gold Coast City Rapid Transit project. As such, there remains scope for broader adoption of user charging or direct government support in recognition of those externalities.

The states can and should encourage earlier participation of long term investors and avoid unsustainable investment metrics driven by short term investors

The third challenge is getting the balancing act right in the risk sharing between the Government and the investor particularly for greenfield projects and patronage based infrastructure projects. Further initiatives are needed. A balance needs to be reached without overly compromising one party lest it's simply not a sustainable partnership. The states need to protect their credit ratings whilst the investor needs some risk sharing as it relates to three risks — patronage, policy and refinance. To date, the Victorian and Queensland Governments have importantly signalled a willingness to meaningfully address this obstacle (e.g. Penlink, the availability charge road for the Peninsula Link project; and the Gold Coast Rapid Transit project).

The fourth challenge is the reality that the magnitude of bid costs and tender risk acts a disincentive for early involvement of long term investors such as superannuation funds. This then results in short term

67 *Infrastructure Partnerships Australia (2010), p.15.*

68 *Infrastructure Australia (2011), opcit, p19.*

investors, the investment banks and construction companies, playing a key role in setting the investment metrics. The key issue is for the state government and long term investors to agree on sustainable investment metrics for individual infrastructure projects. Historically, the state government approach to tenders has not facilitated this outcome.

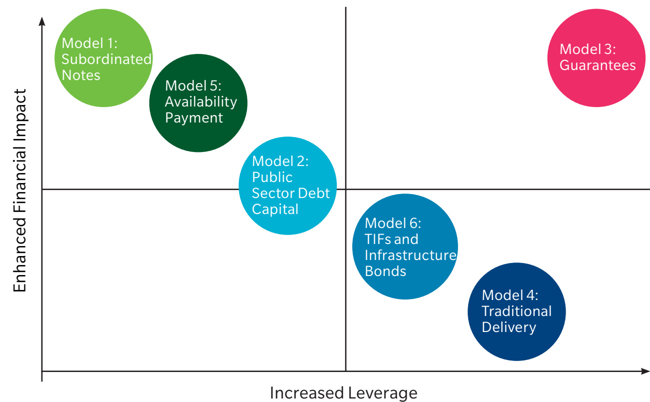
Bid costs and tender risk have clearly resulted in investment banks and construction companies driving the investment transaction metrics. Several iconic Australian toll road failures highlight that this is neither optimal nor sustainable. The one common factor in all three iconic toll road failures was bullish patronage forecasts – all by over 30%. One needs only ask who commissioned the forecasts and whether a success fee was involved to establish that short term investors were bidding patronage. Whilst it is important for some competitive dynamic for the Government to secure value for money, when it is at the expense of long term investors being involved from the outset it becomes problematic. Government can defray the costs by injecting common information and some limited due diligence report requirements (not just geotechnical but also patronage forecasts) that bidding parties can rely upon. This, coupled with pricing and underlying modelling based on the Government's base case, should facilitate greater discipline in the metrics and involvement of long term investors like superannuation funds.

Finally, the fifth and ultimate challenge is the glacial and uncertain flow of infrastructure transactions from Government. Investors really do not have a clear sense of an infrastructure deal pipeline in Australia beyond the next few infrastructure projects in each state. As outlined above, the National Infrastructure Priority List[69] comprises $86 billion in projects. Of those, $19 billion are described as residing in the Ready to Proceed category comprising 11 transport related projects that have economic merit but there is no analysis regarding their commercially feasibility.

There are several established models to facilitate private financing of public infrastructure.[32] These are outlined below.

Importantly, it is not a case of "one size fits all". PwC has developed an insightful and practicable matrix from which to assess the relative merit of the financing models. The objectives forming the basis of the assessment are from a government perspective. Namely, enhancing financial impact (retain risk, achieve cost efficiencies and apply user charges); and increasing leverage (impact on balance sheet and ability to attract private sector capital).

Figure 4.3h
Infrastructure Financing Models



Source: PwC.

The Infrastructure Financing Group, established by Infrastructure Australia, has been tasked with finding solutions for developing a more attractive funding and delivery model to boost private investment in Australia's infrastructure over the long term.

That said, public finance constraints as detailed in Section 5 point to the need for further recourse to private financing of infrastructure as a much needed yet realistic option.

ADEQUATE INFRASTRUCTURE PROVISIONING?

As outlined above, the states and territories are primarily responsible for most public infrastructure investment programs. Infrastructure investment and maintenance priorities are set out by the states in their Annual Budget Papers and respective State Infrastructure Strategies. Some states and territories only forecast infrastructure investment for the four year budget forward estimate period, albeit several have issued infrastructure plans with a 10 year horizon (NSW, TAS, ACT and SA) and a 20 year horizon recently issued by QLD. These estimates suggest the "infrastructure task" for the states and territories over the next four years is around $150 billion. The longer term infrastructure plans provide a very partial picture with only several states providing explicit forecasts for the longer term time horizon.

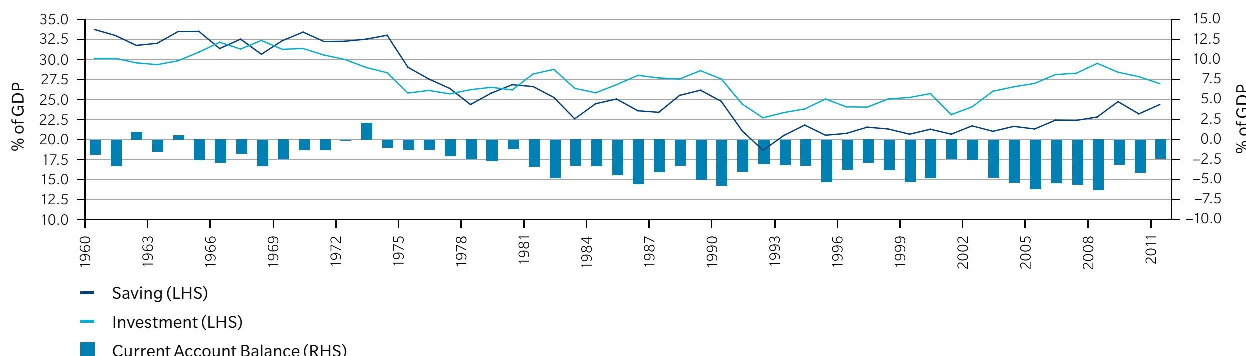
There is clearly a need for the states to not only undertake forward planning of at least 10 years, but to estimate and provision for the financing of the requisite infrastructure task for their respective jurisdictions. In essence, the "infrastructure task" should form a component of the much needed state level Intergenerational Reports (IGRs). This is further discussed in Section 5.

69 As at 30 September 2011
70 PwC (2011)

4.4. FINANCING NATIONAL INVESTMENT

The high levels of investment over the last decade have been financed through a consistent current account deficit — represented by the gap between national investment and national savings (Figure 4.4a).

Figure 4.4a
Gross National Saving and Investment



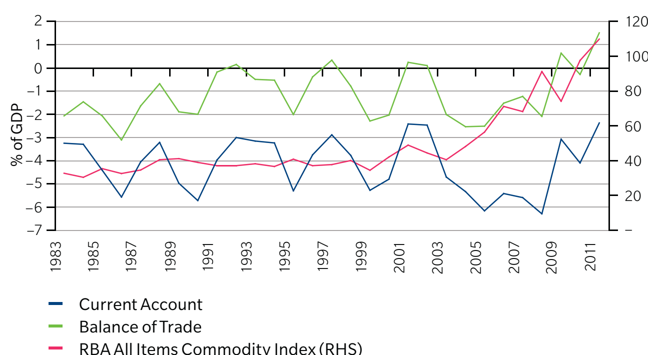
Source: ABS Catalogue 5204.0 & 5302.0

Strong investment is therefore being financed through the use of foreign savings. In this Section the composition of those foreign liabilities and also the risk exposures for the Australian economy is explored.

4.4.1. TRENDS IN THE CURRENT ACCOUNT DEFICIT

Australia's divergence between saving and investment has led to a current account deficit that has fluctuated around the 4% of GDP before increasing to 6.3% in 2008 (Figure 4.4b). Since 2008 strong growth in exports, driven by the mining sector and increasing commodity prices, has meant the current account balance has recovered to 2.4% of GDP. Our reliance on strong commodity prices is again highlighted in these statistics.

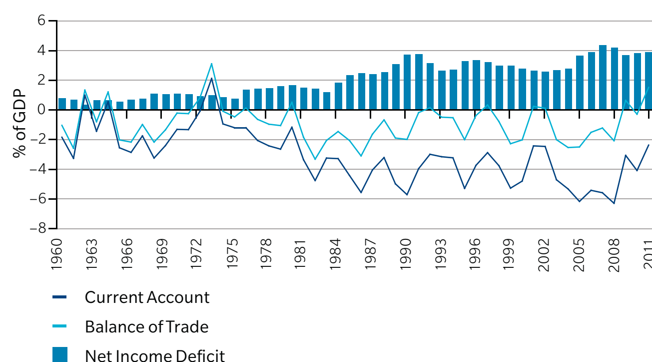
Figure 4.4b
Impact of Commodity Prices of Current Account



Source: ABS Catalogue 5302.0

The difference in the current account deficit and the balance of trade is the net income deficit.[71] This represents the interest paid on Australia's stock of net foreign liabilities, that is to say the interest paid on the money Australia borrows from foreign savers as well as dividend payments to foreign shareholders. The net income deficit has increased over the years, peaking at 4.3% of GDP in 2007 falling back slightly to 3.9% in 2011 (Figure4.4c). Although not an automatic cause for concern the growing use of foreign savings to fund domestic investment warrants further examination.

Figure 4.4c
Net Income Deficit

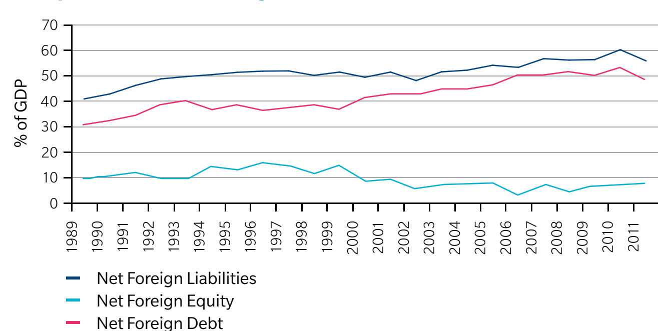


Source: ABS Catalogue 5302.0

71 Gruen (2005)

The gradual rise in Australia's stock of net foreign liabilities peaked at over 60% of GDP in 2010. The composition of foreign investment has also changed over this period. Most of the inflow of foreign capital into Australia is now in the form of debt rather than equity investment. In the early 1990s, by contrast, 23.9% of the stock of foreign investment in Australia was in the form of equity investment in Australian companies. By June 2011, the continuing trend towards foreign borrowings meant that only 11.9% of foreign investment was in the form of equity, having been as low as 6.4% in 2006.

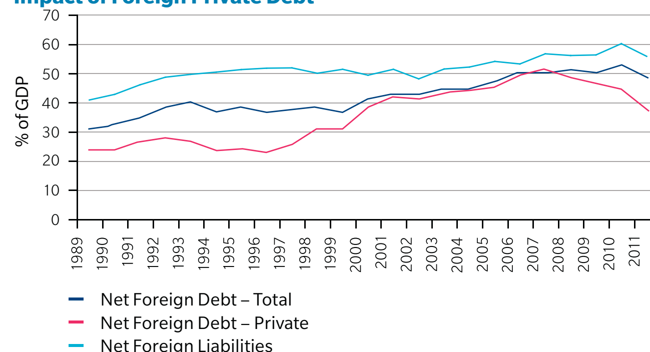
Figure 4.4d
Components of Net Foreign Liabilities



Source: ABS Catalogue 5302.0

The public/private mix of our net foreign debt outstanding has also changed over the last two decades. The amount of private debt has increased to account for almost all of total foreign debt (Figure 4.4e). The recent fall in net foreign debt is a result of the fall in private debt — a further reflection of the recovery in the domestic saving rate over the three years to 2011.

Figure 4.4e
Impact of Foreign Private Debt



Source: ABS Catalogue 5302.0

The large stock of foreign liabilities and the reliance on foreign savings to finance domestic investment means Australia is exposed to external markets. Essential for the ongoing servicing of these liabilities is efficient investment and the associated improvements in capital and labour productivity. For this, Governments needs to maintain the policy impetus for an efficient tax system which is beyond the scope of this Report, however, some limited commentary is provided in Box 5.

BOX 5: TAX REFORM — A CASE OF MORE PLEASE

Although successive Commonwealth Governments have commissioned reports and engaged with industry on tax reform, there have been little concrete reforms in the light of the Henry review of "Australia's Future Tax System" (2010). Reform of the tax system and further reform of the labour market, as outlined in Section 3, are integral to enhancing Australia's investment environment.

> "Considerable room remains for improving the quality and effectiveness of Australia's tax and transfer system...many weaknesses were addressed by the government-commissioned Australia's Future Tax System (AFTS), released in May 2010. It includes 138 recommendations, of which relatively few have been acted upon."[35]

Tax is the key direct policy lever by which the Commonwealth Government can influence efficient investment. A key example affecting investment and productivity is corporate tax. In general, corporate tax lowers domestic productivity by reducing the incentives to invest, and the overall level of investment. Reducing the company income tax rate increases domestic investment. More capital means higher productivity and economic growth and leads to more jobs and higher wages. Although a simplified argument it follows that a simpler taxation system with a lower rate and broader base would reduce the distortions to investment behaviour produced by the current complex system.

The Government has committed to making some adjustments to the tax system. As part of the 2010–11 Commonwealth Budget, the company income tax rate, the main tax on investment, will be reduced from the current rate of 30% to 29% for the 2013-14 financial year and to 28% in 2014-15 financial year, in conjunction with the introduction of the Resource Super Profits Tax (RSPT).

This reduction falls short of the BCA's current position supporting the Henry review proposal of a reduction of the corporate tax rate to 25% and further in time, financed through an offsetting increase in tax on consumption, land or a more efficient payroll tax system.[72] This view has wider independent support, with the OECD claiming that the lowering of taxes on investment and labour can be achieved by increasing the goods and services tax ("GST"), which it says is low by international standards. Reform of the GST and hence where the tax burden fall, would allow a rationalisation of state taxes and could lead to inefficient taxes that are levied with high administrative costs, such as state royalties, conveyance duties and insurance levies being "reduced, reformed or eliminated outright".[73]

Clearly further reform of the labour market, apart from bringing benefits in terms of lower unemployment and higher returns to labour, would better facilitate the structural adjustments needed in an economy in transition.

72 BCA (2011)
73 OECD (2010a), p16

RISKS AND POLICY IMPLICATIONS

A persistent current account deficit, particularly when combined with a high stock of external liabilities, creates vulnerability to external shocks. Specifically for Australia that means that the financial health of the economy, which is currently bolstered by our strong terms of trade, is acutely sensitive to any slowing in China's or emerging Asia's growth and a consequent decline in commodity demand and prices. Negative developments, even temporary, could cause an adverse change in foreign investor sentiment and hence a marked increased in the financial costs at which Australia borrows to fund the investment needed for productivity and growth.

Australia's ability to finance high levels of investment are sustainable at present

Although the temptation is to focus on the mining sector and resource-led industries, the knock-on effects on the wider economy are clear. Reduced foreign investor sentiment has the potential to lead to dearer imports as the Australian dollar depreciates.

While Mercer acknowledges risks to Australia's economic outlook in Section 3, Australia's ability to finance high levels of national investment are sustainable at present.

The relative robustness of the economy means that we have been able to borrow internationally on relatively favourable terms. And with Australia continuing to rely on foreign savings to fund a large part of investment, it remains important for public policy to be formulated with a view to retaining this confidence.

Government needs to shore up confidence through policy discipline and a renewed impetus for structural reform

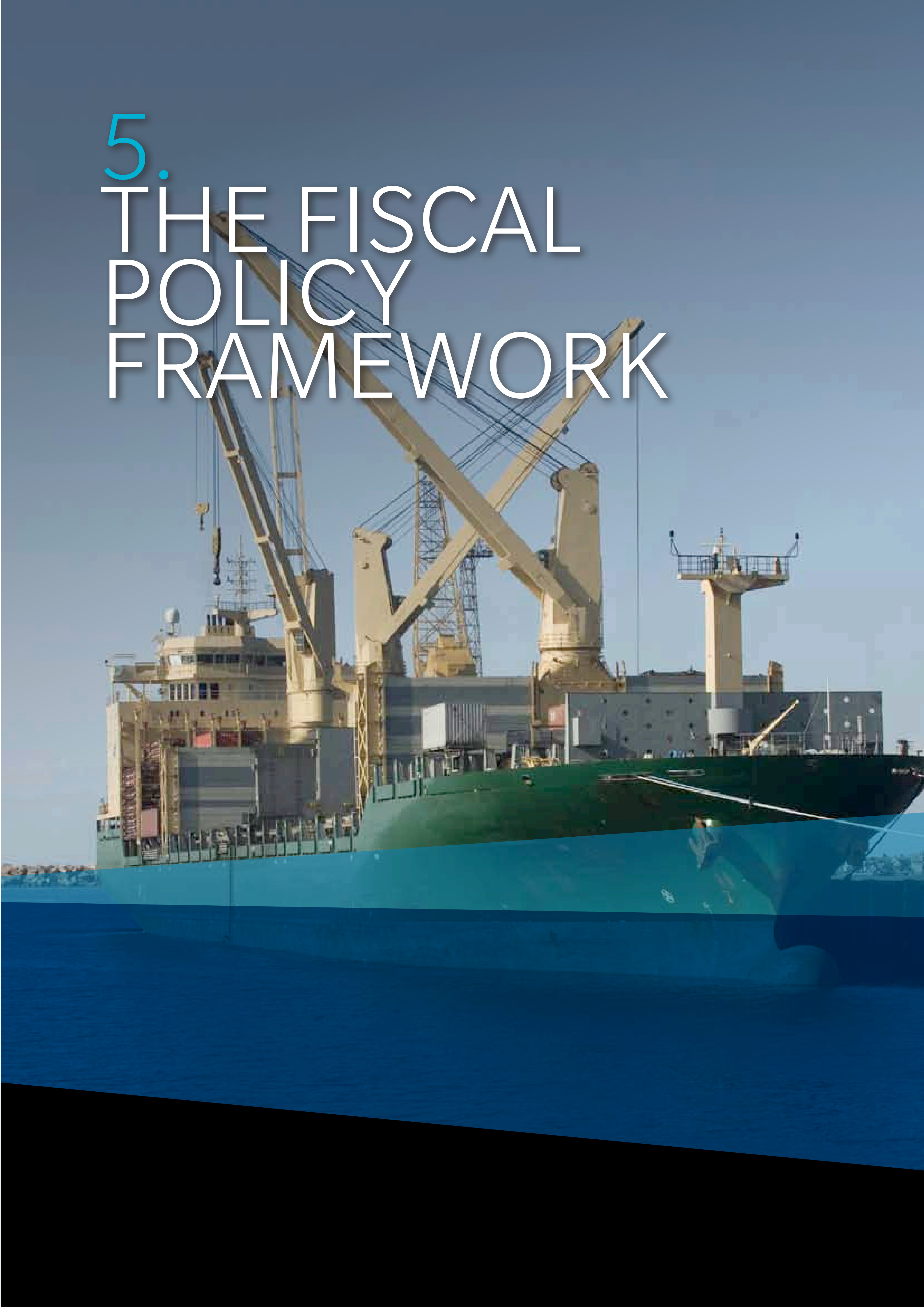
The willingness of foreign investors to finance a current account deficit is closely related to perceptions of the quality of investment being undertaken in the economy. The Asian economic crisis underlines this point. In the affected countries, the loss of foreign investor confidence stemmed from the accumulation of evidence that investment decisions were distorted and corporate balance sheets weak, and not supported by robust financial systems. Concerns about the quality of investment decisions in Australia exist, but are of lesser magnitude.

Where the deficit has arisen as a result of large investment in the economy, the deficit is not seen to be an issue. But this assertion rests on the Government shoring up confidence through:[74]

- Credible monetary policy
- Flexible, open and transparent markets
- Credible market governance frameworks
- Disciplined fiscal policy

Mercer believes that with renewed impetus for structural reform, as outlined in section 3, the Government can satisfy the first three criteria. But we need to revisit the fundamentals of fiscal policy before signing off on it.

74 Henry (2003)


5.
THE FISCAL
POLICY
FRAMEWORK

Public saving is the end product of Commonwealth and state fiscal balances. Public savings are needed for two reasons. Firstly, to provide the flexibility to allow Government to deploy fiscal policy as a counter-cyclical measure in the event of a major economic shock. Secondly, to reserve,[75] through fiscal surplus, for future costs associated with an ageing society. The size of government and government saving is controlled through the all important discipline imposed by fiscal policy rules.

This section examines the fiscal policy rules that have developed over the past two decades, and revisits whether they remain adequate now and into the future.

5.1. WHY DO WE NEED FISCAL POLICY RULES?

In the main, economists and policymakers agree that excessive levels of public deficits and debt are linked with significant costs for an economy. Sustained periods of government deficits exert upward pressure on real interest rates, which adversely impacts private investment and productivity growth. Consistently high debt ratios increase the tax burden and elevate consumer and business expectations of higher tax to pay for that debt, generating distortions in the economy and creating barriers to improvements in productivity and efficiency.

> Ill disciplined fiscal policy backs government into an unpalatable policy corner

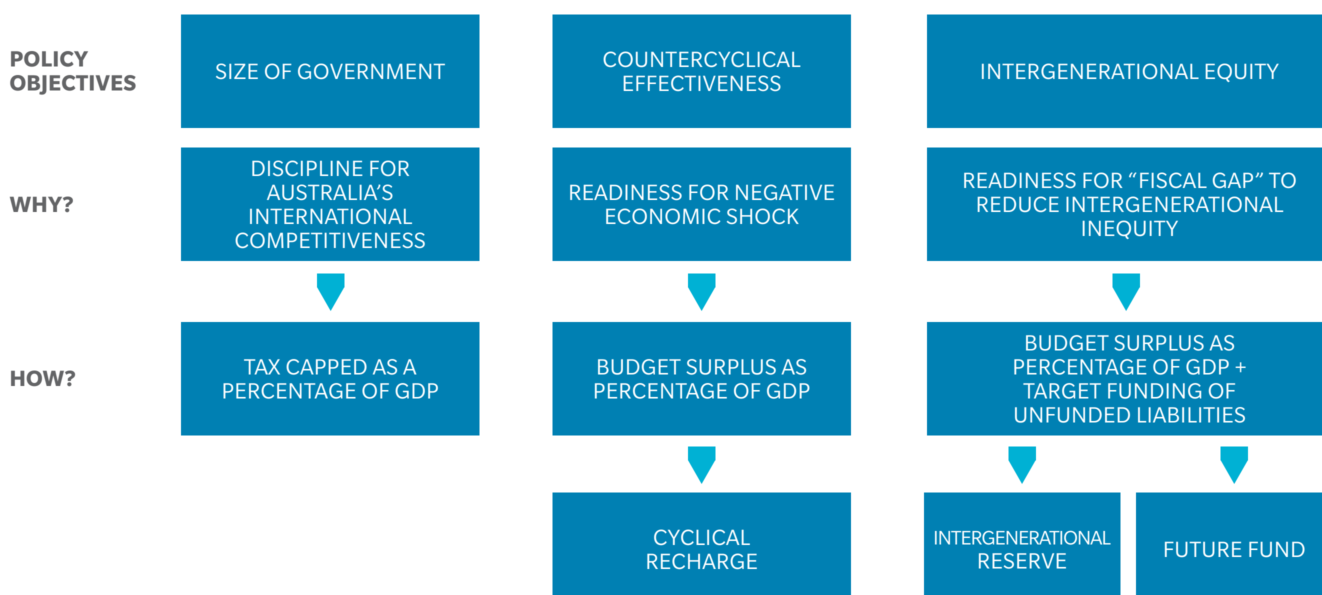
Furthermore, a material stock of government debt can become difficult to control and expose economies to greater volatility and the risk of economic shock. As we are seeing in many European states, ill disciplined fiscal policy over time can result in governments finding themselves backed into a policy corner compelled to impose material, discretionary tax increases or severe spending cuts.

In short, public finances managed in line with transparent and well articulated rules enhance the prospect for strong, sustainable growth in an economy.

> Fiscal rules are integral to securing the medium to long term focus of government action

Fiscal rules are integral for a medium to long term focus of government action. For example, the economic pressures faced as a result of demographic change present an issue of intergenerational equity. The transparent discipline of a responsible fiscal framework and accompanying rules provide a policy

Figure 5.1a
Fiscal Policy Framework



75 *The term reserve is used loosely in the Report – meaning the need to provision funds now for future needs.*

anchor that will prevent excessive spending that will be unsustainable as the tax base narrows and social requirements grow as ageing progresses.

So what should we expect fiscal policy rules to deliver? Broadly speaking, fiscal policy rules should satisfy three fundamental objectives. They should enforce discipline on the size of government, ensure readiness for counter-cyclical action for any major economic shock, and lastly ensure readiness for intergenerational pressure. This broad framework is summarised in our Fiscal Policy Framework on page 72.

> Fiscal rules need to enforce discipline on government size, ensure cyclical readiness for a major economic shock and alliviate intergenerational pressure

As outlined in Section 2, Australia has an established track record of research and policy development on fiscal policy rules. Given increasing exposure of the Australian economy to market volatility, as outlined in Section 3, and sobering fiscal lessons in the wake of the GFC, it is timely to revisit Australia's fiscal policy rules and assess whether they remain adequate and appropriate to do their job.

Since the Charter of Budget Honesty the fiscal framework has stayed broadly consistent. Mercer believes recent developments in the Australian and global economies compel us to revisit the framework and assess the implications of these developments and its ongoing adequacy.

Firstly, and as detailed in Section 3, the Australian economy is in transition and continues to experience record terms of trade. Secondly, previous fiscal discipline translated to the Australian Government being well placed and able to undertake large discretionary fiscal stimulus in response to the GFC. Lastly, the 2010 IGR presents an update on the growing fiscal pressures due to our ageing population.

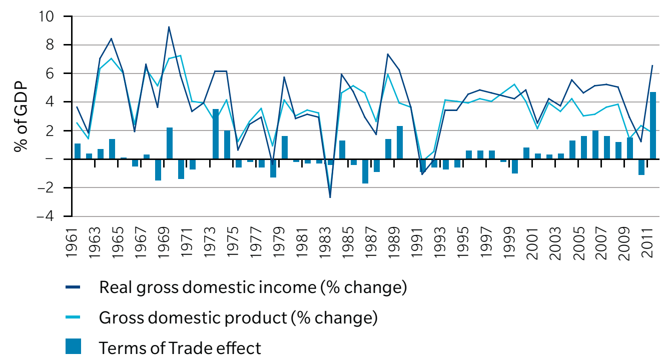
> The GFC's sobering fiscal lessons make it timely to revisit Australia's fiscal policy rules

5.1.1. RECORD TERMS OF TRADE

Australia's terms of trade has replaced employment as the primary indicator of the underlying strength of the Government's budget.[76] Revenue volatility and hence the ongoing level of Australia's terms of trade has a large impact on the structural fiscal balance and hence the ability of the Government to provision for the future. It is important to delineate between cyclical and structural components of the fiscal balance. This allows assessment of the extent to which any year-to-year changes in fiscal policy are expansionary or contractionary and whether fiscal policy is sustainable over the medium term.

It is difficult to come to a firm landing on what is the equilibrium level of our terms of trade. It is therefore difficult to definitively delineate between "windfall" revenues versus revenues with "typical" cyclical volatility.

Figure 5.1b
Terms of Trade Effect



Source: ABS Catalogue 5204.0

Calculating structural fiscal balances is complex. Essentially the aim is to identify components of the fiscal balance which are likely to be temporary because of exceptional developments in real activity, usually measured by the output gap, i.e. divergences of output from estimated trend.

Relying solely on the output gap may not be optimal for countries where production of commodities is a substantial share of output.[77] It may also be important to identify transitory components of the fiscal balance that are related to exceptional output price developments. Currently the OECD does not adjust Australia's cyclical/structural balance for the impact of the high terms of trade. This is only done for Norway.

76 *Access Economics (2011)*
77 *OECD (2006)*

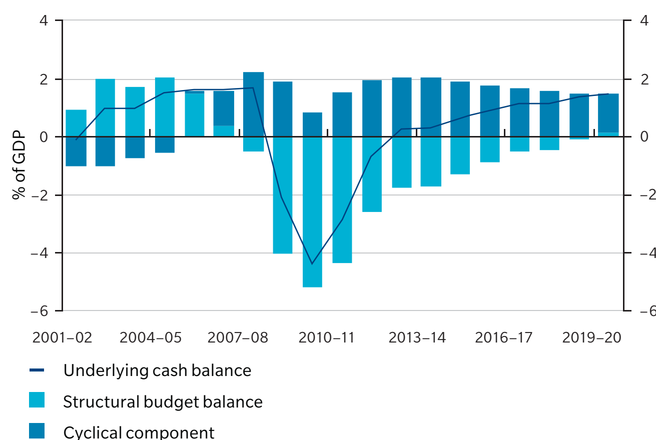
The adjustment to Norway's fiscal balance strips out the effects of tax revenues associated with oil. This volatility of Government revenue is addressed by removing it entirely from structural provisioning. Australia however is faced with terms of trade and volatility issues that differ markedly from Norway's:

- Oil revenues represent 17.4% of GDP in Norway which is over 3 times higher than the contribution of commodity related tax revenue to GDP in Australia
- The revenues associated with commodities are all from a single source in Norway (oil), whereas Australia has a more diversified base for commodity related tax revenue

Importantly, and as discussed below, the Norwegian model is only one of several options for the Government to address the record level of terms of trade in terms of fiscal discipline.

Although the OECD does not adjust Australia's fiscal balance, the Australian Government does make some allowance over the forward estimates. As discussed by McDonald et al (2010),[78] as part of the medium term projections in the 2009–10 Budget it was assumed that the terms of trade would decline by around 15% over a ten year period from 2013–14. The structural budget balance model (Figure 5.1c) assumes a constant structural terms of trade equal to this level.

Figure 5.1c
Structural and Cyclical Components of the Underlying Cash Balance

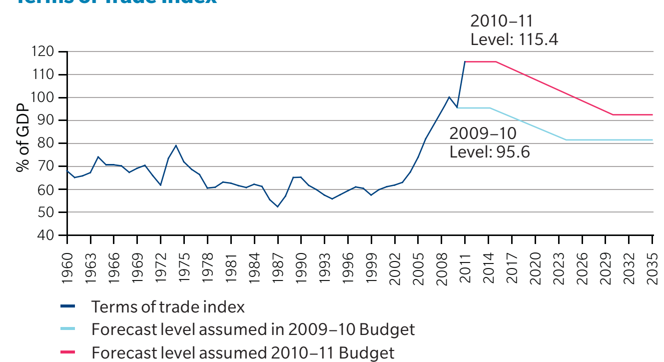


Source: Treasury

The 2009–10 Budget assumed that the terms of trade would decline by around 15% over a ten year period from 2013–14. This was materially amended in the 2010–11 Budget and retained in the 2011–12 Mid Year Economic and Fiscal Outlook (MYEFO). In just a year, the terms of trade outlook was projected to decline by around 20% over a 15 year period, albeit from a higher starting point. This highlights the need for conservatism in how we project the terms of trade and the imperative for Government to diligently meet the fiscal rules even with the anticipated declining terms of trade. Clearly a conservative terms of trade judgement call is required by Government, to ensure that the fiscal projections upon which Government make fiscal decisions is reasonable.

Mercer views the current Budget forecast for the terms of trade as reasonable, albeit not conservative. While we would expect volatility around the terms of trade trajectory assumed in the forecasts, especially driven by short term supply side adjustments, we consider there has been a permanent structural increase in the underlying resources demand. It is equally important that such short term volatility does not erode confidence in the medium term forecasts imbedded in the Budget.

Figure 5.1d
Terms of Trade Index



Source: ABS Catalogue 5206.0, Table 30.

78 McDonald, Yan, Ford and Stephen (2010)

The debate surrounding the permanence of any structural increase in Australia's terms of trade also highlights the greater sensitivity of the budget to commodity prices. In 2010, the BCA commissioned Access Economics to provide analysis on the risk to the Budget of wider economic changes.[79] This paper explored the impact of commodity related revenue volatility on the Budget.

Access Economics found that until 2003, unemployment was a good indicator of the underlying strength of Australia's Budget:

> "In short, the best proxy for the underlying health of Australia's Federal Budget is no longer unemployment — it is now coal and iron ore prices".

This analysis highlights the exposure of public revenues to commodity price volatility. Yet we need to assess how fiscal policy should address this volatility especially as it relates to its impact on the integrity of the fiscal policy rules. This is done below.

5.1.2. RESPONSE TO THE GFC — A LESSON IN THE IMPORTANCE OF FISCAL DISCIPLINE

Assessing fiscal performance is difficult. Although fiscal policy rules and the underlying framework provide a transparent measurable process, during times of stress the counter-cyclical nature of fiscal policy can be implemented in a largely subjective manner. Its relative merit and success can be open for debate. For example during the GFC, the Commonwealth Government undertook what the OECD described as:

> "Significant discretionary measures. One of the largest fiscal stimulus packages in the OECD was made possible by the sound state of Australian public finances — successive surpluses had left public debt low."

As a result of the fiscal response coupled with a coordinated monetary easing the Australian economy remained very resilient to the wider economic stresses and was one of the only industrialised economies to avoid recession. The Government policy response clearly played an integral and positive role. But it can not be delineated from the effects of the strong resources demand from emerging Asia. A point summarised by the OECD and IMF respectively:

> "Although these remarkable results were in part due to the dynamism of the Asian markets, they illustrate both the structural resilience of the economy, well-functioning financial and labour markets and the timely and strong policy response to the crisis."[80]

> "Australia was one of the few advanced economies to escape recession in 2009. This reflected growing links with Asia, including strong demand for commodities from China and India, a prompt and significant macro policy response to the global crisis, a healthy banking sector, and a flexible exchange rate."[81]

The policies themselves are not without judgement. The health of the Australian Government balance sheet meant the fiscal stimulus could be decisive in speed and size, however according to the OECD:

> "the required speed of implementation meant that some spending could have been more cost effective."

Unlike many other, admittedly more indebted nations, the Australian Government did act to ensure that positive movement in consumer and investor confidence as a result of the fiscal stimulus during the GFC was not undermined by the absence of a plan for returning the budget to surplus and meeting the remaining fiscal rules. The Government's associated multi-year plan to restrict the real increase in public spending was assessed by the OECD and IMF as:

> "....appropriate and should be carried out."

> "Staff supported the pace of withdrawal of fiscal stimulus, if the economic recovery proceeds as expected...The fiscal adjustment is faster than past consolidations in Australia and exit plans in most other advanced economies."

79 *Access Economics (2011)*

80 *OECD (2010a), p11*

81 *IMF (2010)*

As discussed in Section 3, Australia's experience through the GFC and the continuing aftermath stands in stark comparison to the US and other European nations. Similar to the Australian Government's response, the US and European countries unleashed large discretionary fiscal stimulus packages in conjunction with monetary easing. The resulting levels of debt being carried on these government balance sheets, coupled with the continuing high levels of unemployment, have devastatingly undermined business and consumer confidence and economic growth.

Clearly these other nations lost sight of the policy fundamentals in that fiscal stimulus should stand ready to be used as counter-cyclical tool for economic shocks. There needs to be a level of discipline to ensure fiscal deficits are reduced or removed during times of growth. The US federal government entered the GFC with material levels of debt and therefore the required fiscal stimulus took them to arguably unsustainable ratios of debt to GDP.

> The US and some European nations lost sight of fiscal policy fundamentals with devastating economic consequences

In summary Government cannot lose sight of the fiscal policy fundamentals. The absence of discipline has manifested, as fiscal policy strayed from its fundamental objectives. It has been used by these countries as a counter cyclical measure when not needed or to satisfy competing policy objectives.

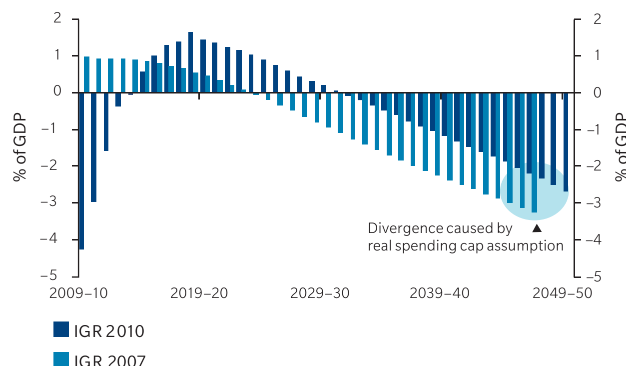
> Australia's fiscal response to the GFC was successful but cannot be delineated from the support of strong resources demand from Asia

5.1.3. FISCAL GAP WIDENING

The proportion of working age people is projected to fall, with only 2.7 people of working age to support each Australian aged 65 years and over by 2050 (compared to 5 working aged people today and 7.5 in 1970). Slower economic growth associated with ageing, increased demand for age-related payments and services, expected technological advancements in health and demand for higher quality health services, will create amorphous pressure on fiscal balances.

These pressures are projected to result in an increase in total Commonwealth Government spending from 22.4% of GDP in 2015–16 to 27.1% of GDP by 2049–50 — that is an increase of $55.7 billion. As a consequence, Commonwealth Government spending is projected to exceed revenue by 2.75% of GDP in 40 years time (Figure 5.1e).

Figure 5.1e
Projected Commonwealth Fiscal Gap



Source: Commonwealth IGR (2010)

> By 2050 only 2.7 Working age people to support each australian aged over 65 years — compared to 5 today

The 2010 IGR projections appear to show an improved fiscal position in 2050 as compared to the 2007 IGR. This is despite a worse than expected starting point for the 2010 report. So what has changed?

As outlined in Section 4.2 above, we have seen that the Government has implemented a supplementary fiscal rule that caps real spending growth to 2% per annum, until the budget is back in surplus. The 2010 IGR assumes that this spending restraint is implemented in full, bringing the economy back to surplus over the forward estimate period. Should the Government not be able to meet this cap then the projected fiscal gap would be significantly wider in 2050, reaching 3.75% of GDP — $53 billion in today's money and highlighting the issues around sensitivity of the fiscal gap to the assumptions.

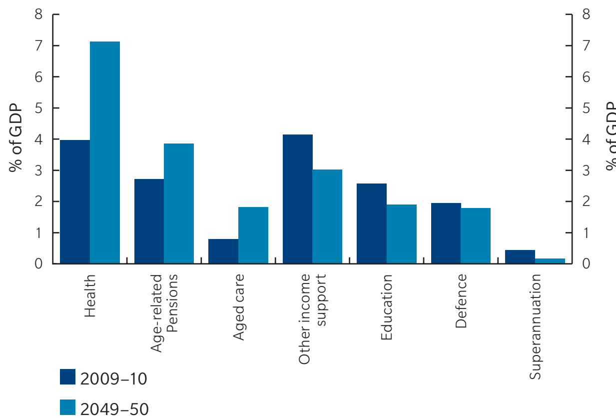
> Government failure to meet the 2% real spending cap will see the commonwealth fiscal gap widen to 3.75% of GDP in 2050

The composition of Government spending is also projected to change materially, with expenditure on health, aged related pensions and aged care increasing significantly. Currently, more than a quarter of Australian Government expenditure is spent on health, age-related pensions and aged care. With no policy change, Government expenditure on these functions is projected to increase over the next 40 years to account for almost half of all Commonwealth expenditures (Figure 5.1f).

Innovation and hard decisions needed now to rein in Australia's future dominant fiscal cost — health expenditure

As the dominant fiscal cost over the long term, health expenditure warrants analysis and action now. Whilst beyond the scope of this Report, innovation and hard decisions will be needed across all fronts — health cost drivers, health cost sharing and health services eligibility.

Figure 5.1f
Composition of Commonwealth Government Expenditure



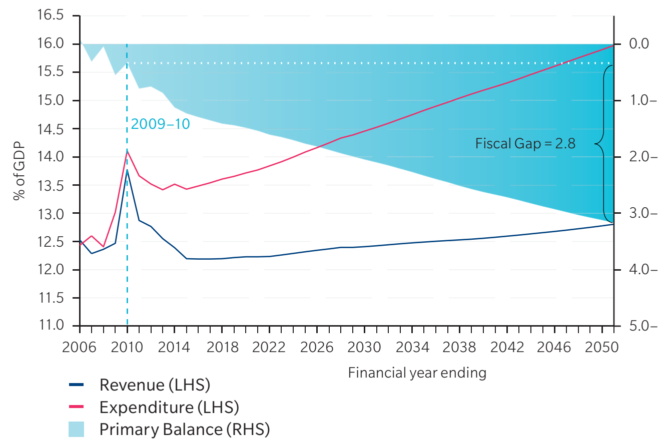
Source: Commonwealth IGR (2010)

The fiscal gap and the implications for intergenerational equity are not limited to the Commonwealth Government. Although our fiscal framework is not specific to the states, the themes of readiness to deal with intergenerational equity applies to the state governments as well.

NSW is the only state to publish an IGR

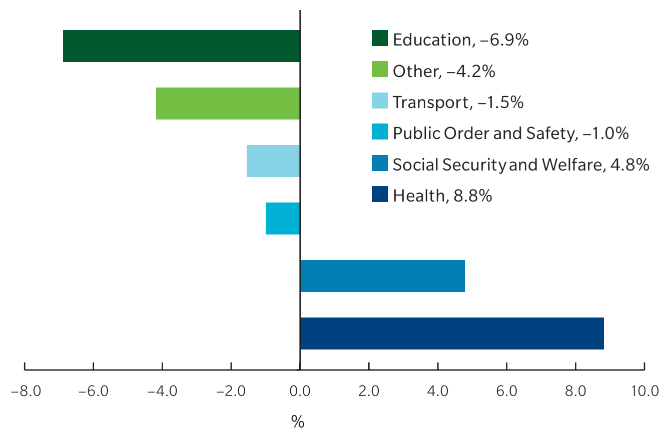
New South Wales is the only state government to date to publish an official state level IGR . It details an unsurprisingly similar trend to that seen at the national level. The 2011 New South Wales report estimates that without policy change, budget expenditure growth will outpace revenue growth every year for the next 40 years and result in a fiscal gap of 2.8% of GSP by 2050–51.

Figure 5.1g
Projected Nsw Fiscal Gap



Source: NSW IGR: Primary Balance and Revenue and Expenditure as a share of GSP

Figure 5.1h
Composition of NSW government expenditure

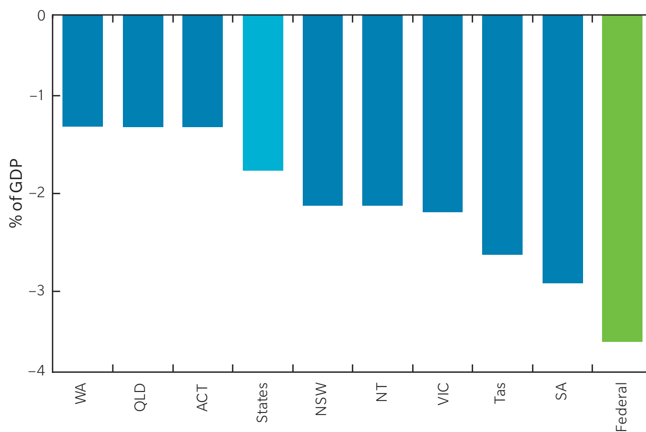


Source: NSW IGR

Collective state fiscal gap forecast to be 2.5% of GDP by 2050

The other states are yet to undertake or publish explicit long term intergenerational forecast. There has been some independent analysis and modelling for the states with a BCA commissioned report by Deloitte Access Economics.[82] This analysis forecasts that the fiscal gap for the states would be on average 2.5% of GDP by 2050. The relative worsening in primary balances between 2020 and 2050 as a percentage of output is shown to be about half that of the Commonwealth average (Figure 5.1i).

Figure 5.1i
State Primary Fiscal Balances



Source: Deloitte Access Economics

Clearly the fiscal gap will widen over time and fiscal policy needs to be addressed to account for the growing pressure that will be exerted on Government balance sheets as a result of an ageing society. The overall target for the construction of any fiscal policy needs to be conservative, to account for the sensitivity of the fiscal gap to assumptions, but also the Government's need to fully meet the real spending cap. The sensitivity of the fiscal gap and whether current Government policy is adequate is discussed further in this section.

5.2. FISCAL EFFECTIVENESS

In this section, how we measure fiscal objectives and whether the rules are appropriate and adequate is explored. It is therefore important to revisit the current rules and assess whether they are suitable given developments in the Australian economy and globally.

The 2011–12 Commonwealth Budget restates the Government's medium-term fiscal strategy; namely, to:[83]

- Achieve budget surpluses, on average, over the medium term
- Keep taxation as a share of GDP below the level for 2007–08 (23.5% of GDP),on average
- Improve the Government's net financial worth over the medium term

In the Updated Economic and Fiscal Outlook (UEFO) released in February 2009 the Government also committed to take action to return the budget to surplus once the economy recovered to grow above trend. As part of this strategy, the Government developed two supplementary and transition fiscal rules to:

- Allow the level of tax receipts to recover naturally as the economy improves, while maintaining the Government's commitment to keep taxation as a share of GDP below the 2007–08 level on average
- Hold real growth in spending to 2% a year until the budget returns to surplus

A close look at the evolution of our fiscal policy rules reveals slippage in "size of government" discipline

Chart 5.2a overleaf, details the evolution of the fiscal policy rules over time. While the extent to which these rules have changed overtime appears relatively small, the greater specificity has emerged for some rules with some obtuse referencing in others.

82 Deloitte Access Economics (2011)

83 Commonwealth (2011–12b)

Figure 5.2a

The Evolution of Australia's Fiscal Policy Rules

RULE	84/85	85/86	86/87	87/88	88/89	89/90	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10	10/11
SIZE OF GOVERNMENT		NO INCREASE IN TAX AS %GDP NO INCREASE IN GOVERNMENT EXPENDITURE AS % GDP						NO NEW NET EXPENDITURE						NOT TO INTRODUCE NEW TAXES OR INCREASE EXISTING TAX RATE		NO INCREASE IN THE OVERALL TAX BURDEN	NOT TO INCREASING THE OVERALL TAX BURDEN FOR 1996-97 LEVELS (22.3% OF GPD)								KEEP TAXATION AS A SHARE OF GDP BELOW THE LEVEL FOR 2007-08 (23.5% ON AVERAGE)		
TARGET TAX % GDP		22.3%	22.3%	22.3%	22.3%												22.3%	22.3%	22.3%	22.3%	22.3%	22.3%	22.3%	22.3%	23.5%	23.5%	23.5%
ACTUAL TAX % GDP	22.3%	22.4%	23.1%	22.5%	22.2%	22.1%	22.1%	20.4%	19.8%	19.8%	21.0%	21.7%	22.3%	21.1%	22.2%	22.8%	24.0%	23.1%	23.9%	23.8%	24.1%	24.1%	23.6%	23.5%	21.7%	20.3%	20.3%
CYCLICAL READINESS		BUDGET DEFICIT TO BE REDUCED IN MONEY TERMS IN 85/86 AND REDUCED AS A % GPD OVER TIME								BUDGET DEFICIT TO BE REDUCED TO 1% GDP				ACHIEVE BUDGET SURPLUSES, ON AVERAGE, OVER THE MEDIUM TERM													
UNDERLYING CASH BALANCE % GDP	-2.5%	-2.0%	-0.8%	0.4%	1.5%	1.5%	-0.1%	-3.0%	-4.0%	-3.9%	-2.8%	-2.1%	-1.1%	0.0%	0.6%	2.0%	0.8%	-0.1%	0.9%	0.9%	1.5%	1.6%	1.6%	1.7%	-2.2%	-4.3%	-3.6%
INTERGENERATIONAL READINESS										HALVING THE RATIO OF GENERAL GOVERNMENT TO GDP FROM				BUILD UPON THE FISCAL CONSOLIDATION IMPLEMENTED IN THE 96-97 BUDGET		IMPROVE THE GOVERNMENT NET ASSETS POSITION OVER THE MEDIUM TERM TO LONGER TERM		IMPROVE THE GOVERNMENT NET WORTH POSITION OVER THE MEDIUM TERM TO LONGER TERM	IMPROVE THE GOVERNMENT NET ASSETS POSITION OVER THE MEDIUM TERM TO LONGER TERM	IMPROVE THE GOVERNMENT NET WORTH POSITION OVER THE MEDIUM TERM TO LONGER TERM					IMPROVE THE GOVERNMENT NET FINANCIAL WORTH OVER THE MEDIUM TERM		
AD-HOC												ENSURE THAT GOVERNMENT SAVINGS COVER INVESTMENT	DIRECTING SUFFICIENT RESOURCES TO HIGH PRIORITY AREAS, WHILE SIGNIFICANTLY REDUCING THE RATIO OF EXPENSES TO GDP BY 00-01	HALVING THE RATIO OF GENERAL GOVERNMENT NET DEBT GDP FROM 20 PERCENT IN 95-96 TO 10% BY 00-01											HOLD REAL GROWTH IN SPENDING TO 2 PER CENT A YEAR UNTIL THE BUDGET RETURNS TO SURPLUS ALLOW THE LEVEL OF TAX RECEIPTS TO RECOVER NATURALLY AS THE ECONOMY IMPROVES		

Terms of trade projections needs to be transparent and reasonable

What does emerge from Chart 5.2a is slippage in fiscal policy discipline as it relates to the size of government. In 15 years we have seen the effective hard cap slip by over a percentage point of GDP – masked by obtuse referencing in the rules from 22.1% to 23.5% today — that is $16 billion of more tax revenue.[84]

WHAT ARE THE RIGHT FOUNDATIONS FOR APPLYING THE FISCAL RULES?

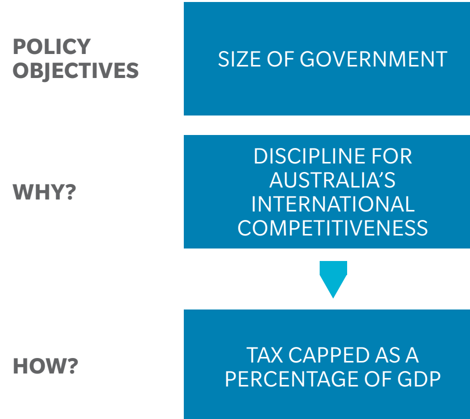
Before the current fiscal rules are assessed, and given the greater volatility of revenues to movements in the terms of trade, it is important that we first ensure that the terms of trade assumptions upon which fiscal framework decisions are made are reasonable. Clearly a conservative terms of trade judgement call is required by Government, despite the Treasury's conclusions that "we do not know what the structural balance is with sufficient precision for it to be an operational tool for policy".[85] For the fiscal rules to deliver on the required fiscal provisioning for cyclical effectiveness and intergenerational equity the permanent or otherwise nature of Australia's terms of trade does require analysis and a judgement to ensure that any temporary improvements in the fiscal balance can be efficiently utilised to alleviate future budget pressures.

As detailed above, Mercer views the current Budget forecast for the terms of trade as reasonable, albeit not conservative. So if the terms of trade forecasts are accepted as reasonable, how should we integrate this "judgement" on the sustainability of the current terms of trade into the implementation of the fiscal rules?

Mercer believes that the current strong yet unsustainable terms of trade level, heightens the imperative for disciplined fiscal action today. Policy decisions today should be premised on the projected decline in the terms of trade. A future terms of trade decline can not justify any call to flex the limits and breach the fiscal policy rules. In saying this, Mercer acknowledges that should the terms of trade volatility induce a major economic shock requiring fiscal stimulus, then there is a case initiate a fiscal stimulus in the context of the fiscal rules.

The current fiscal rules are now assessed against the fiscal policy framework. Taking each pillar of the framework in turn, the current rules are assessed against the size of government, counter-cyclical readiness and intergenerational equity.

5.2.1. SIZE OF GOVERNMENT



The size of government is tax as a percentage of GDP plus/minus any budget deficit/surplus as a percentage of GDP.

For simplicity, the focus is on the Commonwealth Government. This reflects the twin realities that the Commonwealth funds 45%[86] of state expenditure; and surplus provisioning is to largely meet future needs at the Commonwealth level (be it intergenerational equity or cyclical readiness).

The optimal size of government is the subject of many studies which are not considered in depth here, Box 6 provides a brief overview of the range of views on the optimal size of government.

Current 23.5% of GDP revenue cap rule is high by historical standards — but needs to become a hard cap going forward with no further slippage

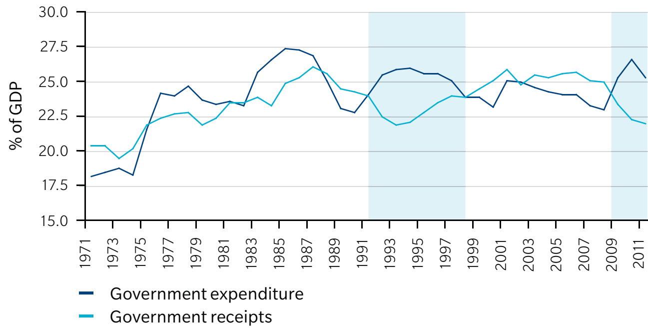
84 Percentage difference expressed in a $ value of present GDP

85 Parkinson (2011)

86 Architecture of Australia's tax and transfer system, Section 10.6: Federal fiscal relations

In Australia, Commonwealth Government expenditure grew materially in the mid-1970s (Figure 5.2b), largely as a result of increased role of government in social security and welfare.[87] The size of government has stayed pretty constant since that time so much so that informed commentators ascribe the Government of the day during the 1970's having presided over a "permanent increase in the size of Australian government".[88]

Figure 5.2b
Government Expenditure and Receipts



Source: Commonwealth 2011–12 budget, Budget Paper 1, Statement 10

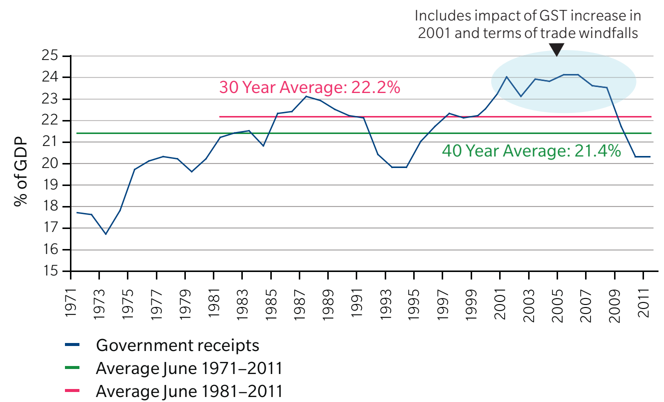
Generally increased expenditure has gone hand in hand with tax receipts i.e. tax pays for expenditure rather that an increase in debt. This highlights the logic in the rule controlling the tax burden. The discretionary role of fiscal policy however does mean that this relationship does not hold in major cyclical downturns, for example during the early 1990s recession and the GFC (highlighted yellow).

> The 1970's government of the day presided over a permanent increase in the size of government

Given the future fiscal gap and the need for international competitiveness, and therefore tax competitiveness, the question becomes, what is the suitable long term constraint to target and is the government's rule of keeping taxation as a share of GDP below the level for 2007–08 (23.5% of GDP) suitable and credible.

The level of government tax receipts as a percentage of GDP does move, as would be expected, in a cyclical manner (Figure 5.2c), albeit with a stronger linkage more recently to Australia's terms of trade. Based on the historical trends, the current target of keeping tax as a percentage of GDP to 23.5% exceeds the 40 year average (of 21.4%). The current target also exceeds the 30 year average (of 22.2%) which includes the impact of the structural increase in government expenditure of the mid 1970s.

Figure 5.2c
Government Tax Receipts



Source: Commonwealth 2011–12 budget, Budget Paper 1, Statement 10

It is both appropriate and good fiscal practice to maintain an explicit cap for the level of tax revenue as a percentage of GDP – a discipline to the size of government. Unfortunately this fiscal rule has seen some slippage over the past 15 years. The current cap of 23.5% exceeds the 30 year average — which already includes the structural increase in the size of government from the 1970s. That said, we do need to allow for intergenerational pressures. It is important to retain transparency and credibility around the size of government to stop any future slippage. Given the starting point Mercer believes that the current cap of 23.5% should be retained but should become a hard cap so future budgets do not see further slippage.

Allowing the revenue cap to reside above the 30 year average allows for some size of government "headroom" in recognition of the intergenerational pressures faced by Government. Importantly, current tax receipts already incorporate some windfall revenues associated with Australia's record terms of trade as well as the one off structural increase in revenue with the introduction of the GST in 2000.

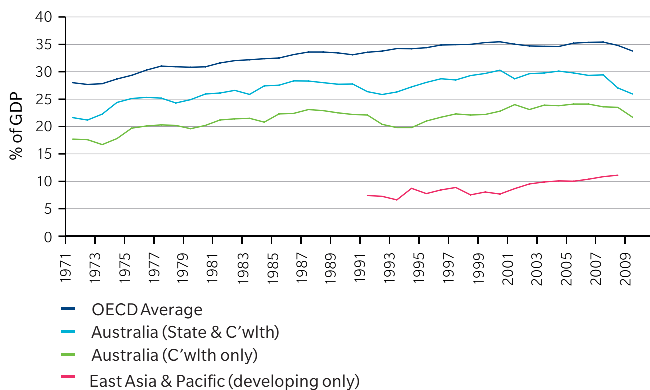
87 Henry (2009)

88 Henry (2009), p25

Mercer therefore views this cap as achievable and reasonable. By imposing a hard cap discipline on the Government, productivity and economic growth enhancing policies (as we have previously identified) are the remaining "swing policy" to reduce intergenerational pressures. As outlined in Box 6, there is a broad range of consensus views on what is the optimal size of government for a developed country, like Australia. Those studies do lend support to the Australian Government's current target of 23.5% of GDP to be reasonable.

In assessing the tax rate it is useful to look at our developed world and Asian counterparts (Figure 5.2d). Australia's tax revenue as a percentage of GDP has been materially lower than the OECD average over time, but we cannot rest on our laurels as the limited data on the East Asia and Pacific averages shows our closest trading partners have materially lower tax receipts as a percentage of GDP.

Figure 5.2d
Government Tax Receipts



Source: OECD World Economic Outlook and World Bank Development Indicators

Given the starting point Mercer believes that the current cap can be retained, but should not move any higher given it already incorporates some size of government head room. The integrity of the tax cap also depends on the cyclical readiness rule being met, requiring a small surplus in the absence of an economic shock. However, and as detailed below, the ability to continue to meet this revenue target, whilst meeting the cyclical rule, will require substantive policy action from Government to begin addressing the approaching fiscal gap.

BOX 6: IS THERE AN OPTIMAL SIZE OF GOVERNMENT?

EMPIRICAL DISCUSSION TO DATE

The relationship between the size of government and productivity is not clear cut. Many academic studies find that government spending has a positive effect on productivity growth. Indeed, it is widely acknowledged that a certain level of government spending, particularly on public goods that generate positive externalities, is essential for productivity growth. However, excessive government spending can hinder productivity growth because of government inefficiencies, the burden of taxation, and the creation of distortions and barriers to free markets.[89]

These opposing effects mean it is not clear whether the overall impact of the size of government on productivity growth is positive or negative, and whether that relationship is consistent over time. One common finding that most studies agree on, is that that an overly large and growing size of government is not conducive to higher productivity growth and economic performance. In that sense there is an intuitive maximum size of government.

There remains a range of views on the threshold at which the size of government (measured as a share of GDP) begins to detract not promote economic growth. A 1996 study assessed the optimal size of government for the US and New Zealand residing between 19% and 23% of GDP.[90] This report was cast against the historical Keynesian backdrop that the maximum tolerable proportion of taxation in an economy is 25% of GDP.

IMF and ECB economists conducted a review of the effects of increased government spending on a range of non-economic indicators. They concluded the maximum size of government is 30% of GDP and that most governments in the developed world exceeded their optimal size between 1960 and 1980.[91]

In Australia, the 1970s Whitlam Government introduced a broad ranging policy agenda — the implementation of which structurally increased the scope and size of Australian Government. Policies included real increases in social welfare payments, free university education, universal medical coverage and significant public sector real wage rises.

Current Treasury thinking suggests that economic analysis can not proffer a definitive answer on what is the optimal size of government:

Based on the numerous efforts to estimate, for developed countries, an empirical relationship between size of government and aggregate measures of things relevant to wellbeing, including rates of economic growth, it would be sensible to conclude that the optimal size of government is not a question that can be answered by a technical economic analysis.[92]

That said, the current fiscal rule that Commonwealth revenue not exceed 23.5% of GDP does imply a ceiling on size of government.

POLICY IMPLICATIONS

Whilst there is a broad range of consensus views on what is the optimal size of government for a developed country, like Australia, those studies do lend support to the Australian Government's current target of 23.5% of GDP to be reasonable.

Importantly, and given the opposing impact that government spending may have on productivity, the absolute level as long as it resides within a disciplined range does not appear to be as important as the efficiency and effectiveness of the underlying government spending. So having satisfied the absolute disciplined level, the focus of policy should be on promoting government expenditure in areas that promote economic growth, such as human capital and economic infrastructure, and outlays on social security and welfare are structured to not impede labour market flexibility.

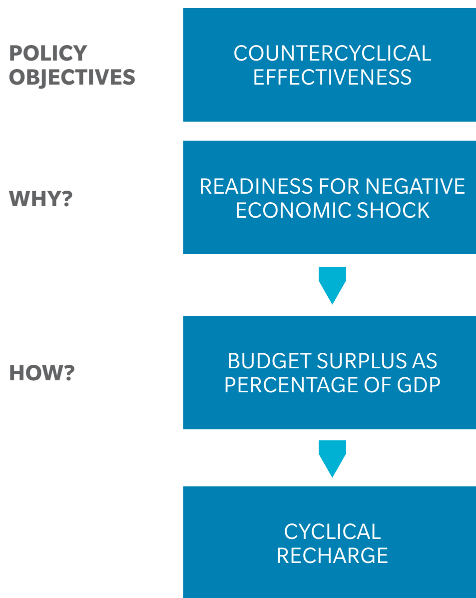
89 *Barro (1991) and Dar and Khalkhali (2002)*

90 *Scully (1995) and (1996) Scully (1995) and (1996)*

91 *Tanzi and Schuknecht (2000)*

92 *Henry (2009)*

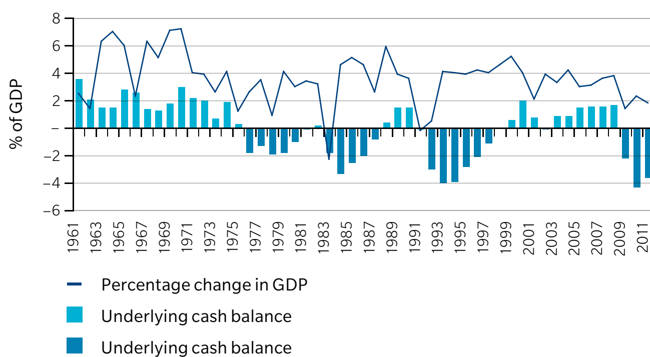
5.2.2. CYCLICAL READINESS



As discussed in Section 3, effective fiscal policy needs to be ready and able to deploy fiscal stimulus for economic shocks to the economy that cannot be managed through monetary policy alone. For the fiscal policy rule to be meaningful and provide for transparency and a measurable benchmark, it does require a hard target. This target does call for a judgement call on the frequency and magnitude of an economic shock requiring fiscal action.

The underlying fiscal cash balance shows how Commonwealth Government deficits have moved over time (Figure 5.2e[93]).

Figure 5.2e
Commonwealth Underlying Cash Balance



Source: Commonwealth 2011–12 budget, Budget Paper 1, Statement 10

NB: Since 1976 shown on a consistent basis.

Earlier data are classified on the basis applying in the relevant Budget year.

It is inherently difficult to delineate how much of the fiscal deficit was needed for counter cyclical fiscal stimulus. We can see that the Government moved into deficits after commensurate falls in GDP during the late 1970's, mid 1980's, mid 1990's and late 2000's — translating to an average of every 10–13 years.

In terms of the magnitude of the required fiscal stimulus, the average level of Commonwealth underlying cash balance as a percentage of GDP in each of the four deficit tranches is 2.2% of GDP.

> The current rule is not enough to shore up integrity in the absence of a hard target for "recharging" fiscal readiness

Although this gives some insight into how the Commonwealth balance has moved over time, it is not possible to delineate between the level of government deficit required to counter an economic shock and the level of government deficit that was motivated for other reasons.

So in terms of the requisite judgement call, Mercer considers it reasonable and prudent to assume that the Commonwealth Government will be required to make a 3% of GDP contribution to the economy in terms of counter cyclical stimulus on average say every 13 years. The sizing and frequency are informed by qualitative assessment of previous economic recessions in Australia requiring fiscal action, as outlined in Section 3. From this judgement call we can then determine the level of surplus that needs to be generated to satisfy the cyclical readiness rule.

The Government's current fiscal stimulus exit rules compel the return to surplus as soon as possible. Mercer believes the rules are appropriate and provide a suitable level of fiscal discipline. Mercer therefore supports the focus and imperative of returning to surplus by 2012–13. This not only supports the retention of international confidence in the Australian Government and economy should Government borrowing be needed for an earlier than anticipated economic shock, but also resumes the journey to restore medium term fiscal discipline.

93 *Underlying cash balance is equal to receipts less payments, less expected Future Fund earnings.*

A 3% of GDP cyclical readiness judgement call is reasonable. After paying down debt, we need to reach this accumulated surplus by 2024

The constraint on real growth in spending is a specific strategy implemented by the Government to ensure the wider fiscal objectives can continue to be met in light of the GFC prompted stimulus. Although it has been seen as a well designed fiscal strategy it will require much fiscal discipline. Given that the benefits of meeting this target have been banked as delivered policy in the Government's forecasts and IGR, any deviation from meeting the measure will result in a real deterioration in the fiscal balance as compared to projections. Mercer notes that although the Government has found it easy to meet this target in the first year, in order to meet it over the forecast period will require substantive restraint in spending in the coming years.

The Government's current rule — to aim for surplus — is right but the imperative now is to shore up its integrity with hard targets informed by the objective — the readiness of fiscal policy for an economic shock. Mercer therefore believes the Government needs to specify a target percentage surplus in the fiscal policy rules based on recharging fiscal readiness in 13 years time for fiscal policy to be able to make a 3% of GDP contribution to the economy. That is to say, a series of small annual surpluses need to accumulate over 13 years to enable debt to be repaid and fiscal capacity to be recharged to be able to deploy a fiscal stimulus equivalent to 3% of GDP.

Government's current fiscal rules do not convert the IGR imperative into an explicit fiscal rule

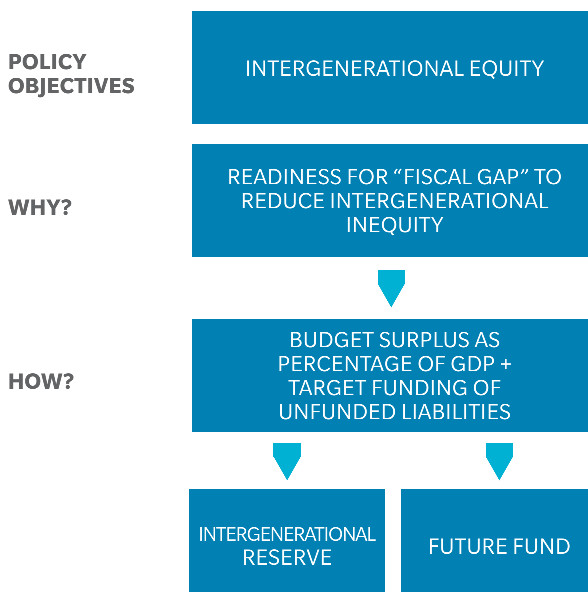
The Government's net debt position is inextricably linked to the notion of cyclical recharging through modest annual surplus. Should a major economic shock requiring fiscal action occur prior to the accumulated surplus being built up over this target period, the Government of the day should borrow in order to finance the fiscal stimulus, subject to international confidence and the terms. This is caveated with the requirement that such borrowing only be permitted with the Government undertaking to return to surplus as soon as practicable and thereby restore the net debt position to pre-stimulus levels. That is, there should be no permanent increase in net debt levels from the stimulus.

Cost effective borrowing rests on the retention of international confidence in the Australian economy, Mercer's preference is therefore to build up the cyclical recharge such that it could be deployed without the need to borrow and therefore satisfy the terms set by overseas lenders. That said Government net debt is currently 8.9% of GDP. Mercer concurs with the Government's priority to pay down the current net debt position to 0% by 2020-21. Reducing net debt supports confidence in the Government's fiscal integrity, thereby facilitating borrowing on relatively reasonable terms if required. Once net debt is removed, and in the absence of a premature major economic shock, the Government should accumulate surpluses to achieve cyclical readiness equivalent to 3% of GDP in the remaining 3 years to 2024.

As it is envisaged that this cyclical recharge will likely be deployed every 13 years, there is no need to establish a reserve fund. Any required fiscal stimulus needs to be deployed expeditiously and there are no defined liabilities, in contrast to those of the Future Fund, Mercer therefore envisages that the accumulated surpluses reaching 3% of GDP would be invested in cash-like instruments and could be managed by the Australian Office of Financial Management (AOFM).

Importantly, the suitability of the current fiscal policy rules to provision for economic shocks inherently assumes a steady state. That is, each generation is equal from a budget perspective — the same size and with equal impact on budget structure. This, of course, is not true. However under the proposed fiscal policy framework the intergenerational objective of fiscal policy is provisioned for through a separate rule as discussed below.

5.2.3. INTERGENERATIONAL EQUITY



Intergenerational equity needs to target a modest surplus to provision for the fiscal gap coupled with hard policy action to reduce the fiscal gap

The IGR aims to increase both transparency and provisioning for the costs associated with an ageing society. The reports highlight key assumptions around the underlying drivers — being population, productivity and participation in order to assess any potential fiscal gap where Government expenditure will outgrow revenues in the future.

Currently the Government's fiscal rules do not convert the output from the IGR into an explicit fiscal rule. A potential obstacle to making a more transparent and credible attempt at provisioning for the projected fiscal gap may be the sensitivity of the projections to their assumptions.

Although assumptions are inherent in fiscal forecasts, a level of scrutiny of several key assumptions is warranted to highlight the potential risk for further deterioration in the fiscal gap. This further elevates the policy imperative of provisioning action today. It also highlights the opportunity for Government to implement policy that can reduce the fiscal gap — informed by the underlying drivers and the anticipated sensitivities.

As we know the Commonwealth projected fiscal gap in 2050 is sensitive to many assumptions including the initial assumption of meeting the real spending cap. Should the Government not achieve the initial reductions in expenditure then under the same set of assumptions the fiscal gap in 2050 would be much more severe — 3.75% of GDP instead of the forecast 2.75% of GDP [94]. The table below outlines the key identifiable assumptions affecting the fiscal gap forecasts:

Figure 5.2f — Intergenerational Report Sensitivities

KEY ASSUMPTIONS	IGR ASSUMPTION	SENSITIVITY	SUITABILITY
POPULATION: FERTILITY	Fertility rate: 1.9%	Minor	Potentially optimistic given the recent pick up has only been temporary
POPULATION: MORTALITY	Men (women) to live 7.6 (6.1) years longer by 2050	Minor	Appropriate
POPULATION: MIGRATION	In line with 40 year average: 0.6%pa of resident population (180,000 pa from 2012)	Minor	Potentially too low given recent decade and expected required migration
LABOUR FORCE PARTICIPATION: GENERAL	Projected to fall from 65% to 61% by 2050	Minor	Appropriate
LABOUR FORCE PARTICIPATION: MATURE AGE	Mature age participation to continue to be lower than 25–54 yr olds	Moderate	Output sensitive to mature age participation albeit, difficult to stimulate[95]
PRODUCTIVITY	In line with 30 year average: 1.6%	Major	Too high given recent decade and expected productivity over forward estimates
INITIAL SPENDING CAP	Policy met in full	Major	Although included in forward estimates and the budget medium term forecast, there is key risk to the fiscal gap of policy not being delivered

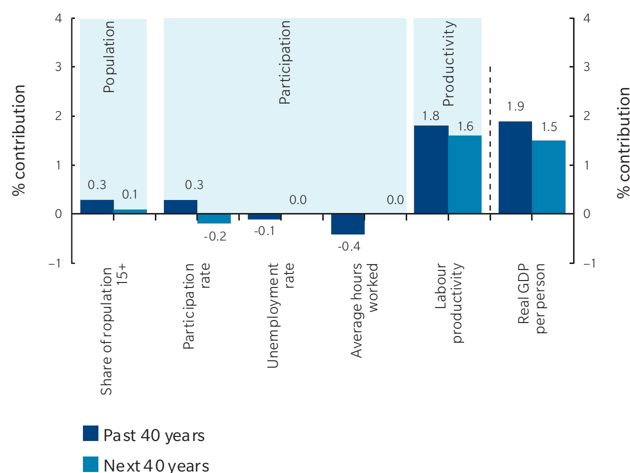
Source: IGR assumptions from Commonwealth IGR 2010, Suitability sourced from Mercer.

94 *Commonwealth, 2010, p.30*

95 *If mature age participation rates were to increase to around 67% by 2050 compared to b ase case of 62% by 2050 real GDP per capita would be 2.4% higher (Commonwealth, 2010, p.30)*

Although the population forecast is sensitive to the assumptions around immigration and fertility rate, the key driver over the last 40 years and projected over the next 40 years is the level of productivity in the economy.

Figure 5.2g
The 3P's of Growth In Real GDP Per Person



Source: Commonwealth IGR (2010)

Given the sensitivity of the fiscal gap forecast, provisioning for intergenerational equity needs to pursue both of the following approaches; noting that the surplus provisioning requirement can be alleviated by supply side policies over time:

- Target a modest percentage of GDP surplus to provision for the projected fiscal gap. Importantly, a medium term milestone by, say 2024, should be set in terms of a reserving target to fund a percentage of the future fiscal gap, to ensure discipline with some flexibility. It is proposed that the surplus targets, and medium term milestones, be developed and announced by the Government in the forthcoming Budget
- Policies on the supply side to negate the impact of ageing population. This effectively reduces the fiscal gap that will need to be filled. Emphasis should be placed on policies that will have the largest impact on the overall gap i.e. productivity; mature labour force participation rate

In this vein, Mercer believes the following policy initiatives should be implemented or considered by Government now to take account of the window of awareness that the public exposure to the fiscal disasters in the Eurozone and potentially US brings:

- Age Pension eligibility age indexed to the rate of increase in life expectancy
- Incentives to increase mature age workforce participation
- Review eligibility and entitlement for Disability Support Pension to encourage workforce participation where appropriate
- Increase in immigration meeting the required skills and age profile

If nothing is done to provision for the inevitable fiscal gap pressures associated with an ageing society then fiscal policy will be relegated to an unsustainable position. Should the Government face a call of 3.75% of GDP in terms of today's GDP, the Government would need to find an additional $53 billion each year.

In order to balance the books the Government would need to introduce higher taxes, expenditure cuts, debt issuance or an unpalatable combination.

> Our "window of awareness" should allow policy initiatives like indexing the age pension eligibility age to life expectancy increases

UNFUNDED SUPERANNUATION LIABILITIES

IGR 2010 assumes superannuation costs associated with the Commonwealth Government's public sector defined benefit schemes[96] will constitute a relatively small proportion of future government obligations. It projects that spending on these schemes will decline from 0.4% of GDP in 2009–10 to 0.2% of GDP in 2049–50.

> Australia is relatively well placed to meet the commitments for unfunded superannuation liabilities

96 *These include the Commonwealth Superannuation Scheme (CSS), the Public Sector Superannuation Scheme (PSS), the Defence Force Retirement and Death Benefits Scheme (DFRDB) and the Military Superannuation and Benefits Scheme (MSBS).*

These figures mask the true picture, as historically, only a small proportion of the costs of superannuation benefits have been funded at the time employees accrue benefit entitlements — the underfunded superannuation liability as at 30 June 2011 was estimated at $130 billion (or around 9% of GDP).

The Government has made an attempt to provision for these liabilities with the Future Fund - established in 2006 to meet the Australian Government's accumulated underfunded superannuation liability. The Future Fund had assets valued at $73 billion at 30 September 2011. Although the provisioning is welcome, it is not sufficient and most importantly is held separately to the budget measure upon which Australia's fiscal policy is built.

Were these underfunded liabilities to be accounted for in projections of the fiscal balance and hence in the measures to which fiscal policy rules applied, the assessment of the fiscal health of the economy would be quite different.

The table below summarises the various public sector unfunded defined benefit superannuation liabilities.

The liability figures for 2011 may be 5% to 10% higher than would normally be the case (due to a low prevailing bond yield used to measure these liabilities under the accounting standard).

The liabilities represent the present value of future cash flows as members retire. Actual year on year outlays are much smaller than these liabilities.

Compared with other developed economies, Australia is relatively well placed to meet its commitments in respect of unfunded superannuation liabilities. While unfunded liabilities are forecast to grow, they are decreasing in size relative to GDP. Almost all schemes (except for the Military Superannuation) have been closed to new employees for a number of years and governments have indicated their intention to fund deficits over a 25 year period.

Nevertheless the table above shows that there remains a substantial unfunded liability (in the order of $134 billion). For the Commonwealth alone this is in the order of $55 billion (and growing). Another way of looking at this is that the Commonwealth has a deficit in the Future Fund which could be topped up with any future budget surpluses to the tune of at least $55billion, reducing the need for any additional sovereign wealth fund arrangements to be considered.

Figure 5.2h
Unfunded Liabilities by State

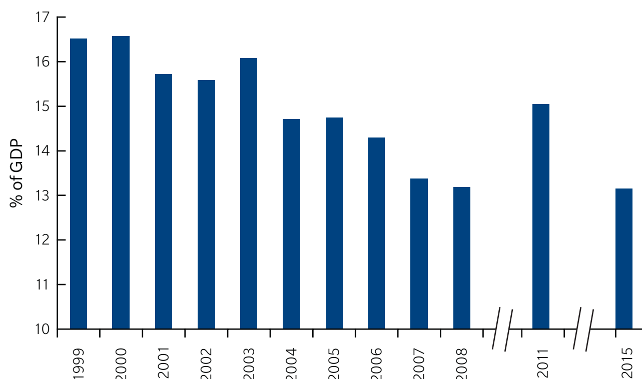
ENTITY	CURRENT YEAR 30 JUNE 2011			FORWARD ESTIMATE
	Assets ($b)	**Liabilities ($b)**	**Net Unfunded 30 June 2011 ($b)**	**Net Unfunded**
NSW	25.4	57.6	32.2	29.6
VIC	16.0	38.6	22.6	22.8
WA	11.6	N/A	7.3	7.8
SA	13.6	22.3	8.7	8.6
TAS	N/A	N/A	4.4	5.6
QLD	32.7	30.6	(2.1)	—
NT	—	2.6	2.6	2.8
ACT	2.3	4.3	2.0	2.4
COMMONWEALTH			129.5	147.8
TOTAL			**209.3**	**227.4**
FUTURE FUND			(75.4)	N/A
TOTAL (NET OF FUTURE FUND)			**133.9**	

Source: Budget Papers

> The primary issue is whether our fiscal policy rules will deliver adequate provisioning for the structural and intergenerational issues Australia faces

Over time the liabilities are expected to decrease as a percentage of GDP. The graph below shows the trends over recent periods (and forward estimates). The impact of historically low bond yields and hence lower discount rates can be seen in the increase in the 2011 valuation of the liabilities.

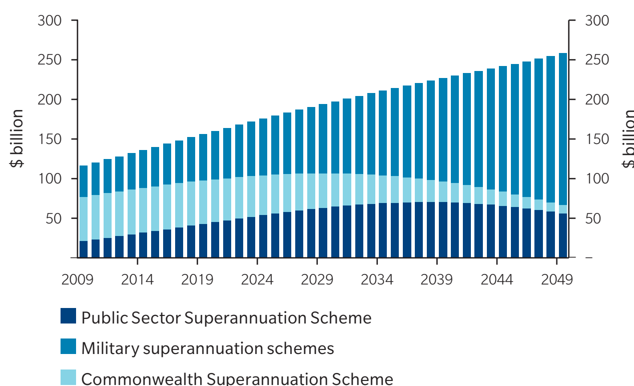
Figure 5.2i
Unfunded Liabilities



Source: data as above, data from 1999 to 2008 from IFSA Superannuation Savings Gap (2008)

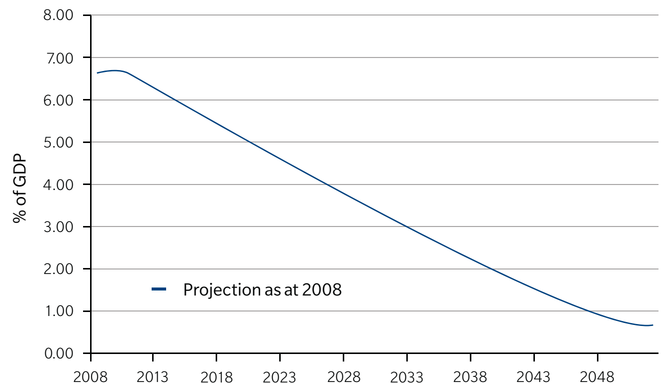
The graph below shows a longer term projection of the Commonwealth Government unfunded superannuation liabilities.

Figure 5.2j
Commonwealth Government Unfunded Superannuation Liabilities



Source: Commonwealth IGR (2010)

Figure 5.2k
Commonwealth Unfunded Liabilities



Source: Commonwealth IGR (2010)

The creation of the Future Fund opened up debate on what to do with budget surplus reserves and whether they should be quarantined in a reserve fund for future liabilities or to fund intergenerational fiscal imbalances. Arguably what you do with the reserves is a second order issue, as long as they are earning interest for the Government and not being used for competing objectives. The primary issue is: have our fiscal policy rules delivered adequate reserving for the structural and intergenerational issues the Australian economy will face in the future? The OECD comments that, in order to "reduce risks of pro-cyclical fiscal policy; spending decisions should be disconnected from resource tax revenues. One option would be to park resources in a reserve fund, and adopt a structural spending rule".[97] Discussion on the relative merits of a wealth or reserve fund is provided in Section 5.3.

As we have seen the degree to which states provision, or are forced to provision, for these liabilities varies greatly and without a comprehensive view of future liabilities, provisioning cannot be accurate nor adequate.

For the fiscal policy rules to deliver on intergenerational equity requires the introduction now of an explicit target of a modest surplus to provision for intergenerational equity. This would be in addition to the cyclical recharge rule. Given the sensitivities of the forecast fiscal gap, the surplus provisioning as part of the fiscal rules should also be set on the conservative basis which takes into account Australia's terms of trade position. Importantly, a medium term milestone by say 2025 should be established in terms of a reserving target to partly fund the future fiscal gap, to ensure discipline albeit with some flexibility along the way. It is proposed that the surplus targets and medium term milestones be developed and announced by the Government in the forthcoming Budget.

97 OECD (2010)

The intergenerational fiscal gap, across Commonwealth and state governments, is estimated to be 5% of GDP by 2050. Mercer has undertaken some indicative estimates to provide a sense of the order of magnitude of the required intergenerational surplus provisioning. We note that although the 5% of GDP is an accumulation of both the Commonwealth and state fiscal gaps, that the Commonwealth are best placed to provision for the cumulative fiscal gap given state governments' limited revenue raising ability. Those estimates suggest that on average over the period a surplus of around 0.6% of GDP per annum, by way of a collective contribution from Commonwealth and state governments, is required to provision for the fiscal gap by 2050. Given the aging profile and intergenerational principle of todays tax payers provisioning for their retirement, Mercer proposes that reserving begins at a rate above the required reserving average and transitions down to 0% of GDP by 2050.

What to do with the reserves is a second order issue

Mercer proposes that the intergenerational reserving begins as soon as practicable – which we envisage as 2013-14. Whilst the Government would be paying down debt in parallel, the intergenerational reserve should earn a rate of return in excess of the cost of servicing Government debt. Further, there is a need to start the reserving now to ensure the future burden on Government budgets is met by today's taxpayers and does not become too great.

Provisioning now through the fiscal rules compels Government to either begin to bear the pain of fiscal provisioning or embark on supply side policies to reduce the fiscal gap itself. The secondary issue of what to do with any reserves is discussed later in the Report clearly the proceeds of the 'intergenerational reserve' should be quarantined in an intergenerational account which earns a rate of interest for Government and has no other policy objectives.

A stabilisation fund is not needed to implement counter cyclical fiscal policy

Our analysis so far has concentrated on the Commonwealth Government. The themes of transparency and credible fiscal policy are all themes that affect state and territory governments as well.

5.2.4. STATE SUMMARY

Although there is broad agreement on the need to structure fiscal policy in such a way that is transparent, credible and sustainable, the methods by which longer term issues of an ageing population are provisioned for are not consistent across the states and territories.

The progress of state governments in developing fiscal policy rules is briefly evaluated and assessed against our fiscal policy framework in the table overleaf.

Figure 5.2I
Assessment of State Governments Against the Fiscal Policy Framework

STATE/ TERRITORY	SIZE OF GOVERNMENT	FISCAL RESPONSIBILITY	INTERGENERATIONAL EQUITY	UNFUNDED LIABILITIES
NSW	No explicit rule	Specific rules on debt, and net foreign liabilities with specific timeframes and caps	Full intergenerational report commissioned although not converted into specific policy	Rule to eliminate by set date, although no specific surplus level targeted
QLD	Operating expenses to be met from operating revenue	Specific rules on debt, and net foreign liabilities with limited timeframes and caps	No intergenerational planning published	General target to fund liabilities
VIC	No explicit rule	Specific rules on debt, and net foreign liabilities with specific timeframes and caps	Has commissioned but not published a long term review of state finances. Excess cash over 5 year rolling average is reserved. Specific target (0.5% GSP) for long term infrastructure spending.	Rule to eliminate by set date, although no specific surplus level targeted
SA	No explicit rule	General rules on state finances with limited timeframes and caps	No intergenerational planning published	General target to fund liabilities
WA	Real per capita government expenses are not to increase	Specific rules on debt, and net foreign liabilities with limited timeframes and caps	No intergenerational planning published	No explicit rule
TAS	No explicit rule	Specific rules on debt, and net foreign liabilities with specific timeframes and caps	No intergenerational planning published	No explicit rule
ACT	No explicit rule	General rules on state finances with limited timeframes and caps	No intergenerational planning published	Rule to eliminate by set date, although no specific surplus level targeted
NT	Expenditure growth not to exceed revenue growth	General rules on debt and states finances with limited timeframes and caps	No intergenerational planning published	No explicit rule

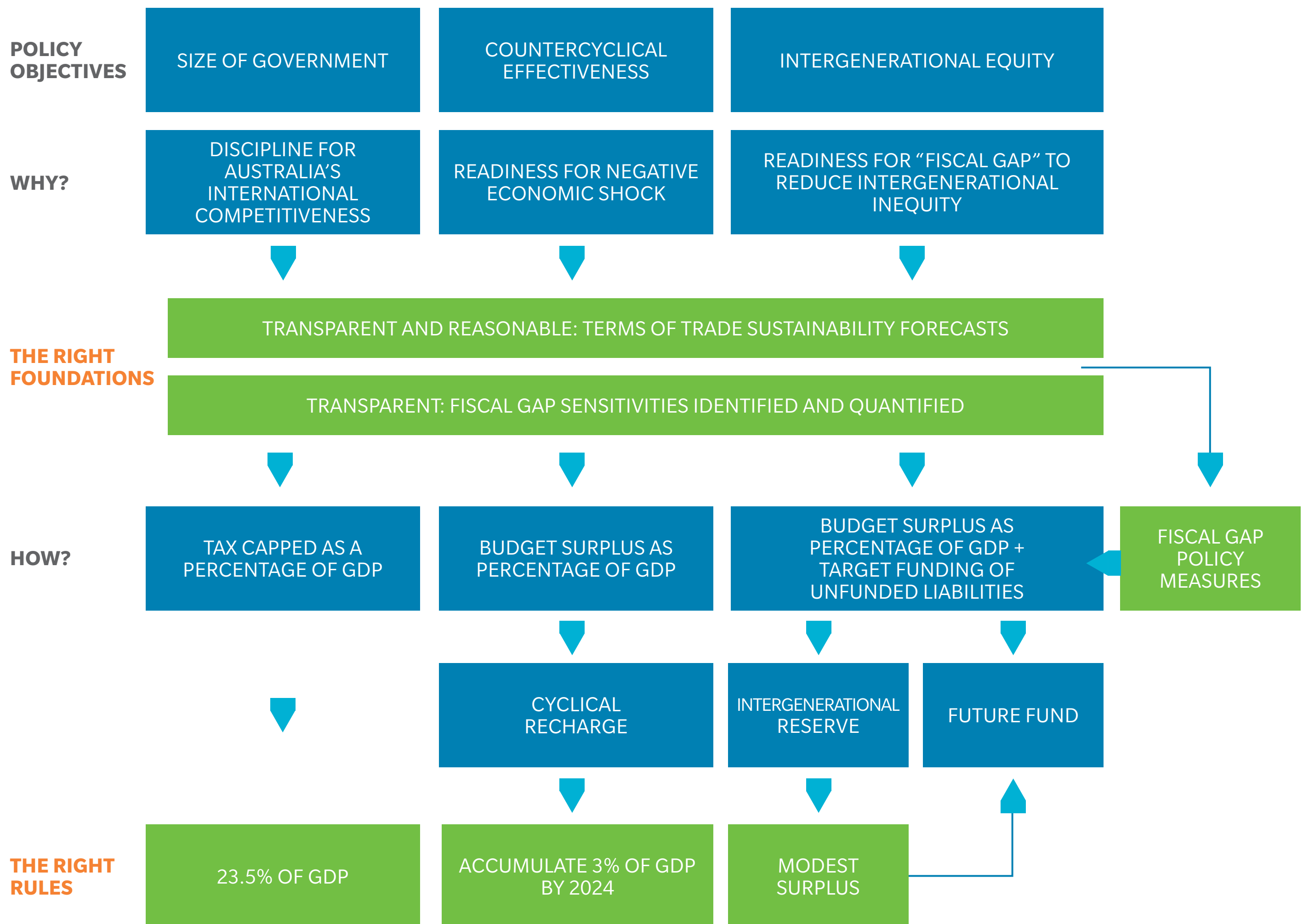
Source: State government budgets. Full details in Appendix A.

Most of the states have quite specific rules relating to their levels of debt to address the broader objective of fiscal responsibility. However there remains an absence of any explicit fiscal policy rules to address intergenerational equity and a range of measures to fund underfunded liabilities. Notably, where a high level rule is in place there is no specific target or cap to provide the degree of transparency and discipline required for fiscal policy sustainability. Appendix A provides further detail on the fiscal policy rules of the respective state and territory governments.

5.2.5. FISCAL EFFECTIVENESS SUMMARY

Overall several areas warrant action to ensure the fiscal policy rules remain appropriate and adequate for Australia's future. Firstly a medium term judgement needs to be made on the ongoing level of our terms of trade. Secondly, an explicit surplus reserving target needs to be specified to address both the cyclical readiness of fiscal policy and intergenerational equity. Thirdly, the Government needs to be clear and transparent in building in the impact of key assumptions on the future fiscal balance. Fourthly, it is important to retain transparency and credibility

Figure 5.2m
Fiscal Policy Framework — Next Steps

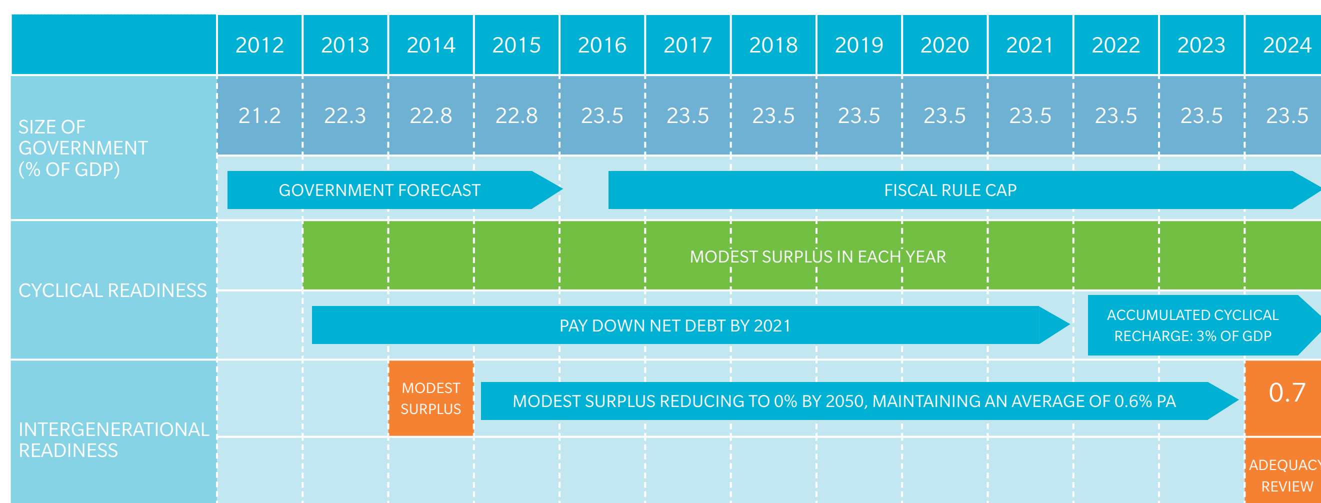


around the size of government to stop any future slippage. Given the starting point Mercer believes that the current cap should be retained but should become a hard cap so future budgets do not see further slippage. Finally, and ideally encouraged by the requirement for an intergenerational reserve, direct policy action to reduce the fiscal gap on the supply side or manage the level of demand

5.2.6. FISCAL RULES — IMPLEMENTATION

The Fiscal Policy Framework sets out the respective and revised fiscal rules for each of the 3 pillars – size of government, cyclical readiness and intergenerational equity. This Report provides indicative guidance on their proposed implementation. Building on the Government's current forecasts for the fiscal balance, the charts below outline the implementation profile required to recharge cyclical readiness and reserve for intergenerational pressures. This is at all times constrained by the size of government rule, the sustainable level of terms of trade and the imperative of meeting the rules in each year.

Figure 5.2n
Fiscal Policy Framework — Implementation Profile



5.3. SOVEREIGN WEALTH FUNDS

Our recommendation to provision and reserve for the pressures associated with an ageing population throws up an arguably second order consideration of how any reserves are to be managed.

There has been debate about whether Australia needs a sovereign wealth fund (SWF) in managing the revenues from the commodity boom. This section begins by defining a SWF and outlines how the different types of funds vary in their objectives. It then assesses the suitability of using a SWF to meet the two objectives relevant to the Australian economy: insulating the budget and the economy from the volatility of commodity prices; and positioning for the fiscal gap as the population ages.

5.3.1. DEFINITION AND TYPES OF SOVEREIGN WEALTH FUNDS

A SWF can be defined as an investment fund owned and/or controlled by Government, which holds, manages and administers a country's financial assets for specific national objectives. SWFs are not a recent phenomenon. They have been in existence since 1953 with the inception of the Kuwait Investment Authority. The Funds are commonly established out of receipts from commodity exports or balance of payment surpluses from non-resource exporting countries.

SWFs can be categorised in a number of ways and the terms are often used interchangeably. The IMF's classification of SWFs are adopted here. The differences are largely dependent upon the source of the budget surpluses and the specific needs of the economy. Our focus is on SWFs funded from the development of non-renewable natural resources.

> Australia already has a sovereign wealth fund — the Future Fund

FISCAL STABILISATION FUND

A stabilisation fund is typically used when an economy is subject to large and unpredictable changes in government revenue, which create difficulties in effectively managing the national budget. This is the case for countries where commodity exports represent a significant share of the economy. The volatile component of revenues is isolated into a separate pool from the Government's Budget.

The stabilisation fund accumulates assets when commodity prices and associated government revenues are high; the government can then draw-down on the fund when commodity revenues are low. The accumulation and withdrawal rules are critical to this model and authorities need to make assumptions about the long run sustainable commodity price and associated revenue. When current prices exceed the long run price, revenues are saved in the fund; when prices are below that reference point, transfers can be made from the fund to support the government budget. Chile has extended the rules to account for both commodity revenues (i.e. the commodity price)

and other government revenues (the output gap); when government revenues are higher than the long-term estimate, whether because of higher commodity prices or above average growth, those revenues are saved. Chile's Economic and Social Stabilisation Fund is described in Appendix B.

As the stabilisation fund is a method of smoothing incoming revenue, the investments of the Fund are necessarily relatively short-term in nature and include money market instruments and government bonds. The funds are typically invested in foreign assets, thereby mitigating the appreciation in the local currency associated with foreign capital inflows.

SAVINGS FUND

In many cases, incoming revenues to governments are sourced from natural resources which are likely to be exhausted. In such circumstances, the sovereign wealth fund is established to manage the country's assets for the benefit of both current and future generations. The challenge for these economies is to transform unsustainable revenue – the well from which resources are drawn will ultimately run dry — into sustainable future income. The investments of these funds must be longer term in nature as the income from the investments will ultimately flow into future budgets of future governments.

PENSION RESERVE FUND

Pension Funds are typically used to set aside assets to match an identified future liability stream. In most cases, this is a future obligation to meet aged pensions. The pension approach has gained prominence amongst developed economies which have aging demographics.

Investments in pension reserve funds are likely to vary depending upon the maturity of the liabilities they are intended to cover. Longer-dated liabilities may mean that the fund has a more growth-oriented investment profile. Alternatively, an asset and liability matching approach may be applied within investment policy. Australia's Future Fund is a classic example of a pension reserve fund. As the first drawdowns to meet pensions from the Future Fund would not occur until 2020, the Future Fund adopted a relatively high-growth asset allocation.

SPECIAL PURPOSE OR DEVELOPMENT FUND

In some cases, a SWF may be created to match a particular need or project. In these instances, funds are isolated and intended to be used only for a specific purpose, typically infrastructure or development programmes. An example in Australia was the establishment of the Higher Education Endowment Fund (HEEF) which was created by the Coalition government. The HEEF was intended to exist into perpetuity and the income used for projects for universities and other tertiary education organisations.

5.3.2. SUITABILITY OF SWFS FOR AUSTRALIA

Australia already has a SWF – the Future Fund - a Pension Reserve Fund created to meet the Government's underfunded public sector superannuation liabilities. The Future Fund also manages the Building Australia Fund, The Education Investment Fund and the Health and Hospitals Fund.

Commodity SWFs have been created to meet fiscal stability needs (stabilisation funds) and long-term saving/intergenerational equity (savings funds). Mercer believes those objectives apply to the Australian economy, which is in the midst of a commodity boom. The following section considers whether those objectives are best met through a SWF or by other means.

5.3.3. USE OF A STABILISATION FUND AND COUNTER-CYCLICAL FISCAL POLICY

The Australian economy and government revenues are becoming increasingly subject to commodity price volatility. It is generally accepted that counter-cyclical fiscal policy will help protect the economy from the volatility inherent in commodity prices. Budget surpluses should be built up when commodity prices are strong, and can be used to support the economy during a downturn. This also supports monetary policy.

Other commodity exporting countries have created stabilisation funds with the intention of implementing counter-cyclical fiscal policy. Their success has been mixed, however, and the failures seem to reflect the inability of the institutional framework to withstand the political pressure to spend during the good times. Creation of a SWF does not stop politicians from raiding the fund directly or indirectly by borrowing against the Fund to finance expenditure.

Chile's Economic and Social Stabilisation Fund (EFSF), described in Appendix B, is one case where a stabilisation fund has been successful. Chile saved during the commodity boom from 2003-2007 and was able to implement significant fiscal stimulus during the downturn associated with the GFC. The success of Chile's stabilisation fund is attributable to the integration of the fund with a disciplined fiscal policy framework. Chile had a structural budget rule that specified the required budget surplus. The counter-cyclical fiscal rules specified when the structural rule could be deviated from according to commodity prices and the economy's growth rate. It was these rules that enabled Chile to implement effective counter-cyclical fiscal policy rather than the vehicle in which the savings were invested.

In this sense, a stabilisation fund is not essential to implement counter-cyclical fiscal policy. The Australian Government was able to implement significant discretionary fiscal policy stimulus in response to the GFC. However, and as discussed earlier in this section, Mercer believes that Australia's fiscal policy framework needs to be strengthened further. Moreover, Mercer believes the Government needs to specify a target percentage surplus in the fiscal policy rules in order to be able to accumulate a sufficient surplus to extend counter-cyclical fiscal stimulus at time of economic shock.

Mercer suggests that the cyclical readiness recharge could be managed by the AOFM. Investments will need to be short-term in nature given the need for liquidity and lack of liability profile (unlike the Future Fund). Mercer agrees with Treasury, that the budget needs to be returned to surplus before the vehicle in which the funds are saved becomes relevant. We also agree that it is sensible to pay down the debt that accumulated from the fiscal stimulus response to the GFC before building up accumulated surpluses. The appropriate level of debt needs to be mindful of the need to retain a deep and liquid market for government securities.

5.3.4. USE OF A SAVINGS FUND

Commodity resources are not renewable and that raises issues of inter-generational equity. A Savings fund seeks to accumulate financial assets that can be used to benefit both current and future generations.

In Australia's case, Mercer believes there is a need for an intergenerational reserve to fund the ageing of population irrespective of our greater exposure to terms of trade movement. The Government should be explicitly providing for this now. This would be in addition to the cyclical recharge rule. As noted, Mercer believes a target of a modest surplus of GDP is required to be established now.

These funds need to be invested over a longer horizon than the cyclical readiness recharge and therefore require a different investment strategy. A new wealth fund need not necessarily be created — the Future Fund already has the capacity to invest these funds and provides the simplest option. Given the Future Fund remains underfunded, this liability provisioning can simply be met earlier than previously targeted. The fund could then either be segregated and an investment strategy designed to meet the long-term liability profile of the fiscal gap or alternatively another fund vehicle could be established. This does not need to be resolved today and should not detract from the discussion on the appropriate provisioning through the fiscal rules proposed.

> Australia needs an intergenerational reserve to provision for the future fiscal gap but a new wealth fund is not needed today to do this

6. FINDINGS AND CONCLUSION

6.1. REVISITING POLICY LEVERS AND TARGETS

The GFC and its continuing aftermath highlight the integral role of fiscal, monetary and prudential policy in weathering economic shocks. The enduring takeout for policy makers must be to never again lose sight of the fundamental objectives of economic policies.

Australia's fiscal stimulus package was one of the largest in the world relative to GDP. It was implemented quickly and closely followed the guidelines developed by the IMF. The monetary response was also fast and bold. Reforms in monetary policy and the establishment of, and compliance with, a set of disciplined fiscal rules positioned Australia to be able to respond boldly to the challenges of the GFC. The powder was dry in both fiscal and monetary policy barrels and the Australian authorities were able to pull both triggers at the time when it mattered most.

In stark comparison, poor fiscal discipline in the period leading up to the GFC saw the US and many North Atlantic countries launch stimulus from a weak fiscal starting point. They are now grappling with unsustainable debt, enforced spending cuts and tax rises against the punishing backdrop of global market volatility.

Australia's economic reform track record has been concentrated in the 1980s, falling away during the 1990s and most recently has been quite sparse. The imperative for policy action seems to be concentrated in periods when our relative economic performance is at its lowest.

We know that the Australian economy is in transition. Our reform efforts must not continue to rest on past laurels and simply rely on our strong terms of trade. Not least as we know this transition opportunity is not without risks. Risks will be realised and opportunities lost if we erode the hard earned integrity of monetary, fiscal and prudential policies. We will not be able to deliver sustained economic growth now and for future generations if we fail to deliver greater flexibility in our labour markets and immigration liberalisation to meet skill shortages.

Reform is needed to alleviate many of the supply side pressures that the economy will face over the next forty years and to preserve both the adequacy and the integrity of the objectives of fiscal and monetary policy — the primary levers for managing our economy.

There is a "window of awareness" now. A public of cautious consumers, fearful of the "patchwork" economy, pronounced global economic uncertainty and market volatility may be ready to accept change. Particularly if that change offers future economic stability.

Fiscal Policy is not a very flexible instrument. It should not be used to fine tune the economy. It should be reserved to prime growth in deep recessions, where monetary policy alone is judged unlikely to be effective. It was used successfully in that role during the GFC. Now that recovery is well established fiscal policy should resume its position as contributor to medium term stability. For the sake of credibility in a future period of crisis, it is imperative that the Government delivers on its pledge to return the budget to surplus by 2012-13.

6.2. HOW ARE NATIONAL SAVINGS AND INVESTMENT PERFORMING AGAINST THIS BACKDROP?

Despite Australia's sound international reputation and ability to finance investment from foreign savings, domestic saving remains important. Even more so as our economy moves through transition. Currently households are deleveraging and private corporate savings are being partly offset by a period of government deficits. In terms of the contribution to sustainable economic growth, the deleveraging of the household sector is a welcome development. It does not pose a barrier to growth in Australia given the Government's fiscal position coupled with the relatively low leverage in the Australian corporate sector.

That said, government policy, through the tax system, continues to encourage households to greater consumption of housing. This consumption bias is perversely further reinforced, by the ability of households to access retirement income as a lump sum, thereby allowing a one off deleverage at retirement. Whilst this bias has been in play for decades, it has become more critical as superannuation balances increase. We need to address the imbalance between lump sum and income streams as part of the overall superannuation mix.

We know that historically Australia has financed its surplus investment through the use of foreign savings. The relative robustness of the economy means that we have been able to borrow internationally on relatively favourable terms. And with Australia continuing to rely on foreign savings to fund a large part of investment, it remains important for public policy to be formulated with a view to retaining this confidence.

Where the current account deficit has arisen as a result of large investment in the economy the deficit is not seen to be an issue. But this assertion rests on the government shoring up confidence through:

- Continued credible monetary policy
- Flexible, open and transparent markets – avoiding reversion to protectionist calls
- Credible market governance frameworks
- Disciplined fiscal policy

Infrastructure investment is in catch up mode but recent increases point to some inroads to what Mercer intuitively believes to be an infrastructure under-spend. In terms of infrastructure investment we make the following observations.

Australia faces a debt financing dichotomy. While Australian Government funding costs are at historically low levels, the cost of private finance remains elevated. This manifests in higher debt margins; constrained debt availability for economic infrastructure projects by the domestic banks with little risk differentiation and most importantly shorter tenors, thereby introducing material refinance risk for long life projects which imposes a higher risk profile.

There is a long way to go in getting the funding economics right — pricing and charging for using economic infrastructure. The reality is that while many of these projects have net economic benefits they are not commercially feasible because we cannot price for the positive externalities they bring to the economy. As such, there remains scope for broader adoption of user charging or direct government support in recognition of those externalities.

There are signs of some progress, albeit slow, on getting the balancing act right in the risk sharing between the government and the investor particularly for Greenfield projects and patronage based infrastructure projects. A balance needs to be reached without overly compromising one party lest it's simply not a sustainable partnership. The states need to protect their credit ratings whilst the investor needs some risk sharing as it relates to three risks — patronage, policy and refinance. There are a number of innovative models and the states need to be encouraged to adopt these in order to access private sector financing of infrastructure. State governments can and should borrow for infrastructure projects that produce a commercial return without trepidation of rating agency consequences.

Bid costs and tender risk continue to act as a disincentive for early involvement of long term investors such as superannuation funds. This has seen short term investors, the investment banks and construction companies, driving the investment metrics. The key issue is for the state government and long term investors to agree on sustainable investment metrics for individual projects. Government can defray the costs by injecting common information and due diligence reports requirements that bidding parties can rely upon. This coupled with pricing and underlying modelling based on the government's base case, should facilitate greater discipline in the metrics and involvement of long term investors like superannuation funds.

The infrastructure deal pipeline from government remains largely glacial and uncertain. There is clearly a need for an infrastructure audit and for all states to undertake forward planning of at least 10 years in order to provision for the financing of the requisite infrastructure task for their respective jurisdictions. In essence, the infrastructure task should form a component of the much needed state level IGRs.

6.3. ARE THE SG AND THE FUTURE FUND ENOUGH?

6.3.1. SUPERANNUATION

The growing costs and fiscal pressures of an ageing society make necessary the Government's policy to increase the superannuation guarantee rate to 12%, subject to such an increase being associated with some wages moderation.

Given the fiscal cost of encouraging superannuation savings to provide for adequate retirement incomes, the Government needs to ensure that the form in which this retirement income is taken delivers on the policy objective – namely, adequate retirement incomes. In contrast to this objective, the form in which this retirement income is taken, namely lump sum, does afford a deleveraging opportunity upon retirement and may incentivise greater household leveraging prior to retirement. This balance needs to be addressed now.

Raising the superannuation guarantee rate and policies to address how superannuation balances are accessed will be further reinforced by the supply side policies Mercer identifies below to reduce the pressure of the fiscal gap.

6.3.2. FUTURE FUND AND UNFUNDED LIABILITIES

Compared with other developed economies, Australia is relatively well placed to meet its unfunded superannuation liabilities. While unfunded liabilities are forecast to grow, they are decreasing in size relative to GDP. The Schemes have been closed to new employees for a number of years and governments have indicated an intention to fund the super deficits over a 25 year period.

Nevertheless there remains a substantial unfunded liability (in the order of $134 billion). For the Commonwealth alone this is in the order of $55 billion and growing. Another way of looking at this is that the Commonwealth has a deficit in the Future Fund.

The balance of the unfunded liability highlights the need for the states to provide explicit provisioning through published timelines of policies to address their unfunded superannuation liabilities.

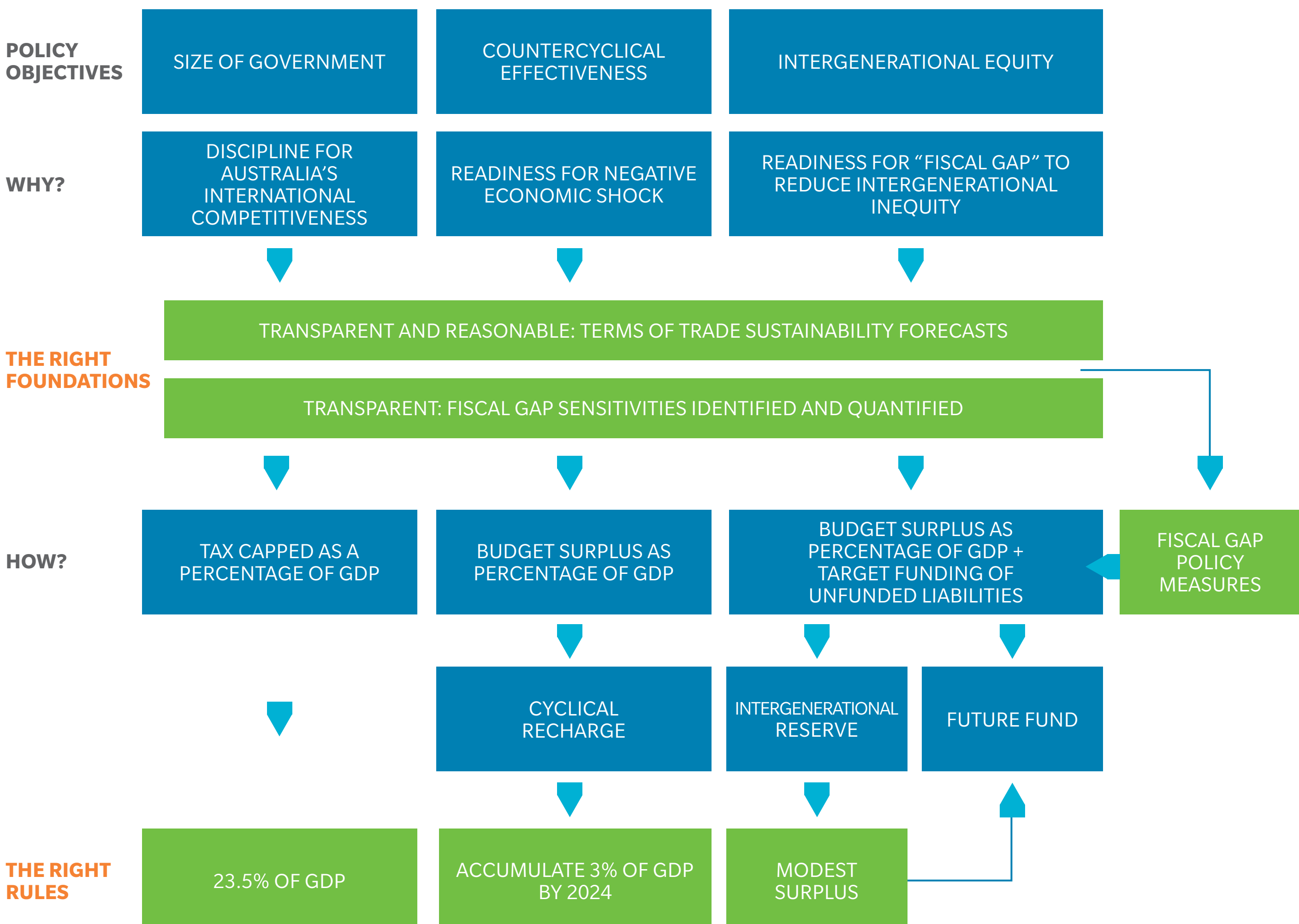
6.4. DO WE NEED TO CHANGE OUR FISCAL POLICY SETTINGS?

To be able to effectively deploy fiscal policy the government must have already exercised discipline and integrity with its prior use. Compared to most other developed economies Australia has performed well and the current medium term focus lends credibility.

Whilst the main architecture is in place, Mercer believes the government can and should "raise the bar" especially against the salient fiscal developments in the Eurozone and the US. Broadly speaking, fiscal policy rules should satisfy three fundamental objectives — the three pillars as outlined below. They should:

- enforce discipline on the size of government for Australia's international competitiveness
- ensure counter-cyclical readiness for a major negative economic shock
- ensure readiness for intergenerational pressure and the fiscal gap to reduce intergenerational inequity

Fiscal Policy Framework — Next Steps



This framework, in our view, will allow the government to deliver on future fiscal policy objectives against the background of an economy in transition and growing intergenerational pressures with our ageing society.

Given the collective experience of Europe and the US, we know that discipline and integrity underpin successful fiscal policy. The medium term focus and surplus position of the government in the lead up to the GFC enabled Australia to deploy a large — counter cyclical fiscal stimulus. That said there needs to be an impetus for government to move promptly to rebuild the surplus in the good times so we can meet the challenges of increased volatilities and an ageing population.

The fiscal rules currently aim for surplus over the medium term, improve net financial worth over the medium term, constrain tax revenue as a percentage of GDP to 23.5% and constrain real growth in spending to 2% until the government finances return to surplus. These rules are in the correct vein but are not adequate when measured against our framework and the elevated risks facing our economy.

Mercer views the current Budget forecast for the terms of trade as reasonable, albeit not conservative. While we would expect volatility around the terms of trade trajectory assumed in the forecasts, especially driven by short term supply side adjustments, we consider there has been a permanent structural increase in the underlying resources demand. It is equally important that such short term volatility does not erode confidence in the medium term forecasts imbedded in the Budget.

Mercer believes that the current strong yet unsustainable terms of trade level, heightens the imperative for disciplined fiscal action today. Policy decisions today should be premised on by the projected decline in the terms of trade. A future terms of trade decline can not justify any call to flex the limits and breach the fiscal policy rules. In saying this, Mercer acknowledges that should the terms of trade volatility induce a major economic shock requiring fiscal stimulus, then there is a case to initiate a fiscal stimulus in the context of the fiscal rules.

6.4.1. SIZE OF GOVERNMENT

It is both appropriate and good fiscal policy to maintain an explicit cap for the level of tax revenue as a percentage of GDP – a discipline to the size of government. Unfortunately this fiscal rule has seen some slippage over the past 15 years. The current cap of 23.5% exceeds the 30 year average – which already including the structural increase in the size of government from the 1970s. That said, we do need to allow for intergenerational pressures. It is important to retain transparency and credibility around the size of government to stop any future slippage. Given the starting point Mercer believes that the current cap should be retained but should become a hard cap so future budgets do not see any further slippage.

Allowing the revenue cap to reside above the 30 year average allows for some size of government headroom in recognition of the intergenerational pressure faced by Government. Importantly, current tax receipts already incorporate some windfall revenues associated with Australia's record terms of trade as well as the one off structural increase in revenue with the introduction of the GST in 2000. Mercer therefore views this cap as achievable and reasonable. By imposing a hard cap discipline on the Government, productivity and economic growth enhancing policies (as we have previously identified) are the remaining swing policy to reduce intergenerational pressures.

6.4.2. CYCLICAL READINESS

The Government's current rule – to aim for surplus – is right but the imperative now is to shore up its integrity with hard targets informed by the objective – the readiness of fiscal policy for an economic shock. Mercer therefore believes the Government needs to specify a target percentage surplus in the fiscal policy rules based on "recharging" fiscal readiness in 13 years time for fiscal policy to be able to make a 3% of GDP contribution to the economy. That is to say, a series of small annual surpluses need to accumulate over 13 years to enable debt to be repaid and fiscal capacity to be recharged to be able to deploy a fiscal stimulus equivalent to 3% of GDP.

The Government's net debt position is inextricably linked to the notion of cyclical recharging through modest annual surplus. Should a major economic shock requiring fiscal action occur prior to the accumulated surplus being built up over this target period, the Government of the day should borrow in order to finance the fiscal stimulus, subject to international confidence and the terms. This is caveated with the requirement that such borrowing

only be permitted with the Government undertaking to return to surplus as soon as practicable and thereby restore the net debt position to pre-stimulus levels. That is, there should be no permanent increase in net debt levels from the stimulus.

Cost effective borrowing rests on the retention of international confidence in the Australian economy, Mercer's preference is therefore to build up the cyclical recharge such that it could be deployed without the need to borrow and therefore satisfy the terms set by overseas lenders. That said Government net debt is currently 8.9% of GDP. Mercer concurs with the Government's priority to pay down the current net debt position to 0% by 2020–21. Reducing net debt supports confidence in the Government's fiscal integrity, thereby facilitating borrowing on relatively reasonable terms if required. Once net debt is removed, and in the absence of a premature major economic shock, the Government should accumulate the surpluses to achieve cyclical readiness equivalent to 3% of GDP in the remaining 3 years to 2024.

The Government's current fiscal stimulus exit rules compel the return to surplus as soon as possible. Mercer believes the rules are appropriate and provide a suitable level of fiscal discipline. Mercer therefore supports the focus and imperative of returning to surplus by 2012-13. This not only supports the retention of international confidence in the Australian Government and economy should Government borrowing be needed for an earlier than anticipated economic shock, but also resumes the journey to restore medium term fiscal discipline.

6.4.3. INTERGENERATIONAL EQUITY

The intergenerational fiscal gap, across Commonwealth and state governments, is estimated to be 5% of GDP by 2050. We know the IGR's fiscal gap forecast is highly sensitive. Provisioning for intergenerational equity therefore needs to pursue both of the following approaches; noting that the surplus provisioning requirement can be alleviated by supply side policies over time.

- Target a modest intergenerational surplus to provision for the projected fiscal gap. Importantly, a medium term milestone by say 2024 should be set in terms of a reserving target to fund a percentage of the future fiscal gap, to ensure discipline with some flexibility. It is proposed that the surplus targets and medium term milestones be developed and announced by the Government in the forthcoming Budget.
- Policies on the supply side to negate the impact of ageing population. This effectively reduces the fiscal gap that will need to be filled. Emphasis should be placed on policies that will have the largest impact on the overall gap i.e. productivity; mature labour force participation rate.

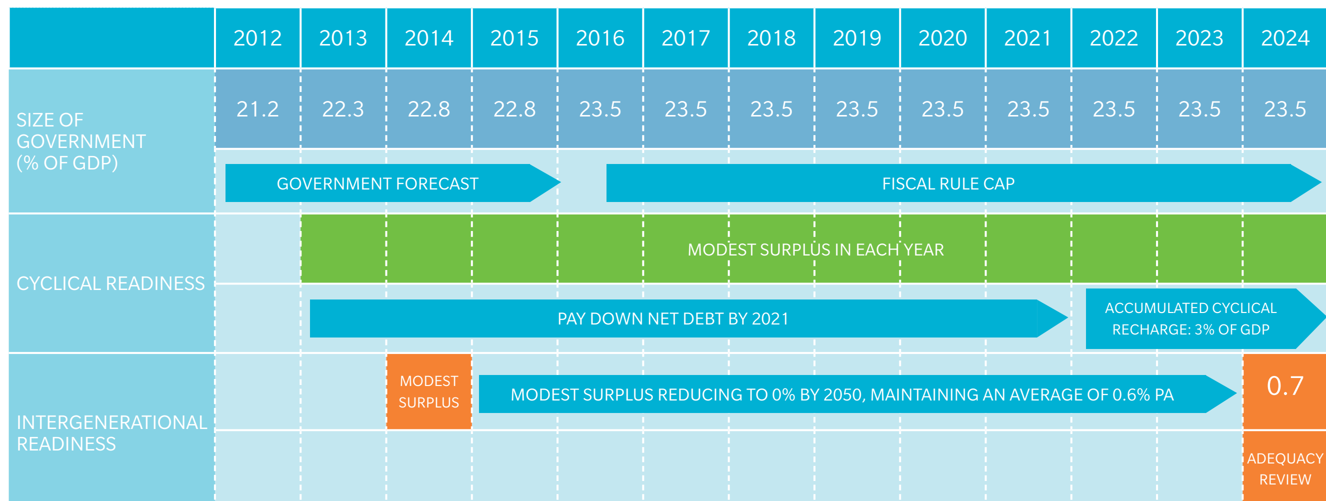
Mercer has undertaken some indicative estimates to provide a sense of the order of magnitude of the required intergenerational surplus provisioning. Those estimates suggest that on average over the period a surplus of around 0.6% of GDP per annum reserved each year is required, by way of a collective contribution from Commonwealth and state governments, is required to provision for the fiscal gap by 2050. Given the ageing profile and the intergenerational principle of today's taxpayers provisioning for their retirement, Mercer proposes that reserving begins at a rate above the required reserving average and transitions down to 0% by 2050. This estimate assumes that the Government does implement meaningful supply side policies that reduce the 2050 fiscal gap by 25%.

Mercer proposes that the intergenerational reserving begins as soon as practicable — which we envisage as 2013–14. Whilst the Government would be paying down debt in parallel the intergenerational reserve should earn a rate of return in excess of the cost of servicing Government debt. Further, there is a need to start the reserving now to ensure the future burden on Government budgets is met by today's taxpayers and does not become too great.

In this vein, Mercer believes the following policy initiatives should be implemented or considered by Government now to take account of the window of awareness that the public exposure to the fiscal disasters in the Eurozone and potentially US brings:

- Age Pension eligibility age indexed to the rate of increase in life expectancy
- Incentives to increase mature age workforce participation
- Review eligibility and entitlement for DSP to encourage workforce participation where appropriate
- Increase in immigration meeting the required skills and age profile

Fiscal Policy Framework — Implementation Profile



6.4.4. FISCAL RULES – IMPLEMENTATION

The Fiscal Policy Framework sets out the respective and revised fiscal rules for each of the 3 pillars – size of government, cyclical readiness and intergenerational equity. This Report provides indicative guidance on their proposed implementation. Building on the Government's current forecasts for the fiscal balance, the charts below outline the implementation profile for the surpluses required to recharge cyclical readiness and reserve for intergenerational pressures. This is at all times constrained by the size of government rule, the sustainable level of terms of trade and the imperative of meeting the rules in each year.

6.5. DO WE NEED A SOVEREIGN WEALTH FUND?

Mercer believes the primary policy imperative is to raise the bar on our fiscal policy rules and supported by supply side action to reduce the growing fiscal gap. Mercer proposes that the government target a cyclical readiness recharge and an intergenerational reserve.

Arguably what you do with the reserves is a second order issue, as long as they are earning interest for the government and not being used for competing objectives. The primary issue is will our fiscal policy rules deliver adequate reserving for the structural and intergenerational issues the Australian economy will face in the future.

CYCLICAL READINESS RECHARGE

The Australian Government was able to implement significant discretionary fiscal policy stimulus in response to the GFC. In this sense and given the medium term and unpredictable nature around the timing of any required fiscal stimulus a separate sovereign wealth fund is not essential to implement counter cyclical fiscal policy. Mercer therefore proposes that the surpluses accumulated as the cyclical readiness recharge should be invested in cash-like instruments and would be managed by the AOFM.

INTERGENERATIONAL RESERVE

The intergenerational reserves need to be invested over a longer horizon than the cyclical readiness recharge and therefore requires a different investment strategy. A new wealth fund need not be created. Both the fiscal gap and unfunded superannuation liabilities are projected liabilities of the Government. Although the liability profiles differ, the Future Fund already has the capacity to invest these funds and provides the simplest option. Given the Future Fund remains underfunded, this liability provisioning can simply be met earlier than previously targeted.

Once the Future Fund is fully funded, the intergenerational reserves could either be segregated within the Future Fund and an investment strategy designed to meet the long-term liability profile of the fiscal gap, or another fund vehicle could be established. This does not need to be resolved today and should not detract from the discussion on the appropriate provisioning through the fiscal rules proposed.

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APPENDIX A

STATE FISCAL POLICY RULES

NEW SOUTH WALES

New South Wales passed the Financial Responsibility Act in 2005, which sets out a range of medium term and longer term fiscal rules and broader principles. There is statutory requirement to review progress against these principles every 5 years. These rules are summarised below, and interestingly the NSW government aim is "maintaining financial results that are fiscally sustainable in the medium and long term".[98] There is a clear attempt to increase the importance of financing longer term liabilities and budget pressures by the NSW government, a point further reinforced by the first state level full NSW Long-Term Fiscal Pressures Report — NSW Intergenerational Report — 2011–12.

FISCAL OBJECTIVE	
Net Financial Liabilities	Medium term: to reduce the level of general government net financial liabilities as a proportion of gross state product to 7.5% or less by 30 June 2010
	Long Term: to reduce the level of general government net financial liabilities as a proportion of gross state product to 6.0% or less by 30 June 2015
Net Debt	Medium term: to maintain underlying general government net debt as a proportion of gross state product at or below its level as at 30 June 2005, unless an increase is required in net debt to reduce one or more components of general net financial liabilities
LONG TERM: AS ABOVE	
Unfunded superannuation liabilities	Long Term: to eliminate total state sector unfunded superannuation liabilities by 30 June 2030

In addition there are 10 fiscal principles set out in the Financial Responsibility Act 2005.

VICTORIA

The Victorian government commissioned an Independent Review of State Finances on 25 January 2011. The interim report has been issued and it is charged with "developing objectives and strategies for responsible financial management, which will serve as a guide to government over both the short and longer term". The initial medium objectives aim to mange the state finances in a fiscally responsible ways but also allow for required future infrastructure spending and the fiscal position based on scenarios related to demographic factors.

FISCAL OBJECTIVE
Over rolling five-year periods, the General government net operating balance is at least equal to the medium-term sustainable level of net infrastructure investment
Over rolling five year periods, General government net infrastructure investment is at least equal to 0.5% of the historical five year average of Gross State Product
General Government net debt is equal to zero on average over a 10 year rolling period
Government superannuation liabilities are equal to zero by 2035
When revenue growth exceeds the rolling five year average, the government preserves the excess in the form of cash reserves or equivalent financial assets.

Source: Interim report of the Independent Review of State Finances, April 2011.

QUEENSLAND

The Financial Accountability Act 2009 requires the State government to prepare a "Charter of Fiscal Responsibility" giving details of the Government's fiscal objectives and the fiscal principles that support those objectives.

The fiscal principles of the Queensland Government are broadly based around three themes: fiscal sustainability; a competitive tax regime; and managing the State's balance sheet.

FISCAL OBJECTIVE	
Fiscal Sustainability	In the General Government sector, meet all operating expenses from operating revenue (where operating revenue is defined as total revenue from transactions and operating expenses are defined as total expenses from transactions less depreciation)
	Growth in own-purpose expenses in the General Government sector to not exceed real per capital growth
	Achieve a General Government net operating surplus as soon as possible, but no later than 2015–16
Competitive Tax Regime	Maintain a competitive tax environment for business
Managing the State's Balance Sheet	Stabilise net financial liabilities as a proportion of revenue in the Non-financial Public Sector
	Target full funding of long-term liabilities such as superannuation in accordance with actuarial advice

Queensland Charter of Fiscal Responsibility, 2010

98 *Financial Responsibility Act, 2005. Section 3(1).*

WESTERN AUSTRALIA

As part of the Western Australia Government Financial Responsibility Act 2000 the government must "set out the Government's medium term targets in relation to the financial element or elements relevant to each target".[99] In other words as part of each Budget the government must state its fiscal objectives.

FISCAL OBJECTIVE
Maintain or increase the real net worth of the total public sector;
Achieve an operating surplus for the general government sector
Maintain the ratio of total non-financial public sector net interest costs as a share of revenue at or below 4.5%;
Ensure that real per capita own-purpose general government expenses do not increase; and
Provide a fair and efficient taxation system that is competitive with other Australian States.
Source: Western Australia 2011-12 Budget, Paper 3, Chapter 3 – Fiscal Strategy.

SOUTH AUSTRALIA

Similarly to Western Australia the State government of South Australia must state its fiscal objectives as part of each Budget.

FISCAL OBJECTIVE
To achieve at least a net operating balance in the general government sector in every year
To achieve net lending outcomes that ensure the ratio of net financial liabilities to revenue continues to decline towards that of other triple-A rated states
To ensure the state has an effective tax regime having regard to the government's social and economic objectives
To provide value for money community services and economic infrastructure within available means
To fully fund accruing superannuation liabilities and progressively fund past service superannuation liabilities
To ensure that risks to state finances are managed prudently to maintain a triple-A rating
To ensure public non-financial corporations (PNFCs) will only be able to borrow where they can demonstrate that investment programs are consistent with commercial returns (including budget funding)
Source: South Australia 2011-12 Budget, Budget Paper 3, Chapter 1, Page 7.

NORTHERN TERRITORY

The Fiscal Integrity and Transparency Act 2006 states that the government's fiscal policy is "to be set in a sustainable medium-term framework".[100] As part of the act the fiscal rules that re to be released as part of each annual budget are to fall in the following principles of sound fiscal management:

(a) the Government must formulate and apply spending and taxing policies with consideration to the effect of these policies on employment and the economic prosperity and development of the Territory;

(b) the Government must formulate and apply spending and taxing policies so as to give rise to a reasonable degree of stability and predictability;

(c) the Government must ensure that funding for current services is to be provided by the current generation;

(d) the Government must manage financial risks faced by the Territory prudently (having regard to economic circumstances), including by maintaining Territory debt at prudent levels.

FISCAL OBJECTIVE	
Sustainable service provision	Expenditure growth not to exceed revenue growth, excluding tied Commonwealth funding
Infrastructure for economic and community development	Maintain infrastructure investment at appropriate levels. Short-term: commit to spending at least twice the level of depreciation expense on capital infrastructure, on average, over the current economic cycle
Competitive tax environment	Ensure Territory taxes and charges are competitive with the average of the states and territories
Prudent management of debt and liabilities	Reduce debt to pre-GFC levels once the economy rebounds
Source: Northern Territory 2011-12 Budget, Budget paper 2, Chapter 3.	

99 *Western Australia Government Financial Responsibility Act 2000, p6.*

100 *Fiscal Integrity and Transparency Act 2006, Part 3, page 4*

ACT

The Financial Management Act 1996 requires the government to adhere to the following principles of responsible fiscal management:[101]

(a) ensuring that the total liabilities of the Territory are at prudent levels to provide a buffer against factors that may impact adversely on the level of total Territory liabilities in the future, and ensuring that, until prudent levels have been achieved, the total operating expenses of the Territory in each financial year are less than its operating income levels in the same financial year;

(b) when prudent levels of total Territory liabilities have been achieved, maintaining the levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Territory do not exceed its operating income levels;

(c) achieving and maintaining levels of Territory net worth to provide a buffer against factors that may impact adversely on levels of Territory net worth in the future;

(d) managing prudently the fiscal risks of the Territory;

(e) pursuing spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden;

(f) giving full, accurate and timely disclosure of financial information about the activities of the government and its agencies.

The current budget sets out the following operating rules:

FISCAL OBJECTIVE
Achieve a General Government Sector Net Operating Surplus
Maintain operating cash surpluses
Maintain a AAA credit rating
Manage debt prudently and maintain net financial liabilities within the range of all AAA rated
jurisdictions
Fully fund the Territory's unfunded superannuation liability by 2030
Maintain quality services and infrastructure
Make targeted investments to achieve strategic objectives of economic growth, reducing
future costs and addressing chronic disadvantage
Maintain taxation revenues at sustainable levels

Source: ACT Budget 2011-12, Budget Paper 2, Page 9.

TASMANIA

The Charter of Budget responsibility Act 2007, set out the principles of sound fiscal management of sound fiscal management:[102]

(a) ensure transparency and accountability in developing, implementing and reporting on fiscal objectives; and

(b) ensure the efficient and effective allocation and sustainable use of resources in achieving objectives; and

(c) ensure that policy decisions have regard to their financial effects on future generations; and

(d) formulate spending and taxation policies that ensure a reasonable degree of equity, stability and predictability; and

(e) manage financial risks prudently.

As part of the 2011–12 budget Tasmania adopted a new set of working rules that incorporate both short and medium/long term targets relating to a range of fiscal objectives:

FISCAL OBJECTIVE	
To achieve and maintain a sustainable Budget position.	Net Operating Balance: Short-term Target: 2011-12: > ($120 million) Medium-term Target:2014-15: > $50 million Long-term Target: 2022-23: > $200 million

101 ACT Financial Management Act 1996, Part 2, Section 11

102 Tasmania Charter of Budget Responsibility Act 2007, Schedule 1, Part 3.

The debt and liability burden on the Tasmanian community will continue to be reduced over the longer term and financial risks will be prudently managed.	General Government Net Debt Short-term Target 2011-12: < $0 Medium-term Target 2014-15: < ($300 million) Long-term Target 2022-23: < ($1 500 million)
	Ratio of Net Financial Liabilities to Revenue for the Non-Financial Public Sector Short-term Target 2011-12: < 115% Medium-term Target 2014-15: < 110% Long-term Target 2022-23: < 110%
A competitive business and taxation environment will be maintained.	Tasmania's Tax Severity Index Short-term Target 2011-12: < 100 Medium-term Target 2014-15: < 100 Long-term Target 2022-23: < 100
Investment in core General Government infrastructure will be maintained in real terms to support the delivery of Government services and to foster economic and industry development.	Capital Expenditure in Excess of Depreciation Short-term Target 2011-12: > $0 Medium-term Target 2014-15: > $0 Long-term Target 2022-23: > $0

Source: Tasmania Budget 2011-12, Budget Paper 1, Chapter 3.

APPENDIX B

CHILE'S PENSION RESERVE FUND AND STABILISATION FUND

Chile has been developing as an economy for many years. As a result, while it would not be described as a "developed economy," it is some way down that path and indeed was the first South American country to become a member of the OECD in 2010. Mining is critical to the Chilean economy. The Chilean government strongly supports foreign investment in the sector and has modified its mining industry laws and regulations to facilitate foreign investment. Chile is the copper mining capital of the world, and is responsible for over 1/3 of the world's copper production.

The importance of copper has, at times, created issues for the management of the Chilean economy. Although its importance has declined significantly since the 1960s when copper exports represented the lion's share of the total exports, copper has always been key to the Chilean economy and variations in copper prices continue to have a substantial impact on government revenues. With this in mind, the government established the Copper Stabilisation Fund (CSF) in 1985. The design of the CSF was relatively simple; whenever the copper price increased, the government directed a proportion of the windfall revenue to the CSF. The funds could then be used in years when the copper price was lower than anticipated.

In 2006, the sovereign wealth fund model was amended when Chile passed the Fiscal Responsibility Law, creating two new sovereign wealth funds. The first of these is the Pension Reserve Fund (PRF). The PRF is designed to fund future pension liabilities; no withdrawals are allowed to be made from the fund for the first ten years. The PRF receives between 0.2% and 0.5% of GDP depending on the size of Chile's overall budget surplus each year.

In 2007, the Chilean Government created the second fund, the Economic and Social Stabilization Fund (ESSF). The ESSF was funded by the closure of the original Copper Stabilization Fund. It continues to operate under the formula established for the CSF in 2001 where fiscal surpluses above 1% of GDP are directed to the stabilisation fund.

The aims of the two funds are quite different. The Pension Reserve Fund's objective is to address an expected future government pension liability shortfall. It takes a longer-term view and has a higher risk profile and can invest in a broader range of asset classes. The Economic and Social Stabilization Fund, on the other hand, has macroeconomic stabilisation objectives. It has the aim of accumulating excess copper revenues when the price of copper is high in order to channel revenues into the budget when the price of copper is low, thereby smoothing out government expenditure. As a stabilisation fund, it has a lower risk profile in terms of its investments because it must take a short-term view due to liquidity concerns. Chile successfully implemented counter cyclical fiscal policy in the lead up to and during the GFC.

PNG'S EXPERIENCE WITH SWFS

Like Australia, Papua New Guinea (PNG) is a resource rich country. Its natural resources include gold, silver, copper ore, crude oil and natural gas Exports of these commodities, as well as coffee, timber and palm oil, account for around two-thirds of GDP, and mining – in particular gold, silver and copper – represents a large proportion of PNG's industry. As a developing economy, managing the wealth arising from these natural resources has been important to the development of the economy and the improvement of the well-being of Papua New Guineans.

The mid 1970's was a pivotal point in PNG's history. It gained its independence from Australia and established the Mineral Resources Stabilisation Fund. The aim of the fund was to reduce the volatility of budget revenue from resource-related income. Tax, royalties and dividend payments were placed in the fund, and the budget was funded from the balance. The 1974 Act establishing the Fund made specific provisions as to the size of the annual withdrawals, which were based on forward forecast of pricing and production. The budget was based on he maximum withdrawal from the Fund – put another way, no specific buffer was used to allow for inaccuracies of forecasts or volatility of incoming payments. Rather than adjusting the withdrawal to a more conservative number, the Parliament altered the terms of the Fund, with no limit of withdrawals. Further, the government borrowed heavily, which resulted in a poor net asset position. The Fund was eventually wound up in 1999.

The 2000s saw PNG attempt to ring fence booming wealth from resources once again with the introduction of a number of Trust funds. Each trust fund (of which there were many) received incoming revenue, which was intended to fund specific expenditure. As they were mainly intended to support shorter term expenditures, the trusts were typically invested in lower returning assets, such as bank deposits. This approach to smoothing incoming revenue was also

unsuccessful. The sharp reduction in commodity prices in 2008 and 2009 during the GFC, resulted in a 60% reduction in government revenue from mineral revenue and around half of the trust fund balances were withdrawn to support the budget.

In the 2011, the IMF report on PNG noted that both the Stabilisation Fund and use of public trusts had been largely unsatisfactory as a means of managing revenue volatility. Indeed the IMF noted that the MRSF had proved to be pro cyclical as a result of poor integration into fiscal policy. The allocation to multiple trusts limited the government's spending flexibility and also raised governance issues.

A large LNG project will start production and begin exporting in 2014. To address the liquidity impact of foreign inflows, the PNG government decided in November 2010 to form a pool of resources that will constitute the basis for the establishment of three offshore SWFs. The objectives of these funds are:

- Fiscal stabilisation
- Savings
- Infrastructure development, respectively

GLOSSARY

ABARES	AUSTRALIAN BUREAU OF AGRICULTURAL AND RESOURCE ECONOMICS AND SCIENCES
ABS	AUSTRALIAN BUREAU OF STATISTICS
ACCC	AUSTRALIAN COMPETITION CONSUMER COMMISSION
ACT	AUSTRALIAN CAPITAL TERRITORY
AOFM	AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT
APRA	AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
ASFA	ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA
ASIC	AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION
BCA	BUSINESS COUNCIL OF AUSTRALIA
COAG	COUNCIL OF AUSTRALIAN GOVERNMENTS
FSC	FINANCIAL SERVICES COUNCIL
GDP	GROSS DOMESTIC PRODUCT
GFC	GLOBAL FINANCIAL CRISIS
GSP	GROSS STATE PRODUCT
GST	GOODS AND SERVICES TAX
HEEF	HIGHER EDUCATION ENDOWMENT FUND
IA	INFRASTRUCTURE AUSTRALIA
IGR	INTERGENERATIONAL REPORT
IMF	INTERNATIONAL MONETARY FUND
LNG	LIQUEFIED NATURAL GAS
MFP	MULTIFACTOR PRODUCTIVITY
MYEFO	MID-YEAR ECONOMIC AND FISCAL OUTLOOK
NOM	NET OVERSEAS MIGRATION
NSW	NEW SOUTH WALES
NT	NORTHERN TERRITORY
OECD	ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
PNG	PAPUA NEW GUINEA
PPP	PUBLIC PRIVATE PARTNERSHIP
PTE	PRIVATE TRADING ENTERPRISES
QLD	QUEENSLAND
RBA	RESERVE BANK OF AUSTRALIA
SA	SOUTH AUSTRALIA
SG	SUPERANNUATION GUARANTEE
SPP	SPECIAL PURPOSE PAYMENTS
SWF	SOVEREIGN WEALTH FUND
TAS	TASMANIA
UEFO	UPDATED ECONOMIC AND FISCAL OUTLOOK
VIC	VICTORIA
VFI	VERTICAL FISCAL IMBALANCE
WA	WESTERN AUSTRALIA

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