# ECONOMIC REALITIES, BUDGET CHOICES FOR A STRONG AUSTRALIA

MAY 2018

Business Council of Australia



Business Council of Australia ABN 75 483 216

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**The Business Council of Australia draws on the expertise of Australia's leading companies to develop and promote solutions to the nation's most pressing economic and social challenges.**

# KEY MESSAGES

## The budget outlook remains vulnerable

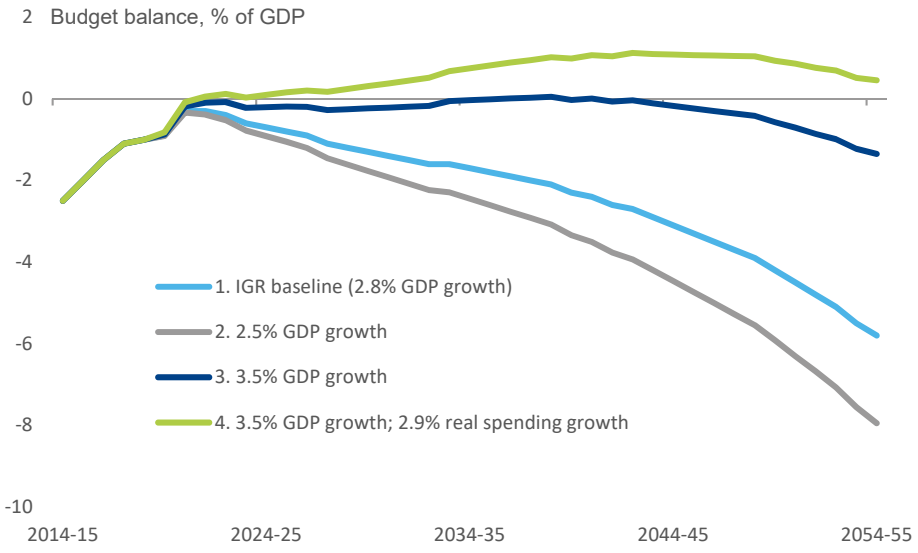
- In the face of continued resistance in the Parliament to even modest spending redesign measures, we expect the 2018-19 budget will rely on a sharp increase in revenue to drive an improvement in the budget balance over the forward estimates.
- But GDP growth, wages and productivity have been stuck in a rut. Overall economic growth is hovering around 2.4% a year, not the 3.0% assumed in the out years of the forward estimates or the long-term average of 3.3% a year.
- While the Business Council welcomes the forecast return to surplus in 2020-21 after 12 years of deficit, longer-term spending pressures including from an ageing population continue to build. On current projections, future spending growth will exceed economic growth and the economy's capacity to pay. The Intergenerational Report (IGR) projects a widening fiscal gap approaching 6% of GDP by 2054-55, and by no means is this a worst-case scenario. Nor does it reflect the fiscal position of state and territory governments.
- As the Business Council warned in its 2017-18 Budget submission, ongoing deficits of even half this, 3% of GDP, would create (in today's terms) more than $50 billion additional debt each year.
- Bridging a gap of this size (let alone achieving a surplus to pay down debt) would require every household to pay $5,000 more in taxes on average every year or spending to be slashed by $50 billion a year — the equivalent of one-third of the social security budget or almost the entire defence and education budgets combined.

## Growth matters

- Without continued restraint of spending growth, stronger economic growth will be needed to ensure that current medium-term budget projections are met, let alone over the longer term as spending pressures rise.
- Without stronger growth, Australia will sleepwalk into a state of widening deficit, along with lower growth in living standards and heightened vulnerability to economic shocks.
- Just a small drop in the terms of trade or weaker-than-expected new business investment would jeopardise the forecast return to surplus in 2020-21.
  - The latest MYEFO estimates that a 10% fall in the terms of trade would blow the deficit out by more than $5 billion by 2018-19. Delayed investment recovery would increase the deficit by more than $4 billion. Of course, the terms of trade could increase, but relying on winning the lottery is a high-risk strategy.
- Over the longer term, the mid-range IGR budget projections (bad as they are), assume GDP growth of 2.8% a year (scenario 1), which has only been achieved once in the last five years.

- If instead GDP growth were to remain around 2.5% a year, then the budget deficit would build to 8% of GDP by 2054-55 — a deficit of more than $140 billion in today's terms (scenario 2 in Figure 1). Tax revenues (in today's dollars) would be $100 billion lower than the IGR projection. And income per person (in today's dollars) would be around $108,000 not $122,000 as in the IGR.
  - This is not mindless scaremongering. If labour productivity continues growing at its current 10-year average of 1.2%, not 1.5% assumed in the IGR, then GDP growth will remain stuck around 2.5%.
- Stronger growth than projected in the IGR paints a different picture. GDP growth averaging 3.5% a year, with spending growth of 3.1% as projected in the IGR, would balance the budget for a couple of decades (scenario 3). At the same time, average real incomes would be $40,000 higher (around $160,000) than projected in the IGR. Tax revenues (in today's dollars) would be some $290 billion higher.
- If this stronger growth were accompanied by just modest restraint in real spending growth, then the budget returns to a sustained surplus with capacity to pay down debt and fund the services the community expects (scenario 4).

**Figure 1: Stronger growth and modest spending restraint generate sustained long-run surplus; growth stuck at its current rate would spell disaster**




**Note: Different rates of GDP growth estimated through a productivity shock.**
**Source: Business Council calculations using 2015 Intergenerational Report 'currently legislated' data and PBO, 2017–18 Budget medium-term projections: economic scenario analysis**

## Creating a virtuous circle of economic growth, higher incomes and a strong budget is the only option

- These are the realities facing the Parliament. The choices are clear.
- If the Parliament wants to ensure Australians continue to receive world class services and enjoy higher incomes, then growth-enhancing policies must be the highest priority

along with fiscal discipline to ensure the community gets better value for the money government spends on its behalf — around $460 billion in 2017-18.

- The alternative low growth/high spending path can only end in tears. Low growth means low incomes and eventually drastically lower spending. Increasing taxes to pay for services will not be a sustainable option.
- This is why the Business Council has consistently recommended a dual strategy of growing the economy and containing fiscal pressures through careful program redesign to improve the budget.
- The two are intertwined: a weak budget position is a drag on growth and weak growth undermines the budget.
- A stronger budget position will promote growth and investment while stronger economic growth will improve budget capacity for providing services and investment — through creating a dividend from higher national, and household, income. Win–win.

### Fiscal discipline remains non-negotiable

- Even with higher growth, maintaining an overarching architecture of fiscal rules will be required for overall budget discipline. Without spending discipline, we will be chasing a moving target and higher revenues risk being frittered away.
- Moreover, the economy can be thrown off course by global shocks in the blink of an eye — the ‘perfect storm’ scenario.
- In short, there is no escape from the need to bring spending growth into line with the economy’s capacity to pay.
- The Business Council welcomes that real spending growth is being held below 2% over the forward estimates, and hopes this is maintained in the 2018-19 budget. But spending remains above its long-run average share of GDP.
- The Business Council recommends that annual real spending growth should be held below 2% until a sustainable surplus — not just crawling over the line — is achieved. At the same time, the overall level of taxation should not exceed the current 30-year average share of GDP. The overall size of government across the federation must be contained.

### Getting better value from spending across the federation is key

- The focus must be on delivering better value for taxpayers’ money. Careful redesign of programs and innovations in service delivery to deliver better value and better outcomes is clearly preferable to being forced to make blunt cuts or impose massive tax hikes in response to a future economic downturn and fiscal crisis.
- Even with the Parliament ruling out many savings measures, the Business Council urges the government to continue to hold the line and effect incremental and structural improvements to improve service delivery by:
  - continuing functional and efficiency reviews

- reinvigorating the COAG process to lay the groundwork for improving spending outcomes in health and education through clear assignment of responsibilities and governance and funding arrangements across the federation
- improving health care by focusing on consumers, being transparent and using data better, restructuring incentives to deliver better quality outcomes (including through greater scope for competition and contestability), and greater use of technologies
- the Productivity Commission estimates potential cumulative gains of at least $140 billion over 20 years (in 2016 dollars) from health care measures. These gains could be reinvested in healthcare or other valuable services.

## Business is now bearing responsibility for bringing the budget back to surplus

- In the immediate to medium term, MYEFO shows stronger growth and revenue forecasts underpin the forecast return to surplus. This includes an extra $8.6 billion in company taxes (which are forecast to reach $97 billion by 2020-21), and some anticipated pick-up in wages growth.
- But long-awaited signs of business recovery, although promising, are uneven and remain hostage to external forces. These forces, which are largely outside our control could be positive, but cannot be relied on.
- GDP per person is growing at less than half the long-term average. New business investment is still only 12.4% of GDP, around the same as in the mid-1990s. Labour productivity fell by 1.0% through the year to December 2017. And real consumer wages are not growing at all.
- Achieving at least 3% economic growth primarily will require stronger productivity growth across the business sector. This is not ideology; it's arithmetic. (Population growth reflecting current immigration settings is already factored into GDP growth projections.)
- And Treasury reckons that for real national income growth per person to return to its long-run average of 2% per year, annual labour productivity growth will need to increase to around 2.5%. This will require embedding the right settings for growth, including: competitive and reliable energy; competitive tax settings; efficient regulation; efficient infrastructure; productive workplaces; and a skilled workforce.
- Achieving sustained productivity growth of 2.5% would be almost unprecedented in modern history, higher than the 'golden decade' of productivity growth in the 1990s when it averaged around 2.2%. This is Australia's growth challenge.

## Locking in stronger growth and higher incomes

- Creating greater economic value through stronger productivity will require building investment in people, skills and capital together with greater innovation and dynamism across enterprises of all shapes and sizes.
- Economies grow when people and enterprises have the flexibility and capacity to grasp opportunities and deal with challenges. Economies grow when they are globally competitive and an open and attractive destination for capital and skilled labour.

- The Business Council is prioritising actions across six areas to drive the dynamic, competitive businesses needed to create more, higher-paying and rewarding jobs and simultaneously deliver a revenue dividend.
- We have recommended specific actions to be implemented immediately and over the medium term across all levels of government.
- Some measures such as moving towards an internationally competitive company tax rate require some investment to achieve large pay-offs.
- Some argue that the budget impact of company tax cuts is a reason for putting them off. But the reduction is being phased in over ten years while the economic benefits will begin to build from day one in response to a credible signal.
- Nor should the absence of a broad tax reform agenda be an excuse for delaying company tax cuts. Cutting the company tax rate should be the top priority of any good, comprehensive tax reform package because it is the most damaging federal tax.
- Stronger growth is critical for breaking free from the logjam which has been created by the failure of the Parliament to acknowledge let alone begin to address spending pressures.
- Expediting growth-enhancing reforms — many of which involve little if any additional fiscal cost — would underpin the income and revenue growth needed to create fiscal capacity for more ambitious broad-based reform of Australia's tax system and federation.
  - Comprehensive tax reform is becoming increasingly urgent for shoring up the revenue base in the face of global and other forces.
  - Reform of the federation is a prerequisite for improving delivery of community services.
- The potential income gains are large. Conservatively they could increase GDP by several per cent, not counting the ongoing benefits for economic dynamism and innovation. Not doing them is choosing to make all Australians poorer.

# PRIORITIES FOR POLICY REFORM

| | What is needed | Actions within 12 months | Medium-term actions | Potential payoffs |
|---|---|---|---|---|
| | **A fair tax system that rewards effort and enterprise and makes the revenue base more resilient** | Pass the full Enterprise Tax Plan (ETP)<br>Personal tax cuts to relieve bracket creep targeted at lower income thresholds<br>Stable, simpler R&D tax incentives without arbitrary intensity thresholds | Personal rates that better reward effort<br>Neutral treatment of savings income and holistically review retirement savings system<br>Efficient/harmonised state and territory taxes including land, payroll taxes and stamp duties<br>Explore deeper restructuring of tax bases | The ETP is estimated to permanently increase annual GDP by 1%<br>Shifting 1% of tax revenue from income taxes to consumption and property taxes would increase GDP per person by 0.25–1.0 percentage points over the long term |
| | **A substantial reduction in the burden of regulation** | Intergovernmental agreement to prioritise regulatory reforms to:<br>■ streamline major projects approvals<br>■ simplify zoning restrictions<br>■ liberalise retail trading hours | Progress regulatory reform pipeline priorities<br>Strengthen the Australian Government's Regulator Performance Framework and introduce similar regimes in the states and territories | At least $5b added to the economy annually<br>Businesses spend an estimated $94b annually to administer and comply with government regulations |
| | **A workplace relations system for a modern economy** | ■ re-work the BOOT test to enable Enterprise Agreements | Revamp the workplace relations system to streamline awards | |
| | **Reliable, affordable and sustainable energy** | Implement the National Energy Guarantee<br>Replace moratoriums on gas ventures with evidence-based assessments | Develop a long-term, whole-of-economy emissions reduction strategy | Contain energy prices; more reliable energy and investment in generation; lower-cost emissions reduction<br>Gas moratoriums cost $1b a year |
| | **Infrastructure that supports growing cities and regions** | Fund high-priority infrastructure investments on IA's priority list<br>COAG to agree an infrastructure reform agenda to implement IA's planning, pricing and procurement reforms | Road pricing and funding reforms | Increase GDP by 0.7% by using Australia's road network more efficiently |
| | **Human capital and skills for the 21st century** | COAG agreement on the creation and design of a tertiary system | An integrated tertiary system that supports life-long learning | A more educated and skilled workforce could lift productivity by an estimated 1.2% after 25 years |
| | **An outward-looking economy** | Enact the TPP11<br>Reverse lower screening thresholds for FDI in agribusiness<br>Continue to champion the rules-based trading system | Pursue further trade liberalisation opportunities<br>Transparent, stable rules to encourage mutually beneficial FDI<br>Explore gradual removal of remnant trade barriers | The TPP11 will increase GDP by 0.5%<br>Halving trade barriers in G20 nations would boost GDP by 7%, jobs by 2% and wages by 4% |

## Higher taxes, higher spending and snake oil will leave Australians behind, not help them get ahead

- The way forward set out here is in stark contrast to the counter-narrative of taxing more to spend more. Those who argue for this latter path would ultimately undermine economic growth and real wages and the capacity to deliver better and fairer outcomes for the community at large and the most vulnerable in particular.
- This is because governments can only spend and redistribute income that has been created by businesses and individuals.
- High taxes inevitably discourage private investment, innovation, risk-taking and entrepreneurship and individual effort — core ingredients of economic growth. Spending and redistribution that fail to account for this will eventually cannibalise their funding source.
  - For example, Treasury has estimated that left unchecked, using bracket creep to fund extra spending would reduce GDP by around 0.35% over the long term, or around $6 billion in today's dollars.
- Likewise, those arguing against growth-enhancing measures — or for wage increases and conditions wildly out of kilter with productivity growth — are selling the community snake oil. It is dangerous nonsense to claim that the link between productivity and real wage growth is broken.
- Stunts and anti-business rhetoric might see a flurry of likes on twitter but they won't deliver higher-paid jobs and enduring improvements in household income and living standards. What the Business Council is proposing will.

**Priorities for growth over the next 12 months**

Priority: Start making the tax system fairer and more competitive

- Enact the full Enterprise Tax Plan to reduce the company tax rate to 25% for all businesses over 10 years.
- Provide bracket creep relief for lower and middle-income earners.
- Maintain the R&D Tax Incentive scheme to encourage innovation activity across enterprises while reducing administrative costs and complexity. An intensity-based scheme will bring unintended consequences and add complexity.
- Continue to ensure and promote trust in the integrity of the tax system.

Priority: Make it easier to do business and modernise workplace relations

- All jurisdictions agree a reinvigorated program of regulation reform, leveraged by incentive payments, that prioritises:
  - streamlined major project approval processes
  - simplification of zoning restrictions
  - liberalisation of retail trading hours.
- Clearly define conduct that is prohibited under section 46 of the *Competition and Consumer Act 2010*.
- Reformulate the *Fair Work Act 2009* as a matter of urgency:
  - Allow Enterprise Agreements to be approved if employees covered by the agreement 'on the whole' are better off under the agreement compared to the award.
  - Begin to limit the scope of what can be included in agreements.

Priority: More reliable, affordable and sustainable energy

- Progress implementation of the National Energy Guarantee through the COAG Energy Council in consultation with industry.
- Remove state-based emissions targets inconsistent with the Guarantee.
- Replace moratoriums on gas exploration with evidence-based, project-by-project assessment.

Priority: Efficient infrastructure for growing cities and regions

- Stop using major infrastructure projects as political footballs — governments should agree to fund high-priority projects on Infrastructure Australia's (IA) priority projects list.
- Reinstate 'asset recycling' initiatives to incentivise state and territory governments to privatise infrastructure assets and reinvest the proceeds into new infrastructure.
- Agree an intergovernmental infrastructure reform agenda that implements the planning, pricing and procurement reforms in IA's plan.
- Streamline approval processes.

Priority: Better choices for future proofing through skills and education

- Begin work to adopt the tertiary model set out in the Business Council's *Future Proof* discussion paper to establish a culture of lifelong learning centred around the needs of individuals and their working lives.

Priority: Champion open trade and investment

- Enact the TPP11 as soon as practicable.
- Reverse the lower screening thresholds introduced for foreign direct investment (FDI) in agribusiness.
- Continue to champion and uphold the international rules-based trading system.

**Priorities for growth over the medium term**

Priority: Fairer, more competitive taxes

- Implement broader tax reforms to reduce the overall burden of the tax system on individual and business enterprise, reduce distortions and complexity, and to shore up the national revenue base in the face of increasing international mobility of capital and people and the structural erosion of other bases.
  - Restructure personal income tax rates to relieve work disincentives posed by higher effective tax rates.
  - Introduce more neutral and fairer treatment of savings income.
  - Examine the retirement income system holistically.
  - Reduce reliance on stamp duties and shift gradually to broader based land taxes.
  - Harmonise payroll tax rules across the states and territories.
  - Simplify taxes and improve integrity and voluntary compliance.
- Explore deeper restructuring of tax bases, including greater reliance on the consumption tax base in the face of global mobility of capital, labour and production.

Priority: Make it easier to do business and modernise workplace relations

- Progress the reform agenda pipeline agreed by COAG as part of the 12-month priorities.
- Strengthen the Australian Government's Regulator Performance Framework and establish similar regimes in the states and territories.
- Implement a workplace relations system that gives enterprises and their employees space and opportunity to improve productivity and increase wages.
  - Define the employment relationship in the legislation, rather than rely on legal precedent, so there is a clear set of rules about what can be included in agreements.
  - Streamline awards to their core purpose of establishing a floor of wages and conditions.
  - Respond to employer concerns about right-of-entry provisions, caused by inherent issues in the legislation.

- Understand the problems organisations face when undertaking structural change, and the barriers that the adverse action provisions present.

Priority: More reliable, affordable and sustainable energy

- Develop a whole-of-economy emissions reduction strategy incorporating access to credible international permits and continuation of the Emissions Reduction Fund.

Priority: Efficient infrastructure

- Implement road policy reforms to link cost-reflective pricing models with road funding and efficient investment.

Priority: A better skilled and responsive workforce

- Implement a seamless national tertiary system to drive a better skilled, more responsive workforce, better matched to changing job opportunities.

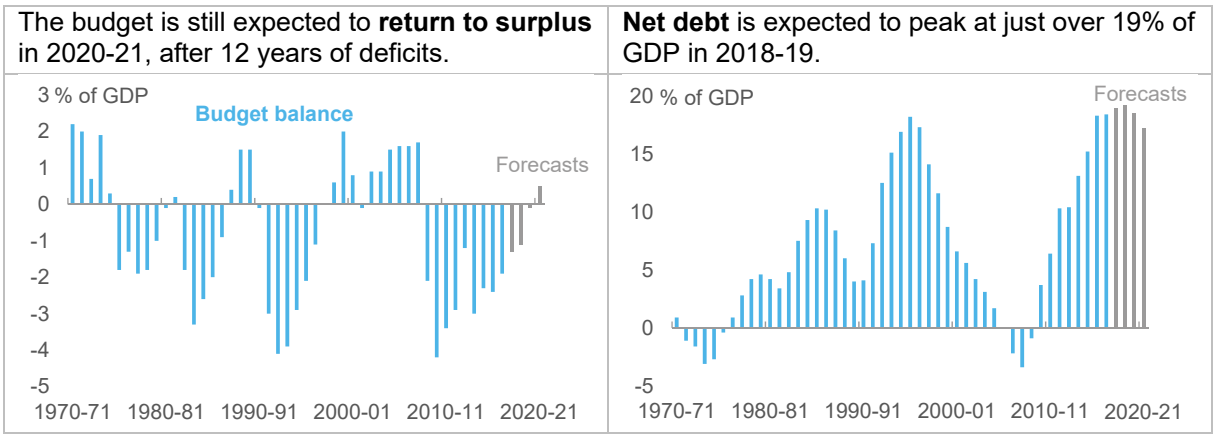
Priority: Promote open trade and investment

- Continue pursuing trade liberalisation opportunities within the multilateral framework and existing agreements, and by forging new agreements.
- Implement a stable and transparent foreign direct investment regime that delivers clear community benefits.
- Explore scope for further reductions in residual domestic trade barriers to facilitate trade flows and global supply chain linkages.

# 1 THE FISCAL CHALLENGE STILL AHEAD

The Business Council welcomes the budget improvement forecast over the forward estimates, delivering a slim surplus by 2020-21 and over the remainder of the decade. Nonetheless, this surplus will be achieved after a record 12 years of consecutive deficit and debt build-up. It will be many years before net debt drops substantially.

**Figure 2: Will 13 be the lucky number?**




**Source: Australian Government, MYEFO 2017-18**

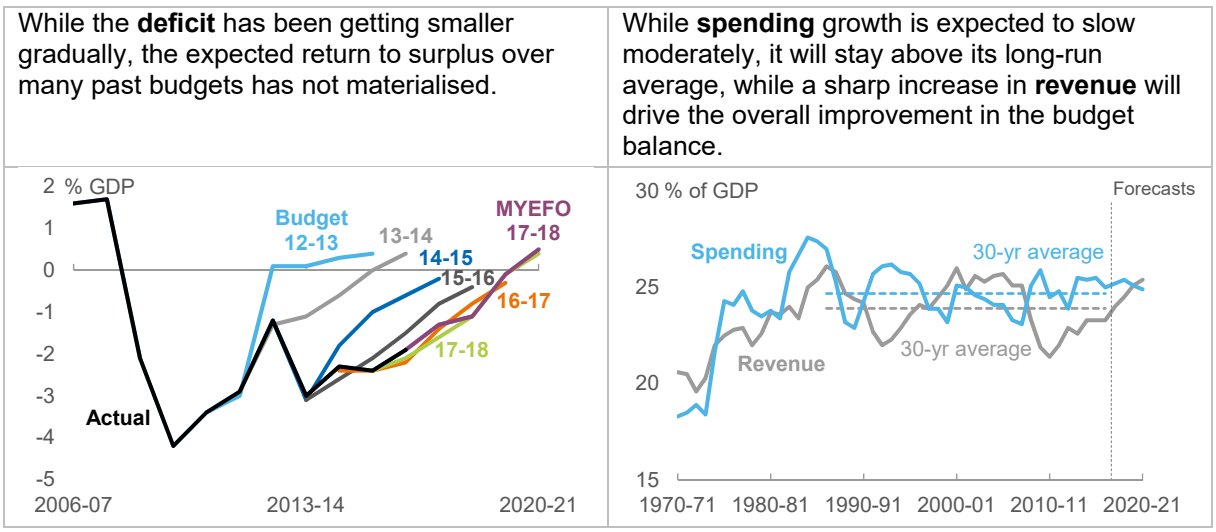
While acknowledging that real spending growth is being held below 2% per annum on average over the forward estimates, the forecast return to surplus comes more from projected revenue growth than spending restraint.

Spending will fall to 24.9% of GDP by 2020-21, just above the 30-year average of 24.7%.

At the same time, the revenue share of GDP is expected to climb sharply to 25.4% of GDP by 2020-21, well above its 30-year average of 23.9%.

Tax receipts likewise are anticipated to jump to 23.8% of GDP compared with a 30-year average of 22.2%. While this falls (just) within the government's tax cap of 23.9% of GDP, the Business Council considers the latter should be treated as an outer bound, not a target.

**Figure 3: Higher revenues will deliver the small surplus forecast for 2020-21**




**Source: Australian Government, MYEFO 2017-18 and prior budget papers**

For several years, revenue forecasts have proved overly optimistic because of weaker than anticipated economic growth.

The 2017-18 Budget seems set to buck the trend as world growth picks up, but nonetheless highlights the sensitivity of the budget to economic performance.

While the budget is benefiting from revenue gains flowing from higher commodity prices which are boosting company profits, this serendipitous revenue spike may prove short-lived. And without it, the budget outcome might well fall short of expectations because of continued subdued economic growth (particularly on a per capita basis) and stubbornly weak wages growth, despite a pick-up in employment and hours worked over 2017.

Indeed, MYEFO revised down Budget forecasts for wages growth over each year of the forward estimates and economic growth for 2017-18. On the positive side, small improvements were made to business investment and unemployment forecasts.

### Underlying spending pressures continue to build

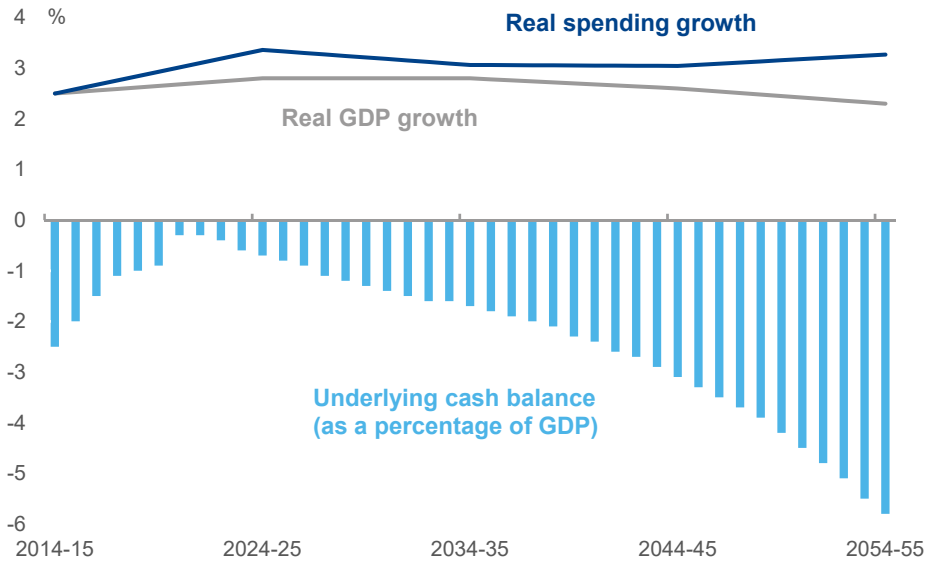
Even if these forward estimates are achieved, the 2017-18 Budget papers project that annual real spending growth will ramp up post 2020-21 from around 2% currently to just under 3%. This is broadly in line with the IGR, which projects annual real spending growth of 3.1% over coming decades.

Major spending drivers are new programs such as the NDIS and an ageing population. There are also budgetary risks from off-budget projects such as the NBN.

On current projections, spending growth of around 3% would slightly exceed the IGR's long-term average annual GDP growth projection of 2.8%.

As the Business Council observed in its 2017-18 Budget submission, this imbalance would generate an ever-growing and unsustainable fiscal gap and debt build-up (Figure 4).

**Figure 4: IGR long-term budget outlook: a widening fiscal gap**




**Note: The data for real spending and GDP growth have been smoothed to illustrate the underlying trends in the data.**
**Source: Business Council calculations using 2015 Intergenerational Report 'currently legislated' data**

According to the IGR, the structural deficit could build to close to 6% of GDP by mid-century, and federal government spending would climb to more than 30% of GDP by 2055 compared with just over 25% today.

As the Business Council warned in its 2017-18 Budget submission, ongoing deficits of even 3% of GDP would create (in today's terms) some $50 billion additional debt each year. The implications are stark:

- Taxes would need to rise by more than $5,000 per household per year or by $2,000 per person to close the deficit, and by much more to pay off debt.
- Relying on bracket creep to close the deficit would see 1.5 million more workers paying the top marginal rate of tax of 47%.
- Alternatively, services would have to be slashed. Saving $50 billion requires cutting the equivalent of one-third of today's social security budget or almost the entire education and defence budgets combined.
- Burgeoning debt would leave no buffer to respond to economic shocks — a 'perfect storm scenario' — or any capacity for substantial investments in physical and social infrastructure. Other policies, including a more competitive tax system, which are urgently needed to deliver stronger economic growth, would languish.

None of these options is acceptable but, without intervention, one or some combination of them is inevitable.

# 2 ECONOMIC PERFORMANCE MATTERS A LOT FOR BUDGET OUTCOMES (AND LIVING STANDARDS)

Realising budget economic forecasts will be critical for achieving the forecast surplus in 2020-21. Just a small shortfall in revenue growth due to lower than anticipated terms of trade, investment or wages growth, for example, would jeopardise the forecast $10.2 billion surplus.

The latest MYEFO estimates that a 10% fall in the terms of trade would blow the deficit out by more than $5 billion by 2018-19. Delayed investment recovery would increase the deficit by more than $4 billion.

On the other hand, higher commodity prices could fortuitously deliver a bigger surplus. But luck is not a strategy.

Over the longer term, if action is not taken to slow the rate of spending growth, then the rate of economic growth becomes even more critical.

Current budget forward estimates forecast 3% real GDP growth from 2018-19. As noted earlier, the IGR projections assume long-run annual GDP growth of 2.8%. This is also in line with Treasury long-run projections.

Achieving this will not be easy, let alone a higher number. Currently, year-on-year real GDP growth is 2.3% and has averaged 2.6% a year over the past 10 years.

The Business Council has constructed several scenarios around the baseline ‘currently legislated’ scenario in the IGR. For reasons outlined below, the IGR’s ‘currently legislated’ scenario is considered a suitable baseline on which to base projections for scenario analysis.

While the underlying cash balance outlook has evolved since the IGR, improving the outlook over the medium-term (see MYEFO 2017-18 tax cap scenario in Figure 5), longer-term spending pressures driving a fiscal gap over time have not been fully addressed.

As noted earlier, progress on repairing the budget has been supported by an uptick in commodity prices, but that is unlikely to be sustained, while spending redesign measures continue to face resistance. So even if the mid-term outlook has improved, sustaining a surplus in the longer term in the absence of further spending restraint, will require significantly stronger productivity growth.

Each scenario analyses the impact on the underlying cash balance from a shock to the 1.5% annual labour productivity growth rate assumed in the IGR over the next 40 years. This was the historical average at the time of the IGR report, but it cannot be taken as given going forward. As the IGR notes, given the expected demographic changes over the next several decades, productivity growth will have to play an even more important role in the future.

The scenarios in Figures 1 and 5 show the impact on the underlying budget balance from a permanent shock to productivity growth (relative to the 1.5% IGR baseline) from 2019-20.

**Why assume that tax revenues are capped?**

As in the Budget and the IGR, these scenarios assume that tax revenues are capped at 23.9% of GDP, in line with the government's cap.

If tax revenues were uncapped, then higher tax collections, mainly from bracket creep, would drive budget improvement, assuming that spending did not increase to match higher receipts (see 'uncapped trajectory' in Figure 5).

Bracket creep means that income earners pay more income tax because of the interaction of wage inflation and progressive tax rates, not because they are better off in real terms. Put another way, average tax rates increase for any level of income.

While allowing this to occur is an option, it is an unpalatable one, particularly as it would disproportionately hurt low- to middle-income earners. History suggests that government routinely prevent bracket creep from persisting for too long because not to do so would impose punitive burdens on working households.

If bracket creep were allowed to continue unchecked in future, the average tax rate for someone earning average weekly ordinary time earnings would increase from a shade over 24% today to close to 30% within a decade. In today's terms, this represents a tax increase of around $4,000 a year per person.

### If growth doesn't improve, the budget will be in serious trouble

Anything less than solid economic and productivity growth will have serious implications for the budget.

For example, labour productivity growth of 1.2% a year (equivalent to 2.5% GDP growth) sees the projected budget deficit in 2054-55 increase from 5.8% of GDP to almost 8% of GDP (a deficit of more than $140 billion in today's terms).

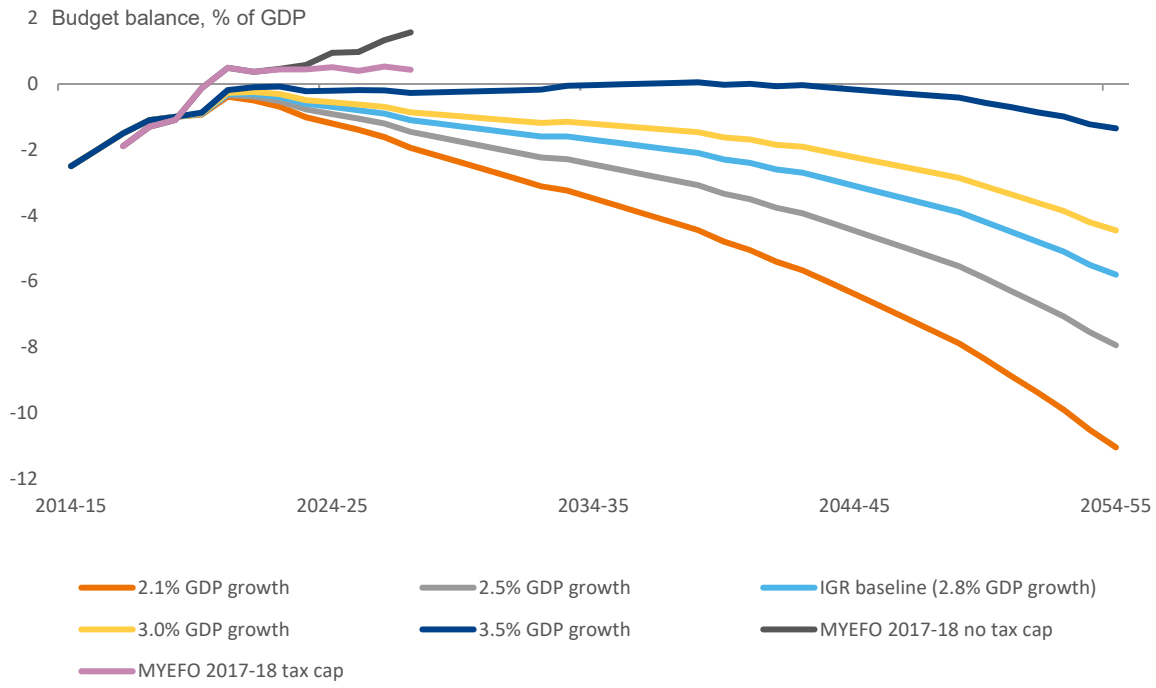
This is not mindless scaremongering. Productivity growth has been averaging 1.2%, not 1.5%, over the past decade.

### Exceptional productivity growth gets the budget into the black, for a while

Labour productivity growth of 2.2% a year (equivalent to 3.5% GDP growth) over the next 40 years would lead to a prolonged period of budget balance, before the impact of demographics and spending pressures takes over.

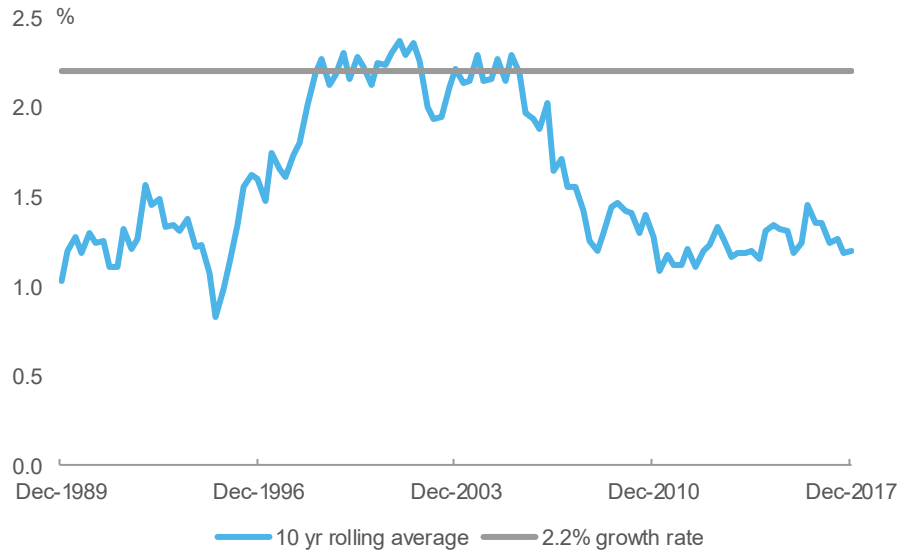
In recent history, this has only been achieved over the 1990s and early 2000s (see Figure 6).

## Figure 5: A sustained increase in productivity growth balances the budget over the long term; continuing at the rate we're going spells disaster




**Note: Different rates of GDP growth estimated through a productivity shock.**
**Source: Business Council calculations using 2015 Intergenerational Report 'currently legislated' data and PBO, 2017–18 Budget medium-term projections: economic scenario analysis**

## Figure 6: Is 2.2% annual labour productivity growth achievable again?




**Source: ABS cat. no. 5206.0**

**Do recent budget improvements mean mission accomplished?**

The budget deficit and outlook has improved in the three years since the Intergenerational Report was published. This has been driven by an improved revenue outlook as well as the passage of savings measures.

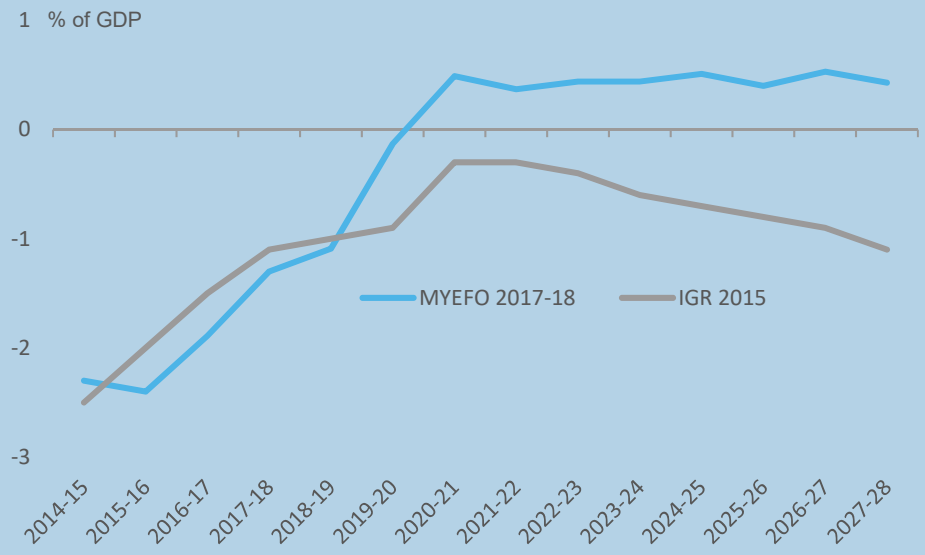
While this improvement in the medium-term outlook is welcome, it does not mean that budget repair is job done and that the IGR 'currently legislated', central scenario is superseded.

For a start, the past couple of years generated worse *actual* budget outcomes than were estimated by the IGR, highlighting that budget forecasts cannot be taken as a given.

Many of the measures driving the IGR's more optimistic 'proposed policy' scenario are either not legislated or have been abandoned. The cumulative impact of these policies is large. Changes also involved shifting costs to state and territory governments, which still fall on taxpayers, and could still return to the Commonwealth's ledger.

For these reasons, the IGR's 'currently legislated' scenario is considered a suitable baseline on which to base projections for scenario analysis. The long-term budget outlook is unlikely to have changed materially, while the broad orders of magnitude and impacts of each scenario show the relative potential gains (and losses) of different growth scenarios.

**Figure 7: MYEFO 2017-18 vs IGR, underlying cash balance**




**Source: Australian Government, MYEFO 2017-18; Australian Government, 2015 Intergenerational Report ('currently legislated' data)**

# 3 FISCAL DISCIPLINE CANNOT GET A LEAVE PASS

On current long-term spending projections, consistent, historically high economic growth would be required to lock in a period of budget balance let alone surplus.

But even at the highest end of productivity and growth assumptions such improvement is unlikely to be permanent without slowing currently projected spending growth.

Moreover, over-reliance on the economy doing all the work is a highly risky strategy. The economy can be thrown off course by global shocks in the blink of an eye — the 'perfect storm' scenario.

While the current pick-up in world economic growth is good news for many Australian businesses, there are many risks and sustained recovery is not a sure thing.

Federal government debt has been building for 10 years already — unprecedented in Australia's post-WW2 history — and further build-up, even at a slower rate, will leave the economy and budget unacceptably vulnerable to shocks.

Recent stock market volatility emanating in the US in response to interest rate pressures, brings home how susceptible Australia's economy is to global forces. Higher interest rates in the US are likely to have flow-on effects for Australia at a time of rising government and household indebtedness.

### Low revenues are the not the culprit and higher taxes are not the answer

The answer is not higher taxes. While revenues have fallen short of successive forecasts for many years, revenue shortfalls are not to blame for ongoing deficits.

Revenues dipped in the wake of the global financial crisis and subsequent terms of trade decline but have steadily recovered since. Revenue growth has been quite strong; missed forecasts have just been stronger.

As noted earlier, tax receipts likewise are anticipated to jump to 23.8% of GDP, just a shade under the government's cap of 23.9% of GDP and above the long-term average. By 2019-20 total receipts will be almost $500 billion, equivalent to a quarter of GDP.

### Slowing spending growth remains non-negotiable

Consistently high spending growth has created the structural deficit and will drive it in the future.

Slowing the rate of growth in spending will be essential for long-term budget repair, improving service delivery and delivering maximum community value for taxpayers' money. Containing spending growth will also increase capacity to invest in productive assets and implement policy reforms including broad taxation reform.

Unsurprisingly, slowing spending growth has a more direct, one-for-one, impact on reducing the deficit than economic growth. On the other hand, stronger growth has the added benefits of delivering higher per capita incomes and achieving budget improvement without reducing spending.

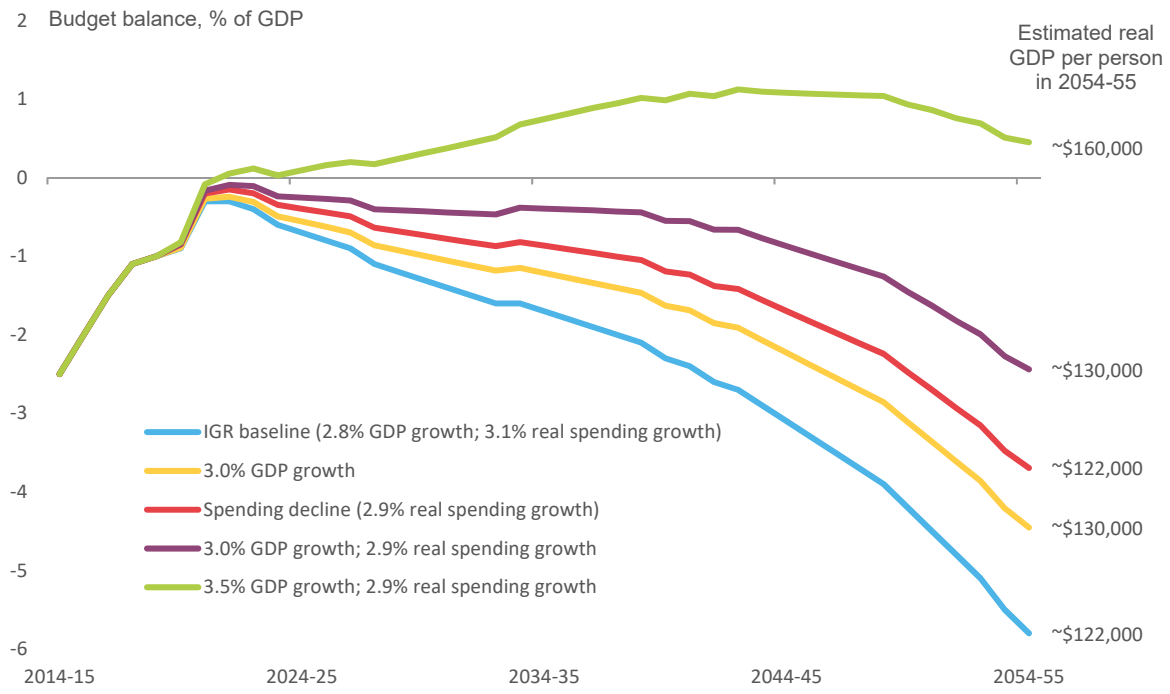
For example, a permanent increase in productivity growth of 0.2 percentage points a year will make some progress to reducing the budget deficit by 2054-55. If instead real spending

growth were reduced by 0.2 percentage points a year, budget improvement would be relatively greater.

A combined productivity improvement and reduction in spending of just 0.2 percentage points each could more than halve the projected deficit by 2054-55 (Figure 8), while delivering average incomes more than 6% higher than projected in the baseline.

And if there were stronger GDP growth (3.5%) alongside modest spending restraint, then the budget returns to a sustained surplus with capacity to pay down debt and fund the services the community expects.

**Figure 8: Higher productivity AND slower spending growth reduce the deficit while increasing incomes (current dollars)**




**Note: Different rates of GDP growth estimated through a productivity shock.**
**Source: Business Council calculations using 2015 Intergenerational Report 'currently legislated' data**

In its 2017-18 Budget submission, the Business Council recommended:

- an architecture for embedding a systematic approach to improving program outcomes and delivering sustainable budgets, guided and supported by overarching fiscal goals and rules to contain spending and revenue growth and the overall size of government
- measures to prevent budget slippage in the immediate term including the passage of several blocked savings measures and continuation of functional and efficiency reviews, which have the capacity to achieve savings, deliver better outcomes and moderate the trajectory of spending
- actions over the medium term across several program areas, including health care and education, that would contain growth in outlays at the same time as improving program effectiveness and service quality through better targeting and productivity improvements
- management of emerging spending risks.

While commending the federal government for measures it has taken since to slow spending growth, these recommendations still stand.

### An overarching framework of fiscal discipline will be crucial to delivering fiscal goals

For several years, the Business Council has recommended four goals that go to the heart of competent and prudent fiscal management in the interests of the Australian community now and in the future:

1. Ensure the sustainability of priority services, including an adequate safety net, that are integral to community living standards and the functioning of our society.
2. Ensure capacity for investments in infrastructure and human capital, vital for innovation and productivity growth and higher incomes.
3. Progressively return the budget to surplus to build resilience and flexibility for dealing with economic shocks and volatility, and for underpinning business confidence and investment.
4. Preserve Australia's AAA credit rating to retain financial capacity and maintain investor confidence.

Ultimately, budget repair will require improvements in individual programs. However, rules and benchmarks can provide an overarching framework for guiding and assessing progress on achieving these goals (or identifying backsliding).

The Charter of Budget Honesty commits the federal government to producing a medium-term fiscal strategy that outlines principles-based fiscal objectives and the steps that will be taken to secure them.

The Business Council strongly supports the government's fiscal architecture and medium-term strategy to reduce the government's share of the economy over time by reducing the payments to GDP ratio and net debt, with the aim of restoring a surplus of at least 1% of GDP.

But such commitments are not binding and — consistent with international experience — have often not been fully executed, therefore failing to ensure meaningful fiscal discipline.

More explicit rules and independent oversight and reporting by the Parliamentary Budget Office would help deliver fiscal objectives.

### Clear fiscal ground rules would provide discipline and consistency

There is international evidence that fiscal rules — which can take the harder form of numerical limits relating to debt, spending and taxes — can effectively anchor fiscal strategies and budget repair goals. The number of countries with fiscal rules has grown from six in 1985 to 85 in 2014.

Fiscal rules provide signposts for each year's budget in progressing towards longer-term goals such as those outlined by the Business Council.

They also provide discipline. Without them, longer-term goals can more easily be deferred or fiscal discipline can be inconsistent.

The adoption of fiscal rules would not prevent government having the flexibility to change course were an extraordinary economic shock or natural disaster to result in a significant and unexpected call on budget resources.

The Business Council recommends a combination of fiscal rules and independent oversight and reporting.

### 1 Overall level of taxation should not exceed the current 30-year average share of GDP

This rule ensures that the problem of spending, as the government has rightly emphasised, is addressed as opposed to increasing taxes to fund increasing expenditure.

It also recognises that stronger economic growth will be the most sustainable means of increasing revenues.

### 2 Annual real spending growth should not exceed 2% in any one year until a sustainable surplus is achieved

As long as the economy grows in excess of 2%, this rule would bring government spending into line with receipts and bring the budget back to balance and a sustainable surplus.

Two per cent should be an outer boundary for real spending growth in any given year, not a target. Barring an economic shock or reduced receipts, it would ensure steady improvement in the budget bottom line each year.

The Business Council notes that real spending growth is projected to be 1.9% a year on average over the forward estimates, but that this is underpinned in part by measures that are yet to be legislated. As already noted, beyond the forward estimates real spending growth is projected to rise to just under 3% per annum, above projected GDP growth.

### 3 The productivity of government spending must be monitored and improved

Ideally government sector productivity should also be monitored and a target set for improvement. Unfortunately, government sector productivity is not measured well, if at all, because of the difficulty in measuring outputs.

However, where possible, productivity measures and benchmarks should be developed to enable greater performance monitoring and assessment.

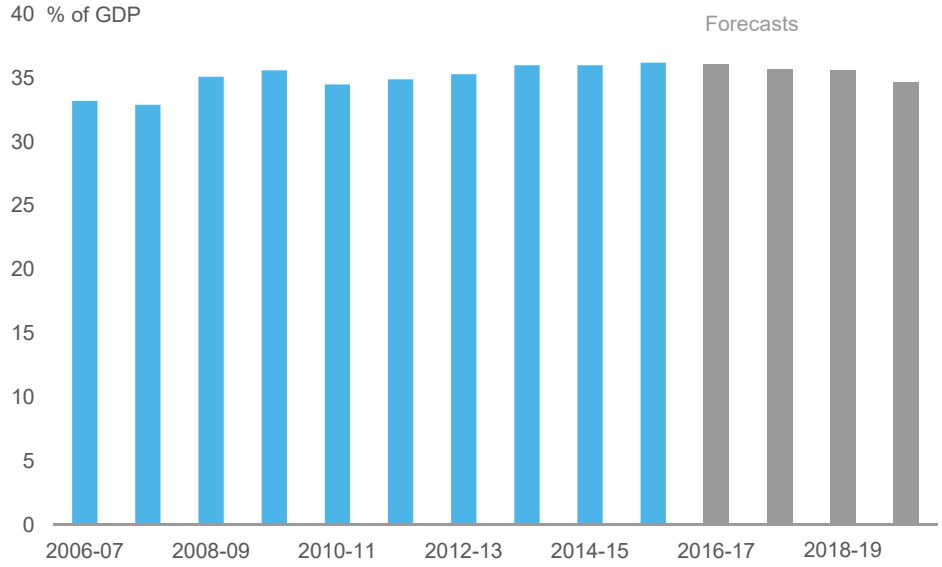
The Harper review provided a road map for increasing competition in the delivery of key social services. The federal, state and territory governments[1] should work together to develop benchmarks including private sector comparators.

### 4 Expenditure by all governments must be contained

The federal government accounts for the lion's share of government spending and debt but state and local governments also raise revenues and spend taxpayer funds. Total spending for all governments currently exceeds $600 billion a year. In 2017-18 the total size of government (federal, state, local) is estimated to be 35.7% of GDP (including public non-financial corporations).

[1] Hereafter, references to state governments include territory governments.

**Figure 9: Spending by all governments has edged up**




**Source: Australian Government, Budget 2017-18**

It is important that there is a benchmark for the size of government to ensure discipline over time, particularly as health absorbs increasing funding across the federation and major new government programs commence.

An overall benchmark would also guard against shifting of costs across jurisdictions and to off-budget entities.

The Business Council believes that the Parliamentary Budget Office (PBO) should be given responsibility for reporting on the overall size of government and identifying major trends and risks.

### There are many practical savings and efficiency measures that can be progressed

With the Parliament ruling out most savings measures, the Business Council nonetheless urges the government to continue to hold the line and effect incremental and structural improvements where possible.

- Functional and efficiency reviews comprehensively assess all aspects of a federal government department or agency to ensure that resources align with government policy objectives.
- These reviews should encompass the rationale for and performance of more than 1,200 federal government bodies with a view to reducing duplication and identifying scope for rationalisation.
- The government should reinvigorate the COAG process to lay the groundwork for improving spending outcomes and slowing the rate of growth for major spending areas such as health care, education and the NDIS, through appropriate assignment of responsibilities and governance and funding arrangements across the federation.

- Building on the Harper review recommendations, the Productivity Commission has made several recommendations for improving productivity in government services. These include eliminating low-value health interventions and implementing patient-centred care.
- The Business Council similarly has outlined numerous areas for improvement to the operation of the healthcare system including a consumer focus and consumer choice, greater transparency and better use of data, restructured incentives to deliver better quality outcomes, and greater use of technologies. There is significant opportunity to inject more competition and contestability in human services delivery — including health care — to improve consumer outcomes and operational efficiency.
- Importantly, achieving better value from given resources in the government sector delivers a dividend that can be reinvested in the delivery of services without requiring increased spending. The Productivity Commission[2] estimates potential cumulative gains of at least $140 billion over 20 years from reforming the healthcare system.

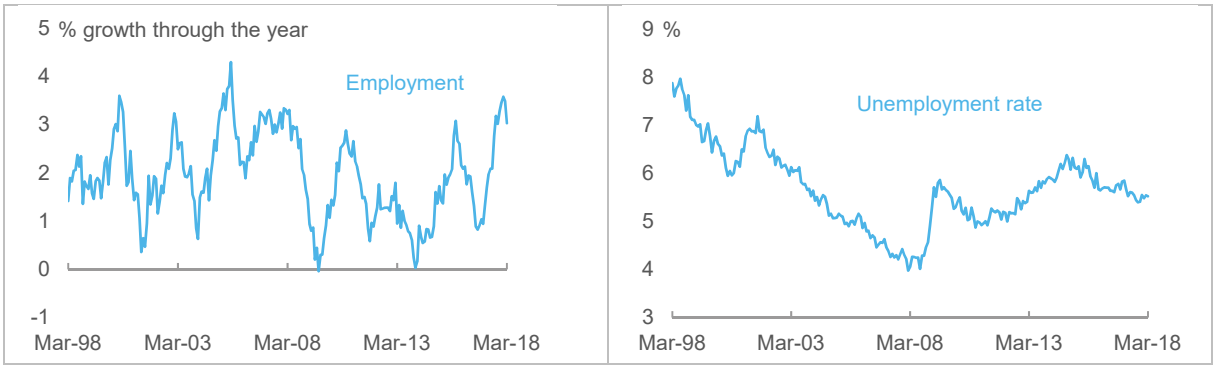
[2] Productivity Commission, *Shifting the Dial: 5 Year Productivity Review*, 2017.

# 4 SIGNS OF RECOVERY, BUT THE ECONOMY IS NOT OUT OF THE WOODS YET

The Business Council welcomes recent signs of economic recovery, particularly strong job creation with more people participating in the labour market. The unemployment rate has slowly declined over recent years, but it currently seems stuck at around 5.5%.

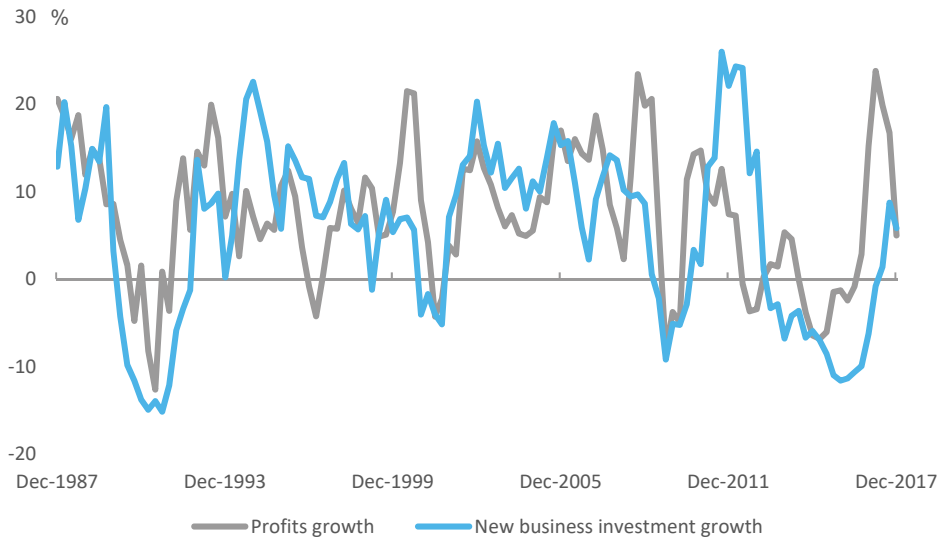
A long-awaited pick-up in new business investment and profits after several years of decline is also good news.

**Figure 10: Employment growth has picked up strongly, but the unemployment rate is moving sideways**




**Source: ABS cat. no. 6202.0**

**Figure 11: Profits and investment growth emerge from the doldrums**




**Source: ABS cat. no. 5206.0**

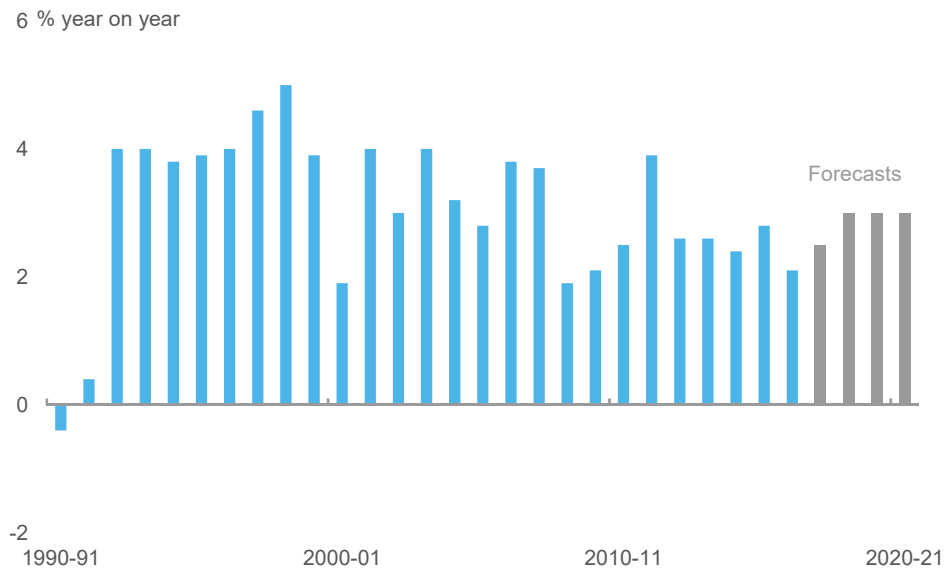
But recovery is in its early days and is patchy across the economy. Half of the recent rebound in business profits emanated from the mining sector.

Notwithstanding some improvement, new business investment remains low relative to GDP — 12.4%, around the same as in the mid-1990s following recession.

Wages growth is slowly improving but real consumer wages are stagnant and per capita GDP growth remains flat:

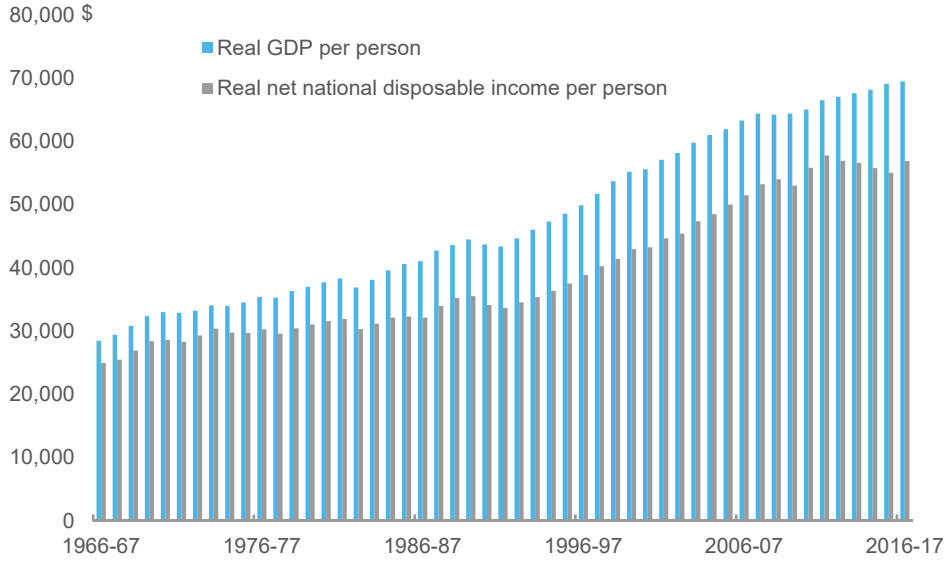
- Year-on-year real GDP growth of 2.3% to December 2017 is not stellar, and MYEFO downgraded the GDP forecast for 2017-18 to 2.5%.
- Once population growth is accounted for, income growth per person remains weak. (Real income per person is a better indicator of living standards than aggregate growth.)
  - Real GDP per person is trending below 1% per year, less than half the long-run average of 2% a year.
  - Reflecting the ebb and flow of the terms of trade, average real net national disposable income has just climbed back to $57,000, about the same as five years ago.
  - There has been essentially no growth in real consumer wages since 2011-12 despite low CPI growth; indeed, they didn't grow at all through the year to December 2017.

**Figure 12: GDP growth is expected to improve, a bit**




**Source: ABS cat. no. 5206.0; MYEFO 2017-18**

**Figure 13: Growth in GDP and income per person is less encouraging**

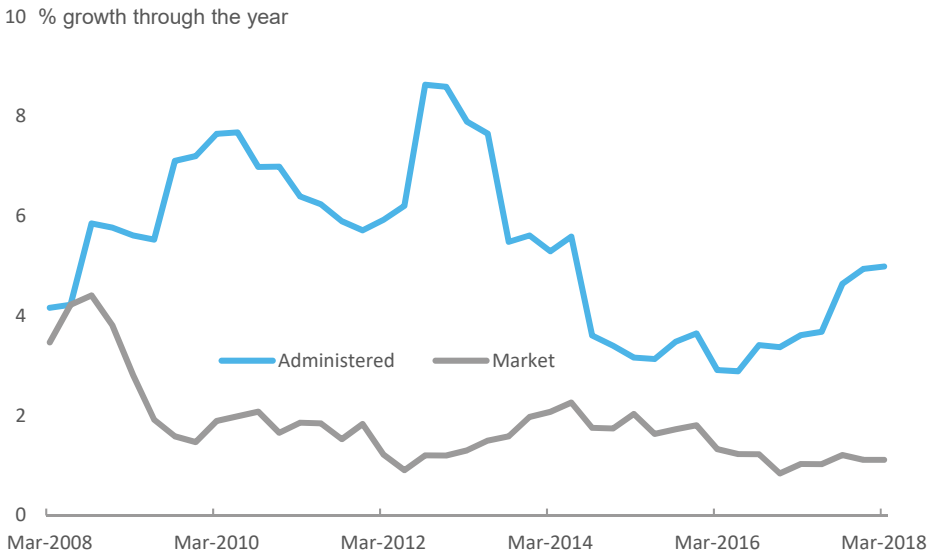



**Source: ABS cat. no. 5206.0**

And for many, particularly lower income households, their purchasing power is being further eroded by price increases for essential services that significantly exceed general inflation.

These above-average price increases are often the result of or exacerbated by government intervention rather than market forces, although the cause matters little to those households footing the bills.

**Figure 14: 'Administered' prices, which include utilities, health care and education, are rising much faster than prices in the market sector**




**Source: ABS cat. no. 6401.0**

## Uncharted territory or just the same but different?

Sluggishness in wages and incomes despite recent improved profitability in some sectors has led to claims that normal economic relationships have broken down and that we are in a new paradigm.

There are many forces at work, which are complicating analysis and prediction, but this does not mean that economic relationships no longer apply.

One important factor is that the economy for several years has been adjusting to the legacy of the terms of trade boom and heightened risk and uncertainty created by the GFC.

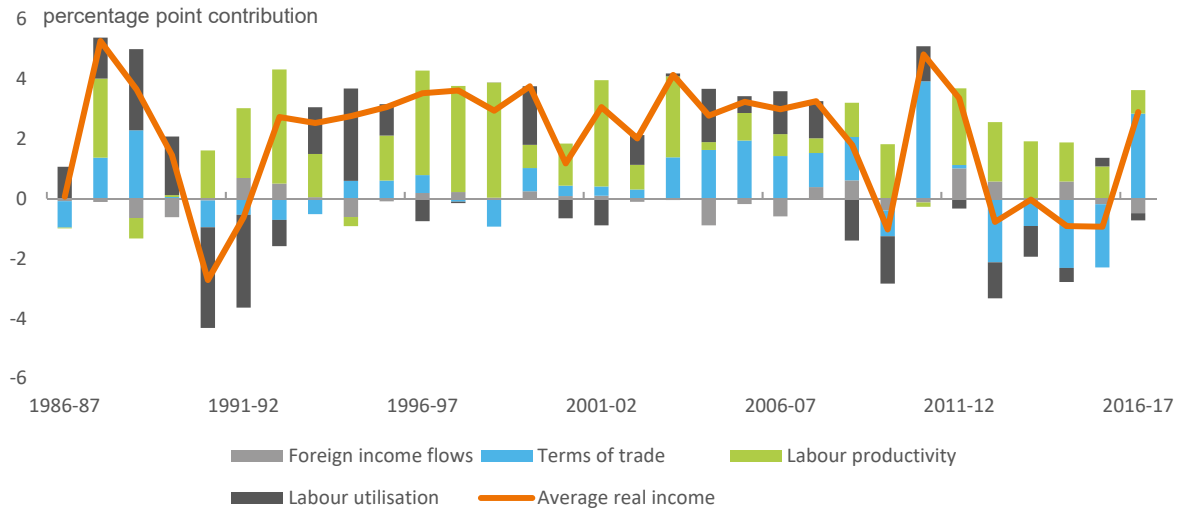
During the mining boom the Australian economy underwent a period of 'real appreciation' that fed into higher costs, including higher labour costs across the economy. This was an inevitable and necessary response to higher commodity prices that facilitated structural adjustment, at the same time as spreading income gains across the community.

The end of the terms of trade boom bequeathed an old-fashioned real wage 'overhang' — which, coupled with only modest productivity growth since, has necessitated wage moderation to restore business competitiveness at lower output prices.

Recently, higher commodity prices have again boosted profits and GDP after detracting from growth for several years (Figure 15). By the end of 2017, Australia's terms of trade had recovered part of the ground lost since their peak in 2011, although they have softened somewhat since (Figure 16).

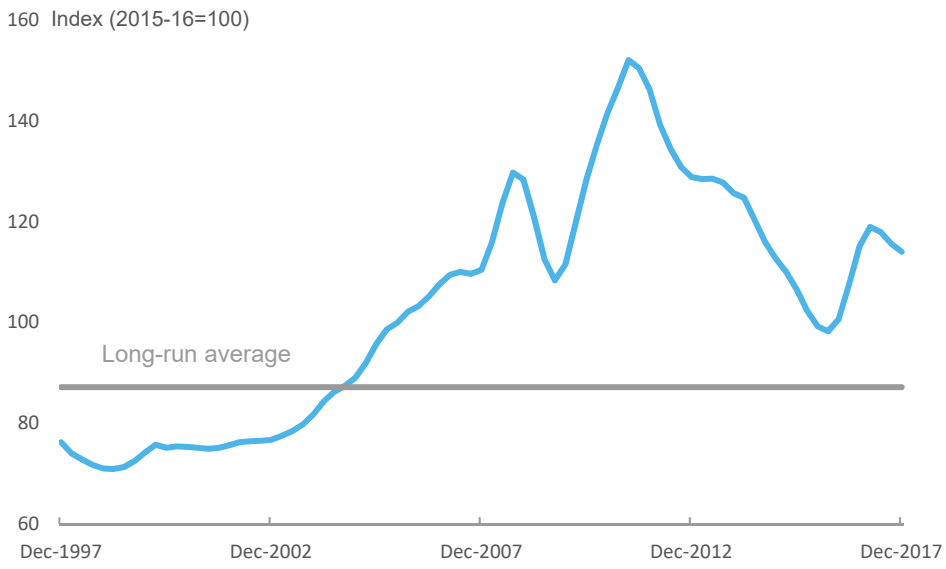
Even though this commodity price spike is below boom levels, the economic boost has been amplified by higher output levels off the back of massive investments in resource projects, combined with business initiatives to reduce their production costs.

**Figure 15: Contributions to average income growth: the terms of trade come to the rescue (again) but for how long?**




**Source: Business Council calculation using ABS cat. no. 5206.0**

### Figure 16: Have the terms of trade peaked (again)?




**Source: ABS cat. no. 5206.0**

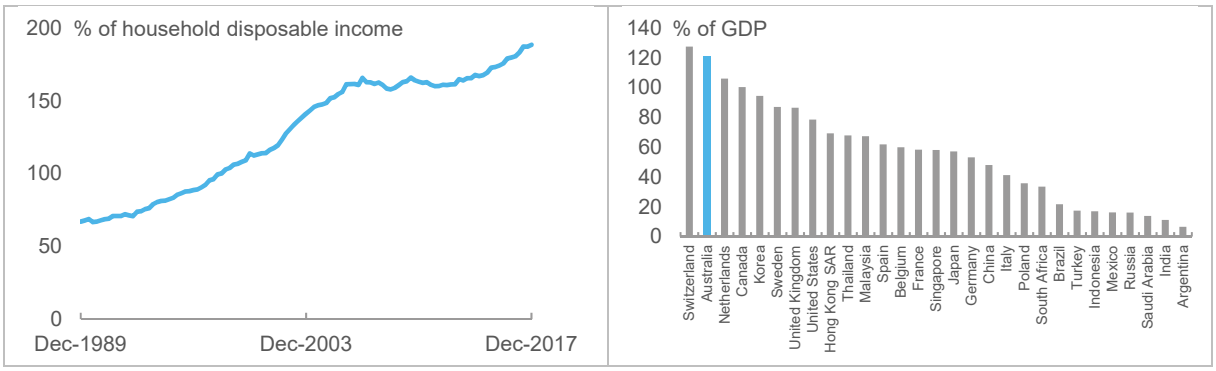
Higher commodity prices have boosted profitability of the resources sector in particular.

If businesses anticipate that more buoyant conditions will be sustained, improved profitability over 2017 will translate to increased activity with flow-on benefits to other industries, labour demand, and therefore wages and employment. But it is far from certain how long the resurgence in commodity prices will last.

So, while businesses on balance are reasonably optimistic that conditions are improving, global risks (such as the threat to world trade from a trade war), high production costs (including rapidly rising energy prices) and high domestic consumer indebtedness (Figure 17) are tempering their exuberance.

And many businesses are not only facing high costs but also flat prices (the latter possibly reflecting competitive pressures from new business models and changing preferences).

### Figure 17: Household debt has risen




**Source: RBA, e02; BIS Quarterly Review**

### Productivity growth continues to disappoint

The fact that economic recovery is not across the board is not unusual. Not all businesses or sectors can, will or indeed should do well in an economy all the time. The structure of an economy shifts continually: creative destruction, new technologies and ideas mean new firms drive out less efficient ones. Preferences and trade patterns shift. But these processes should boost productivity and per capita incomes over time and this is not evident in recent economic data.

Through the year to December 2017, labour productivity fell by 1.0%. For several years, labour productivity growth has been below the long-run average of 1.5% (see Figure 6). The latest estimates of multi-factor productivity growth — which essentially captures the gains from innovation in all its forms — continue to disappoint (see Figure 20).

Ironically, strong jobs growth over 2017 probably partly explains declining in labour productivity growth. Put simply, additional labour inputs are not yet translating to commensurate increases in output.

Modest labour productivity growth in turn helps explain the coexistence of strong employment growth and low wages growth. It suggests that increases in labour supply rather than labour demand are driving jobs growth, putting downward pressure on wages growth. The labour force increased by over 360,000 people over the year to March 2018.

While job creation is unambiguously a good thing, the point remains that until value added growth outstrips labour input growth, wage growth will continue to plod along.

Locking in the recent turnaround in profits and business investment and achieving stronger multi-factor productivity growth will be critical for rekindling enduring strong wages and per capita income growth along with growth in jobs.

### The link between productivity and real wages is not broken

Wages growth has been poor for several years, notwithstanding modest growth in labour productivity. This has led some commentators to claim that the link between wages and labour productivity is broken. Similar claims are being made about the US economy. They are incorrect. Reasons for slow wages growth differ in the two economies, but as Professor Larry Summers recently observed, increases in productivity continue to largely translate into increases in pay, all else equal.

One major explanation for slow wages growth in Australia is the large correction in the terms of trade from late 2011. During the terms of trade boom nominal wages grew at around 4.0% a year. Businesses benefiting from high export prices could afford this as higher prices outstripped wage rises, slowing ‘real’ producer wage growth. (Real producer wages are the wages businesses pay workers relative to the prices businesses are paid for their outputs.) In contrast, real consumer wages (the wages workers receive relative to what they pay for goods and services) grew rapidly, reflecting strong nominal wage growth and lower consumer prices driven by lower import prices.

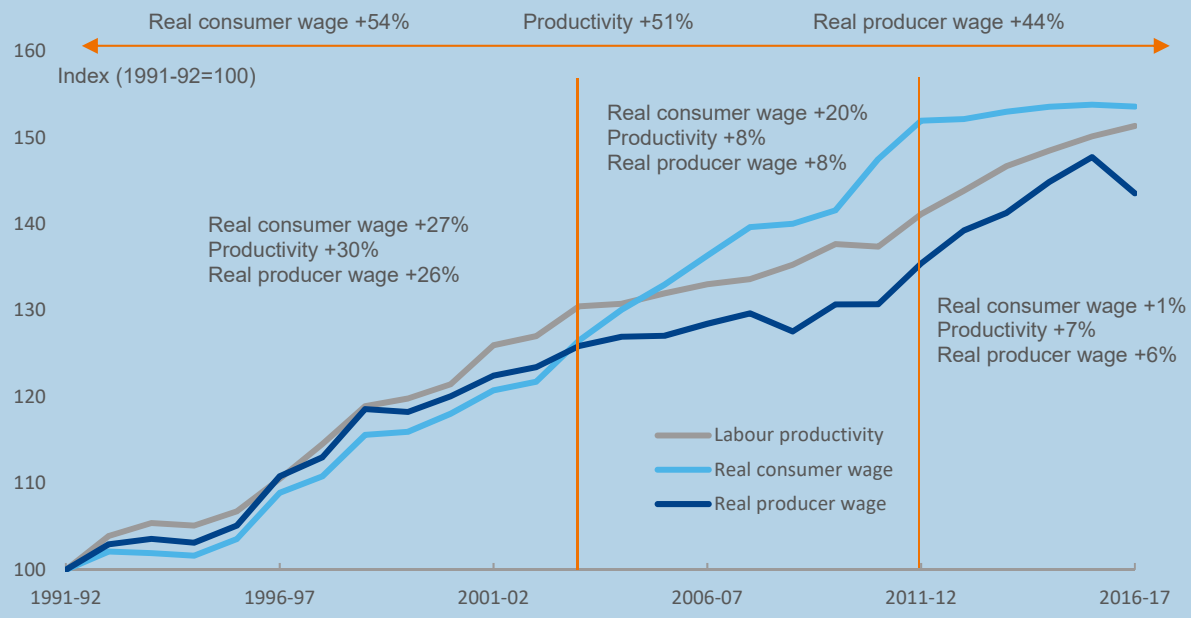
The abrupt drop in export prices left producers with uncompetitively high wages and unit costs. They faced a cost–price squeeze. As can be seen in Figure 18, the real producer

wage jumped significantly. In response, their demand for labour would have weakened significantly, resulting in slower wages and employment growth.

Both consumer and producer real wages have had to realign with productivity growth. Restoring the balance has taken some years, with slow labour productivity growth placing more of the adjustment burden on (slower) wages growth. But consumer real wages and producer real wages were converging to labour productivity growth, at least up until the more recent terms of trade spike which again reduced the real producer wage.

Arbitrarily increasing nominal wages would see wages and productivity growth driven further apart, magnifying and prolonging the adjustment process. On the other hand, increasing labour productivity growth would allow higher wages growth.

**Figure 18: Real wages are converging to labour productivity growth in the wake of declining terms of trade**




**Source: ABS cat. no. 5206.0**

Wages growth has also likely been affected by a recent sharp increase in labour supply, sectoral shifts in employment and possibly population ageing, which are affecting labour productivity. And although it has improved over 2017, business investment will need to continue to grow strongly to drive higher productivity.

US research suggests that the retirement of baby boomers accounts for as much as one-third of low wages growth in the US in recent years, as this large cohort of retirees earns higher wages on average than new job entrants, reflecting their work experience. Australia is going through a similar demographic transition with possibly similar wage effects.

# 5 THE RISK OF HEADING DOWN A DEAD END

People understandably are frustrated when they see their incomes stagnate or even decline, at the same time as prices for many essential services, such as energy and health care rise faster than the CPI. It is small wonder that cost of living pressures top community concerns.

This disenchantment is leading to political debate focusing increasingly on fairness and inequality. Both are critical issues warranting serious discussion across the community.

But, regrettably, the debate has become mired in slogans, misinformation and misunderstanding of the evidence.

This is driving knee-jerk political opposition to fiscal restraint, calls for higher taxes on businesses and high-income earners as well as significant minimum and across-the-board wage increases, based on the erroneous view that economic growth and budget discipline can only come at the expense of fairness.

The debate is also diverting attention from the need to better understand and address serious and complex community problems such as entrenched disadvantage. As the Productivity Commission found, getting a job is the main route out of disadvantage for most people.[3]

Reducing youth unemployment rates as high as 20% in many regional areas and pockets of major cities, should be prioritised over actions that have superficial appeal but which would only reduce employment opportunities for the least skilled. For example, substantial increases in the minimum wage would be a poorly targeted way of redistributing income and would only see the most disadvantaged job seekers miss out.

**Inequality has not worsened but entrenched disadvantage is concerning**

- Using the 'gold standard' measure of real (after tax and transfer) equivalised household income, income inequality as measured by the Gini coefficient does not appear to have worsened recently.
- Other measures cited as evidence of worsening inequality, such as the ratio of income in the highest income decile to the lowest decile, are less comprehensive.
- The labour share of income says little about the final distribution of income. It broadly reflects the aggregate production function and labour intensity of the economy. And as Treasury has pointed out, Australia's labour share of income has been relatively stable within a band of 52–56% in recent years.
- The profit share has increased over time, but this mirrors a halving in the share of mixed income to around 10%, reflecting a trend to incorporation of smaller, particularly farm, businesses during the 1970s and 1980s.
- Lifetime incomes and income mobility are important considerations in income equality, which 'snapshot' inequality measures such as the Gini coefficient miss.
- For example, all else given, an ageing population will tend to worsen measured income inequality as older people generally earn less (and run down savings). Likewise, having more young people studying for longer could also affect inequality measures. Neither is necessarily of policy concern, provided older people have

[3] Productivity Commission, *Deep and Persistent Disadvantage in Australia*, 2013.

adequate savings and students receive an income payoff from additional study over their working lives.

- On the other hand, if households are entrenched in the lowest income groups for generation after generation, this is of great concern. The causes are complex and multi-dimensional — disadvantage is not just about low income. But employment is the way out of disadvantage for most people.

Source: Australian Treasury *Analysis of Wages Growth*, 2017.

### Redistribution without growth is ultimately a negative-sum game

It goes without saying that we all want a fair, cohesive and inclusive society.

It also goes without saying that redistribution of income is an essential part of a fair and compassionate society that cares for people who are incapable of supporting themselves.

But by definition, redistribution means someone gains while someone else loses.

Arguing about how the pie is divided up does not offer an enduring solution to the low-income-growth predicament which is creating community anxiety in the first place.

Below par economic growth will diminish economic opportunities and ultimately fuel social discontent instead of delivering the fairer, inclusive outcomes sought. This is a downward spiral we must escape from.

Likewise, opposing fiscal discipline for the professed aim of promoting a fairer society might earn instant twitter-spheric approbation but demonstrates scant regard for the unavoidable harmful consequences for Australians' living standards.

The government and the Parliament have an overriding obligation to give the community the best value for the $410 billion in federal taxes it currently pays. This is unarguable. Not to strive to do so means needlessly depressing living standards.

Tax increases chasing ever higher spending, or the unsustainable build-up of debt, will ultimately impair the capacity to deliver better outcomes for the community at large and the most vulnerable in particular.

High taxes inevitably discourage private investment, innovation, risk-taking and entrepreneurship and individual effort, the core ingredients of economic growth. For example, Treasury has estimated that if bracket creep were relied on to fund higher spending, GDP would fall by around 0.35% over the long term, or around $6 billion in today's dollars.

Spending and redistribution that do not account for this growth impact ultimately cannibalise their funding source and limit people's opportunities and choices about their work and lives.

### A strong economy is the bedrock of a prosperous and fair society

Promoting fairness requires much more than redistribution.

Fairness is as much, if not more, about providing opportunities for all individuals to get ahead and supporting and rewarding personal effort. It is about delivering better outcomes across generations and people's entire lifetimes.

A strong economy is integral to achieving this. Economic growth measures the increase in value of what we produce as a nation from all the resources — our people, our capital, land and natural resources — we have at hand.

Generating more value translates to higher incomes, more jobs and greater purchasing power. Across-the-board income growth and the extensive income redistribution mechanisms that support the less well-off in Australia have only been made possible by strong economic growth over many decades.

This isn't to imply that economic prosperity is everything. There's much more to life than money and material things. Most of us would place our family and friends a long way ahead of material possessions.

But we also want our family and friends to have enriched lives — to have an education that allows them to achieve their potential, to have fulfilling and rewarding jobs and careers, to own their own homes, to have access to world-class health care, to be financially secure.

A strong economy is the bedrock of a resilient, vibrant, compassionate and liveable community.

# 6 THE GROWTH CHALLENGE

Australia has enjoyed decades of economic growth that have delivered higher living standards across the board. Recent slower income growth notwithstanding, real income per person has doubled over the past 40 years.

But success arguably has had a downside. Continued growth and rising living standards are being taken for granted.

### Forgetting what drives growth carries grave risk

Securing high living standards, individual economic opportunity and the compassionate society we all want requires an understanding of the fundamental drivers of economic prosperity.

Aside from occasional, lucky increases in the price of our exports (which we cannot control), real income per person can only be increased by producing more valued output per person.

This means getting more value from what we produce using our 'endowments' — our people, capital and natural resources.

This may seem to be stating the blindingly obvious. At one level, it is just arithmetic. But it is worth restating because there simply is no other way to increase real per capita income. It is not ideology — there simply is no other way.

Producing more valued output per person requires increasing and improving our human and physical capital, and innovating to produce existing goods and services more efficiently or to develop better ones. It is also about allowing our resources to be allocated where they can create the most value.

There is no magic source of perpetual higher income growth. It doesn't come from wishful thinking, stunts, or a government spending program or tax. It doesn't come from one new technology. It requires an ongoing, unrelenting process of improvement.

**Stunts will not drive sustainable higher household incomes**

Opposition to spending growth restraint in part reflects concerns about the impact on households of several years of subdued wages growth. These concerns are understandable. But in seeking remedies, forgetting or wilfully ignoring what drives real wages and income growth and improvements in living standards carries grave risk.

Businesses pay their workers more when the marginal value of what workers produce increases. The marginal value of output is the product of how much an extra unit of labour produces times the price of that output.

Output prices are determined in markets and are largely outside the control of individual producers. (Of course, businesses can try to increase their prices, but in competitive markets they will lose sales and profits.)

This means that real wages over the long term are determined by the productivity of labour — how much a unit of labour produces. Terms of trade (price) shifts can drive labour productivity and wages apart for a time — as occurred during the terms of trade boom over the 2000s — but not forever.

Importantly, slow wages growth experienced over the past several years does not mean that the link between wages growth and labour productivity has been severed. In fact, slow wages growth to a significant degree is reflecting the realignment of wages and productivity growth in the wake of the large terms of trade decline in 2011.

Those calling for businesses just to increase wages arbitrarily are selling the community snake oil. Increasing nominal wages without regard to productivity would ultimately do nothing for workers' real wages because it would increase producer costs (and consumer prices) and reduce the demand for labour.

In short, wage increases out of line with labour productivity growth cannot be sustained — they trigger market responses and adjustments including offsetting the nominal wage increase through some combination of higher prices, lower wage growth over time and lower employment.

**Productivity growth will continue to be the key**

Productivity estimates should be viewed with care and over longer time periods to avoid noise from cyclical effects and measurement issues. Nor is labour productivity growth everything: other drivers of income growth include increased labour utilisation and improvements in the terms of trade.

But terms of trade increases — that is, an increase in the prices of our exports relative to the prices of what we import — are outside our control and cannot be relied on.

And there are natural limits to increasing labour utilisation. Labour utilisation has made a relatively small contribution to income growth in the past (about 10% over 40 years). In future, with an ageing population, the policy challenge will be to slow the inevitable decline in aggregate workforce participation by encouraging people to enter and remain in employment.

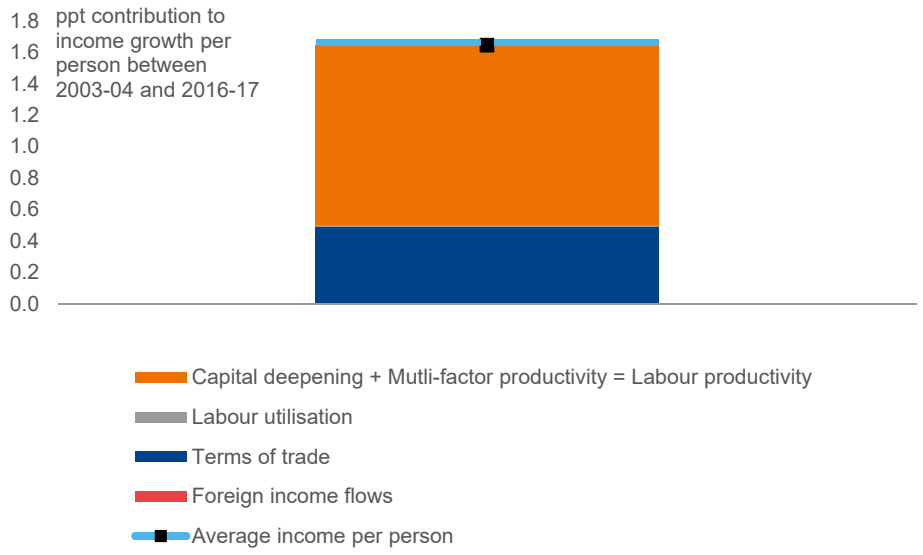
The drag effect of an ageing population on participation is well underway. Projected immigration growth will offset this to some degree but cannot do so indefinitely, as migrants also age. Moreover, continued immigration at current rates is already accounted for in economic and budget projections. Nonetheless, a decline in migration, or a reduction in the skilled component of the migration program, would weaken this positive participation effect.

For these reasons, over the long term, labour productivity has been by far the single most important driver of Australia's economic growth, accounting for around 80% of the improvement in average income growth over the last 40 years. Without terms of trade effects, it would be around 90%. Capital deepening rather than multi-factor productivity (MFP) has been the biggest source of labour productivity growth (Figure 20).

Going forward, labour productivity — from both investment and MFP — will need to become a greater driver of income growth, as the positive influence of the terms of trade boom on our incomes is reversed and the population ages.

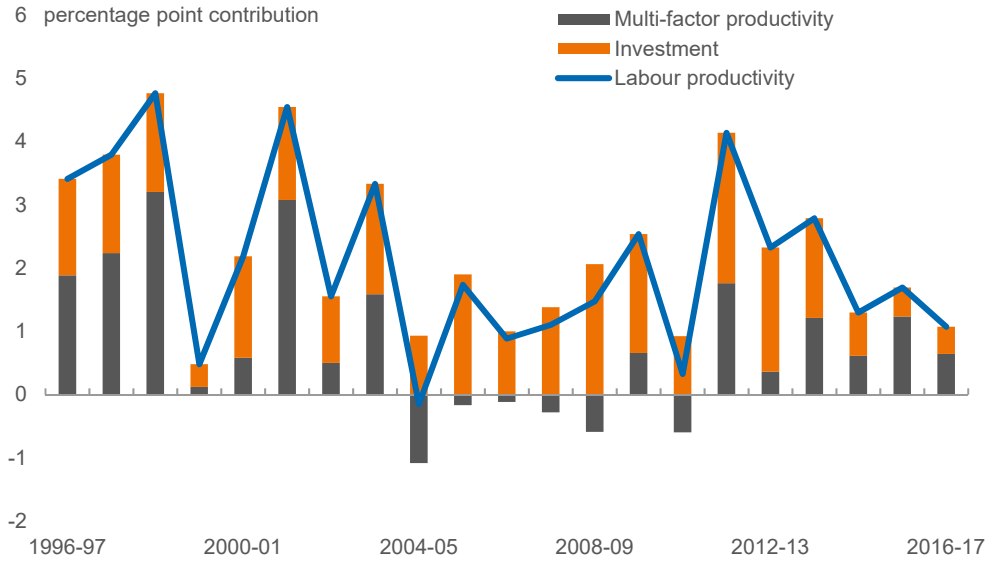
- Treasury's confronting arithmetic shows that for real gross national income growth per person to return to its long-run average of 2% per year, annual labour productivity growth will need to increase to around 2.5%.
- Achieving this would be unprecedented in modern history, higher than the 'golden decade' of productivity growth in the 1990s when it averaged around 2.2%. This is Australia's growth challenge.

## Figure 19: Increased output per worker (labour productivity) has been by far the main driver of growth in average income (2003-04 to 2016-17)




**Source: Business Council calculation using ABS, 5206.0**

## Figure 20: Over time, business investment has been the main driver of labour productivity




**Source: Business Council calculation using ABS, 5260.0.55.002**

# 7 CREATING THE SETTINGS FOR GROWTH

### Growth is about people making decisions to do things better

Individual businesses and the people in them ultimately drive productivity growth. They are where decisions are made about what goods and services to produce, what technologies to use, what to invest in, how many and who to employ, and how to deploy them.

To be successful, businesses must produce what people want to buy — including consumers in export markets — at prices they are willing to pay. Competing with other businesses for customers means that any business must continually invest in capital and their employees and innovate to produce better goods and services at competitive prices.

It is this process of continual improvement driven by businesses new and old, small and large, vying for customers, that ultimately drives economic growth, creating better paying jobs for their workers and delivering benefits to consumers.

New technologies obviously play a crucial role in the growth process, but they are the means, not the underlying drivers. Technology and knowledge are often freely available around the globe, yet many countries remain impoverished. There are more fundamental pre-conditions at play.

### Government policy settings can either help or hinder growth

Policy settings are critical for providing an environment that either fosters or hinders growth. While businesses are where wealth is created, governments profoundly shape the environment in which businesses operate.

Governments set the rules and incentive framework, they invest in public and social infrastructure, they redistribute income and directly provide a range of public services.

- A crucial role for government is to ensure that the 'rules of the game' — that is, the architecture of institutions, laws and policies including taxes and regulations — promote the right incentives and price signals for individuals and firms to make efficient production, consumption and investment decisions. Promoting a competitive market environment is fundamental for innovation and growth.

- Reducing impediments to the efficient allocation of resources (such as distorting taxes and subsidies, regulations and prohibitions and barriers to trade and investment) can be an important source of income gain. Most of the economic reforms in the 1980s and 1990s removed such price distortions, with the gains captured in productivity growth. But many impediments to flexible, efficient resource allocation remain (or have been introduced since) and their removal or reduction would likewise enhance productivity and income growth.

- Enterprises must also have the flexibility to adapt in the face of opportunities and challenges. Regulations need to strike the right balance between providing legitimate safeguards and enabling enterprises to be agile, efficient, innovative and willing to take risks.

- To take advantage of new opportunities and implement innovative technology or systems, employees and employers also need to have the capabilities to make

changes. Governments help build capabilities for enterprises and entrepreneurship through investing in public infrastructure and human capital and skills.

- Governments also play a direct role in productivity growth through how efficiently and innovatively they deliver public services. Going forward, service delivery in health and education will become increasingly important for productivity growth as these sectors expand as a share of the economy.

**Productivity improvements come in many ways from businesses of all types and sizes**

Innovative enterprises are not a discrete sector of the economy. 'Old' industries can be as innovative as new ones. Many of Australia's resources companies, for example, operate at the global technology frontier because they set that frontier.

Nor is innovation just about 'high-tech' inventions. At the end of the day, inventions and new technologies have to be adopted and applied in the production of outputs that consumers value for them to enhance productivity economic growth.

**Productivity growth is not about making people work harder or paying them less**

- It is the precise opposite. It is about businesses, and governments, investing and working smarter to create greater value using the same amount of, or fewer, inputs.
- Ultimately this is the only way to create an income 'dividend'. A dividend that is shared by all Australians through higher wages, better quality goods and services at lower prices and by giving governments greater capacity to provide essential services.

Productivity growth comes from the application of new technologies, from knowledge transfer and learning by doing, and from reorganising processes and people within enterprises.

So policies that favour one form or source of innovation over others are likely to overlook or even discourage important sources of productivity growth.

Equally, policies must not create an artificial divide between small and big businesses. Penalising commercial success and efficient scale unambiguously impedes productivity growth.

**Start-ups do not have a monopoly on productivity-enhancing innovation**

There is a perception that productivity growth only comes from start-ups. Innovation and market entry by small firms are clearly important with the 'creative destruction' driven by new entrants a significant driver of productivity growth. But they are not the only source.

- ABS data show that larger Australian businesses are more likely to innovate than smaller ones. More than three-quarters of Australia's largest employers are actively innovating compared with fewer than half of small businesses.
- Recent OECD research finds that the firms pushing the global technology frontier are large, relatively young and multinational businesses.
- The Productivity Commission estimated that 1% of small businesses introduced an innovative product or service that was 'new to Australia' in 2012-13, compared with 14% of large businesses.
- There is also consistent international evidence that larger manufacturing enterprises generally have significantly higher productivity levels than smaller ones.

So policies should not undermine larger businesses and discourage the growth of younger firms from achieving efficient scale. Policies that penalise large firms and discourage small firms from growing to achieve efficient scale can impose large costs on an economy.

- Recent research by Garicano et al. finds a remarkably large economic cost (more than 3% of GDP) resulting from French labour laws which, by exempting smaller firms, effectively tax successful large and more efficient firms.

Sources: Business Council calculation using ABS cat. no. 8166.0; Andrews et al., *Frontier firms, technology diffusion and public policy: Micro evidence from OECD countries*, 2015; Productivity Commission, *Business Set-up, Transfer and Closure*, 2015; Garicano, L., C. Lelarge, and J. Van Reenen. "Firm Size Distortions and the Productivity Distribution: Evidence from France", *American Economic Review* Vol. 106, No. 11 (2016): 3439-3479.

## An agenda for stronger growth

The Business Council acknowledges government policies in energy, trade and company tax. But more needs to be done to create a policy environment that supports and liberates businesses of all sizes to take risks, invest and innovate in any way they can.

The Business Council's growth agenda focuses on six priority areas for creating globally competitive businesses that will, in turn, create more high-paying and rewarding jobs.

We have outlined priorities for implementation immediately and over the medium term. They will require action by all levels of government, in many cases working together through a reinvigorated COAG process.

Importantly, while some measures such as a more internationally competitive company tax rate will require some upfront investment to achieve large pay-offs, many would involve little or no additional fiscal cost.

Expediting them would underpin the income and revenue growth needed to create fiscal capacity for more ambitious broad-based reform of Australia's tax system which, in turn, is becoming increasingly urgent for shoring up the revenue base in the face of erosion by global forces. This would also underpin reform of the federation, which will be essential for better delivery of community services.

# 8 A FAIR TAX SYSTEM THAT BETTER REWARDS EFFORT AND ENTERPRISE

- Taxes penalise the activities they tax. Of course, taxes are necessary for raising revenues. But Australia's tax system excessively penalises highly productive activities and harms growth unnecessarily.
- This is because the current tax system relies too heavily on personal and business income taxes set at high rates that discourage people from taking risks, investing, innovating and working.
- It relies too heavily on taxes that are volatile, have narrow bases or rely on a small number of taxpayers, and overly complex taxes that impose unduly high compliance costs.

The Australian tax system urgently needs renovation, moving to a mix of taxes that does not overly discourage people from participating in the workforce and being entrepreneurial, and does not unnecessarily penalise businesses from investing, innovating and creating well-paid jobs in Australia.

That urgency is intensifying in the face of increasing international mobility of capital and people and the structural erosion of other tax bases.

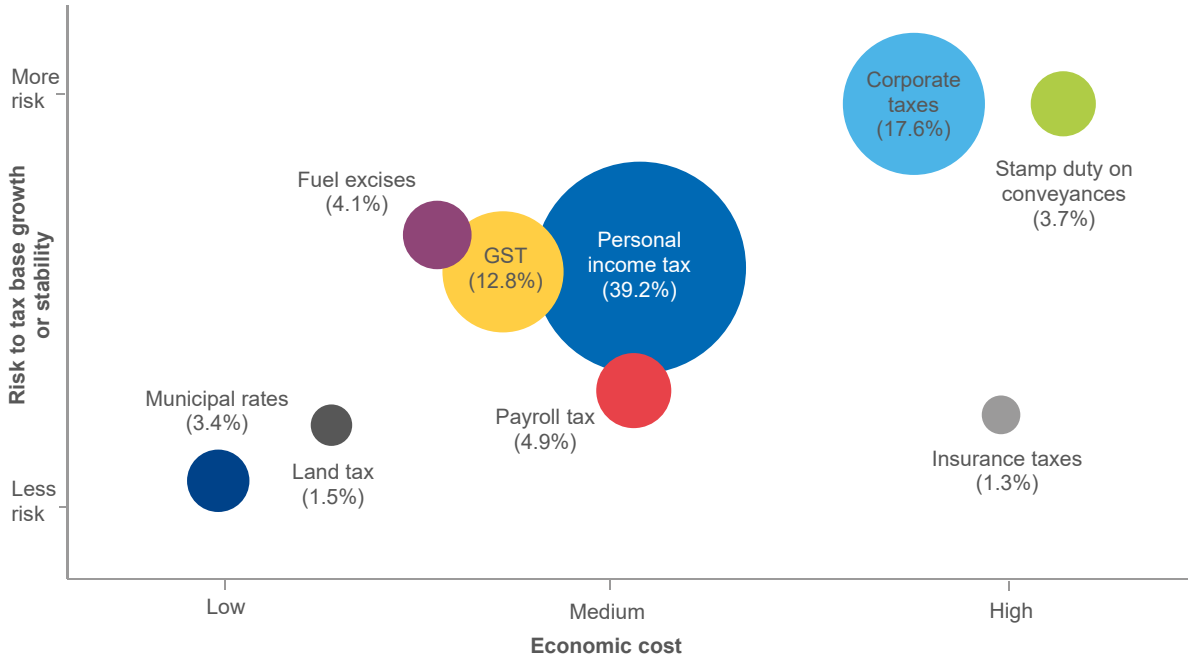
It is vital that broad taxation reform is not shunted from the policy agenda because it is deemed politically difficult.

### The need for tax reform has not abated

In March 2016, the Business Council laid out a comprehensive three-stage plan to achieve growth-enhancing tax reform by 2025. While some changes have been made since, including changes to superannuation taxation and tougher business integrity measures, the plan remains relevant and, if anything, has become more pressing. It called for:

- lower personal income taxes (especially around the tax/transfer interface) and addressing bracket creep to improve work incentives
- progressive lowering of the company tax rate to make businesses more competitive in the global contest for investment
- a rebalancing from narrow and volatile tax bases to broader les mobile tax bases, including in state jurisdictions, to shore up the future revenue base
- more neutral tax treatment of savings income
- improved tax integrity and simpler taxes.

**Figure 21: Australia relies too much on taxes that harm growth and risk revenue**




**Note: Percentage and size of circle shows share of tax revenue in 2013-14.**
**Source: Roger Brake, *An inside perspective on the Tax White Paper*, 2015**

Since then, the Government's Enterprise Tax Plan has eased some pressure on bracket creep and is progressively reducing the company tax rate for businesses with turnover up to $50 million. A number of business tax integrity measures have been introduced.

**Business tax integrity measures have been strengthened**

Many of Australia's integrity measures have been comprehensively amended over the past few years, with recent changes to the transfer pricing and thin capitalisation laws making these regimes arguably the most robust in the world.

Australia's laws have also been recently tightened, or changes have been announced, to better align with OECD Base Erosion and Profit Shifting (BEPS) Project recommendations. Australia is already either compliant or acting on the OECD's BEPS recommendations. Changes announced/enacted over recent years include the Multinational Anti-Avoidance Law; Diverted Profits Tax, country-by-country reporting, a doubling of penalties that apply to large companies who engage in tax avoidance, changes to transfer pricing laws and public disclosure of the tax information of large companies. Changes to hybrid rules are currently out for consultation.

The ATO performs detailed one-on-one reviews of the largest 100 companies, who pay about 40% of all company tax. Extra government funding is enabling the ATO, under the Tax Avoidance Taskforce, to extend these reviews to over 1,000 companies.

### Average personal tax rates continue to increase

Doing nothing to improve the tax system does not mean nothing will happen. The past decade has been a demonstration of this as the existing fissures in the tax system have widened. For example, the PBO has estimated the average tax rate faced by almost all taxpayers, except the bottom quintile, have increased over this period.

Although the government moderated the immediate effect of bracket creep for middle-income earners in its Enterprise Tax Plan, the PBO still expects taxpayers in the middle quintile to face the largest increase in average tax rates.

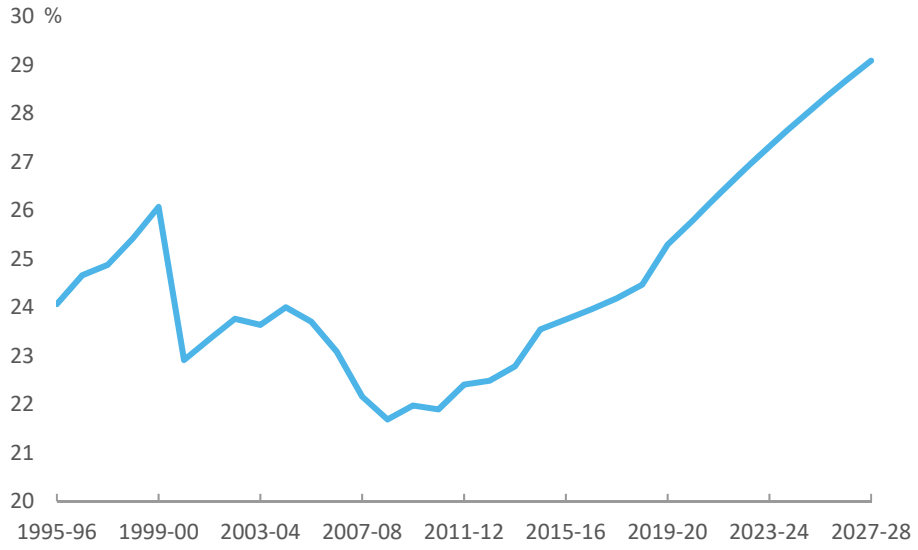
Treasury estimates that if bracket creep funded additional spending, GDP would fall by around 0.35% over the long term, or around $6 billion in today's dollars.

The Business Council estimates that without personal tax relief the average tax rate on full-time average weekly ordinary time earnings will soar from around 24% today to around 29% a decade from now. In today's terms, this represent a $4,000 increase in tax paid per person.

The improved budget outlook over the forward estimates provides some capacity for limited tax cuts, particularly as tax collections are fast approaching the 23.9% of GDP tax cap. But deep personal income tax cuts, particularly at lower income levels, will not be possible without stronger growth and fiscal discipline.

To illustrate, increasing the second tax threshold from $37,000 to $40,000 would cost the budget around $3.5 billion a year. This represents a $405 tax cut for individuals earning $40,000 and above. If the second tax threshold was increased to $44,000, this would cost the budget around $8 billion a year and be a $945 tax cut for individuals earning $44,000 and above.

**Figure 22: Average personal income tax rates will soar without bracket creep relief**




**Source: ABS cat. no. 6302.0 and Business Council calculations. Average tax rates are calculated using full-time adult average weekly ordinary time earnings.**

**Australia's company tax rate is becoming less and less competitive by the day**

The Enterprise Tax Plan proposes to reduce the company tax rate to 25% over 10 years.

The failure of the Parliament to pass the full company tax cuts means that Australia's biggest companies that do the lion's share of investing in the economy and pay the lion's share of company tax will continue to pay one of the highest company tax rates in the industrialised world.

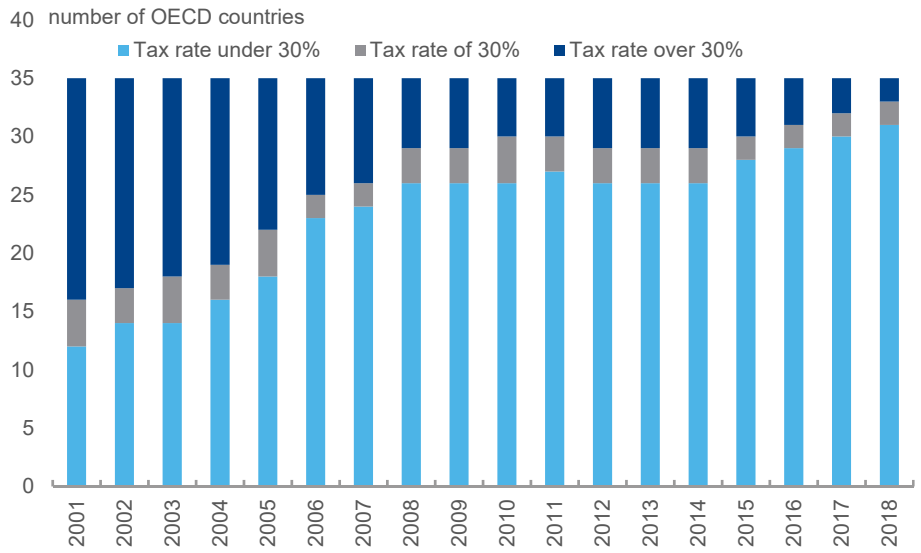
Reducing the company tax rate for larger businesses is becoming more urgent by the day. Since 2008, almost two in every three industrialised nations have reduced or are planning to reduce their rates.

**Reducing punitive personal and company income tax rates will lift growth**

- Higher marginal effective company tax rates are associated with lower rates of economic growth and therefore a smaller economy in the long term.
- The OECD analysis finds that this negative relationship is "strongly significant [and] statistically stable". The presence of dividend imputation offsets this effect to some extent but does not negate it (particularly for a net capital importing country like Australia). The analysis also finds that a revenue-neutral company tax cut does not increase inequality.
- Reducing the tax wedge (the combined impact of taxes and withdrawal of benefits) on incomes below and above the median both increase economic growth. The former will reduce inequality while the later will (if done in isolation) increase inequality.
- If bracket creep is not addressed, the average personal income tax rate paid by Australian workers will rise. Treasury modelling estimates that if rising average tax rates are used for budget repair rather than reducing spending growth, GDP would be 0.35% lower every year over the long term.
- The OECD estimates that shifting 1% of tax revenue from income taxes to consumption and property taxes would increase GDP per person by around 0.25–1.0 percentage points over the long term. The growth effect will be on the stronger side if company tax is reduced rather than personal income tax.

Sources: OECD, *The effects of the tax mix on inequality and growth*, 2017; Treasury, *Economic and fiscal effects of rising average tax rates*, 2016; OECD, *Tax Policy Reform and Economic Growth*, 2010.

**Figure 23: More than 30 of 35 OECD countries have a lower company tax rate**




**Note: Historical data based on current OECD membership**
**Source: OECD, Tax database, combined statutory tax rates**

In this rapidly changing global environment, the government's 10-year plan will barely keep Australia in the game. A company tax rate of 25% in 2026-27 is still above the current OECD average of 24% and Asian average of 21%.

As the rest of the world moves, not changing our rate is akin to increasing it. This increases the marginal burden of the tax: that is, the harmful impact on investment and growth increases. Yet the Parliament continues to oppose even this modest reduction for a mishmash of ill-informed reasons.

A company tax cut will promote productivity growth and real incomes in two main ways:

- Through encouraging additional investment. Modelling estimates that this channel will permanently increase annual GDP by 1% ($18 billion in today's terms). Real wages are also 1.2% higher — that is, about $750 per year an average wage earner.
- Through promoting multi-factor productivity growth through the technology and knowledge spillovers that accompany new investments. The magnitude of this effect has not been modelled but could exceed the direct investment effect.
  - The OECD has found that lower corporate tax rates promote total factor productivity growth of the most dynamic and innovative enterprises.

In short, not passing the company tax cuts for larger businesses is anti-growth. Failure to pass the full Enterprise Tax Plan will also lock in a two-tier system that discourages successful businesses from expanding.

While the Business Council would prefer to be having a discussion about broader tax reform, the absence of a broad tax reform agenda should not be a reason to delay any tax reform. The Enterprise Tax Plan represents the only growth-enhancing plan currently on the table.

Importantly, reducing the corporate tax rate would also be the first step in any good, comprehensive tax reform package because it is the most damaging federal tax. Treasury

analysis shows that the 30 percent company tax rate is the most harmful federal tax in terms of its impact on economic growth.

### Stable R&D tax incentives are needed to support investment in innovation

It is widely accepted that investment in R&D is likely to be underprovided by the market because of investors do not take into account the additional gains that spill over from their investments to the community. Hence, public support is required to encourage socially optimal levels of R&D.

Australia's competitors have both lower statutory corporate tax rates and broader business tax measures in areas such as interest deductibility, accelerated depreciation and R&D tax incentives that are at least equivalent to, if not more favourable than, Australia. For example, New Zealand recently announced it will introduce an R&D tax incentive from 1 April 2019. The proposal currently out for consultation offers a more competitive set of arrangements than Australia's R&D Tax Incentive.

The R&D Tax Incentive recognises that the marginal benefits of much R&D activity cannot be adequately recouped by those bearing the costs.

The Business Council appreciates that the government is concerned about the growing cost and focus of the scheme, particularly the cost of the refundable element of the scheme (which does not apply to larger firms). In this regard, there is some scope for simplifying and reducing the $437 million of compliance costs borne by business and government.

Ad hoc changes to the scheme will increase policy uncertainty and risk undermining the research and development it intends to support. If changes are pursued, they should allow for appropriate transitions for all companies to avoid the risk of incremental R&D expenditure being shifted overseas.

### Broader tax reform is still required across the federation

The overarching objective of tax reform over the medium term must be to redesign and improve the tax system by shifting from less efficient taxes to more efficient ones, so that the average economic burden of raising each dollar of revenue falls.

#### A more neutral and fairer treatment of savings income

Currently, capital income from different forms of investment in Australia is taxed very differently, leading to inefficient investment allocation and perceived unfairness.

Ideally, income from savings should be taxed at a lower rate than current income to counteract the compounding effects of taxation, while tax policy should not unduly distort investment decisions. A more neutral and fairer treatment of all savings such as capital gains, rental income and interest on savings deposits is needed.

#### Examine the retirement income system as a whole

As much as possible, the tax treatment of superannuation and other savings income should be consistent, while acknowledging that superannuation is a much less flexible form of saving.

There is a strong case for concessional tax treatment of superannuation because savings are compulsory for employees and locked in for very long periods. However, the tax system should facilitate superannuation balances large enough to provide for comfortable living standards during retirement and reduced reliance on the age pension, not large-scale wealth accumulation.

Any reforms must be undertaken with a clear sense of how the changes will achieve these policy goals, and a careful and holistic analysis of the retirement income system. Appropriate transitional arrangements that account for the long-term horizons over which retirement decisions are made will be necessary.

### Harmonising payroll tax rules

Payroll tax rules and exemptions should be aligned across states. The current exemptions and differences between states mean a more complex system and businesses potentially have to deal with eight different regimes if they operate nationwide.

Payroll tax exemptions for small businesses can also deter them from growing into larger businesses. Ideally the number of exemptions would be reduced to broaden the base.

### Reduce reliance on distorting stamp duties

Stamp duties are highly inefficient and volatile, making them harmful to economic growth and budget stability. Treasury estimates that each dollar of revenue raised through stamp duties on property costs the economy around 72 cents.

Stamp duties increase the cost of buying a house and discourage people and businesses from moving. This causes an inefficient use of the building stock. Stamp duties can discourage new housing development as the tax is paid twice: once by the developer when the land is acquired and again when the final owner buys the new house.

State government reliance on stamp duties could be reduced by using the land tax base better. A broadly applied, well-designed land tax would be efficient as it has little impact on incentives to invest, work and save. But such reform is difficult and transitional arrangements would need to be carefully designed to manage the switch from taxing property and insurance purchasers to all owners of property.

**Consumers would benefit if stamp duty was replaced by more efficient taxes**

It is estimated that replacing property stamp duties with more efficient taxes could increase real consumption by around $6.5 billion to $11 billion per year and increase GDP by around $3.5 billion.

Business Council calculations using Deloitte Access Economics, *The economic impact of stamp duty: Three reform options*, 2015.

### Deeper restructuring is likely to be required

Greater mobility of production, capital, high-skilled workers and digitisation will increasingly compromise Australia's company and personal income tax bases. The rapid growth in relatively mobile, intangible production inputs such as intellectual property poses particular challenges for traditional 'territorial' company taxes. Over time, these forces will compel

greater reliance on less mobile and more geographically defined bases such as land and consumption.

**Recommendation 1**

- The Enterprise Tax Plan Bill should be passed in full to ensure that Australia is not left stranded in the global contest for investment and that a distortionary two-tier system does not become entrenched.
- Personal income tax cuts are needed to protect lower to middle-income households from the imminent impacts of bracket creep.
- R&D tax incentives should not be reduced arbitrarily. Measures to reduce the compliance burden would free up funds.
- Continue to ensure and build trust in the integrity of the tax system.
- Broader tax reform to reduce the overall burden of the tax system on individual and business enterprise, reduce distortions and complexity, and to shore up the revenue base must be put back on the policy agenda, including:
  - restructuring of personal income tax rates to relieve work disincentives posed by high effective tax rates
  - more neutral and fairer treatment of savings income
  - holistically examining the retirement income system
  - reducing reliance on stamp duties and shifting gradually to broader based land taxes
  - harmonising payroll tax rules across the states and territories
  - less complex taxes and improve integrity and voluntary compliance
  - exploring options for deeper structural reform to shore up the revenue base against erosion in a highly mobile, information/digital age.

# 9 REDUCING THE DEAD HAND OF EXCESSIVE REGULATION

- Regulations, like taxes, are needed to deliver social goals. But regulations, like taxes, also impose costs. Reducing the costs without reducing benefits is unambiguously good for the economy.
- The cumulative burden of regulation on business continue to grow apace. The burden directly adds to production costs and deters innovation and entrepreneurship, discouraging business growth and investment, chilling economic dynamism, innovation and discouraging start-ups.
- Deloitte conservatively estimates that businesses spend $94 billion annually to administer and comply with federal and state government regulations.

Source: Deloitte, *Get out of your own way: Unleashing productivity*, 2014

Unnecessary regulation directly adds to production costs and delays much needed investment. To encourage private investment and drive productivity increases, the Business Council strongly supports measures to improve the efficiency of business regulation through:

- a reinvigorated program of regulation reform across all jurisdictions
- strengthening best practice regulation processes
- improving regulator performance.

The Australian Government has made progress in each of these areas, for example by reducing the cost of compliance on Australian business by more than $5 billion since 2013 and establishing a Regulator Performance Framework. But more needs to be done.

**It's becoming harder not easier to do business in Australia**

Australia's competitiveness rankings are in decline:

- In 2017 Australia ranked 15th on the World Bank's Ease of Doing Business index, down two places from 2016. Australia's best ranking was 6th in 2006.
- Australia is now ranked 21st by the World Economic Forum (WEF) Global Competitiveness Index Report, gradually slipping from a ranking of 15th in 2009.
- The WEF survey of Australian business executives asked the respondents how burdensome is it for companies to comply with public administration's requirements. This includes permits, regulations and regulatory reporting obligations. In this category, Australia was ranked 80th out of 137 countries.

**Reducing the burden of regulation would increase productivity growth**

Removing burdensome regulation is likely to increase productivity growth. The OECD has found that "regulations hurt in particular those firms that have the potential to excel in domestic and international markets".

Increasing just one aspect of business regulation — the ease of starting a business — has a negative effect of productivity growth. Poschke finds that if entry costs for businesses are increased to 10% of GDP per capita (for Australia this is around $7,000), total factor productivity is reduced by 0.8%.

Regulation not only has a direct impact on the industry involved, but the effect reverberates through the economy. Higher levels of regulation on businesses that supply intermediate inputs in the supply chain (for example business services), will decrease the productivity of businesses that use these inputs.

Bourles et al. estimate that if Australia had adopted the lightest practice regulation of non-manufacturing upstream industries (providers of intermediate inputs) seen in the US in 2000, Australia MFP would be 5.6 percentage points higher in 2007 than otherwise. The research finds that the negative impact of upstream regulation on downstream productivity is larger for countries closer to the technological frontier. The negative impact of regulation in upstream industries on downstream productivity has also increased over time as the world has become more connected and the use of information and communications technologies more widespread.

Sources: Arnold et al., *Regulation, allocative efficiency and productivity in OECD countries: industry and firm-level evidence*, 2008; Poschke, *The regulation of entry and aggregate productivity*, 2009; Bourles et al., *Do product market regulations in upstream sectors curb productivity growth? Panel data evidence for OECD countries*, 2013.

## A pipeline of reform priorities

The Business Council has identified a number of specific regulatory reform priorities that will provide significant economic benefits. Many will require the cooperation of the states:

- **Major project approval reform**: All states should adopt the Business Council's best practice model for major project approval (*Competitive Project Approvals, 2016*) to speed up approvals and provide greater certainty for investors and the community. The model supports decision making within 12 months under a single application, single assessment and single approval approach.

  These reforms can help to bring forward Australia's pipeline of almost of almost $400 billion in prospective major public and private investments.[4] Approval delays and uncertainty are extremely costly — the net economic cost of a one-year delay in approving a major project of average size (capex ~$500m) is $26 million to $59 million, and for a larger project like an offshore liquefied natural gas project, the cost can be between $0.5 and $2 billion.[5]

- **Simplify zoning restrictions**. Zoning regulations prevent housing supply from keeping pace with demand, especially within our major capital cities, and contribute to high house prices. To address housing affordability pressures that are also having wider economic impacts, all governments should reform zoning regulations to allow greater density in key residential and transport corridors, implement faster land release for new housing and

[4] Deloitte Access Economics Investment Monitor, December 2017, p. 9

[5] Productivity Commission, *Major Project Development Assessment Processes*, 2013.

increase the use of complying developments to speed up approvals. The RBA estimates that zoning restrictions increase the average house price by $489,000 in Sydney and $324,000 in Melbourne.[6]

- **Retailing restrictions should be removed:** States such as Western Australia, South Australia and Queensland impose archaic restrictions on retail trading hours that are harmful to consumers. Such restrictions have no place in the modern, digital economy and should be removed. The Productivity Commission has estimated the costs imposed by these retailing restrictions at approximately $600 million per year.[7]

- **Skilled migration**: Regulatory restrictions that are preventing businesses from quickly accessing highly skilled migrants to fill genuine skill shortages should be removed. More occupations should qualify for a four-year temporary skill shortage visa and costly labour market testing requirements should be reduced or removed. Business welcomes the announcement of the Global Talent Visa Pilot scheme.

- **Heavy vehicle reform:** Increasing inter-jurisdictional consistency of heavy vehicle specifications, curfews, load limitations and travel time restrictions, as well as the establishment of a national heavy vehicle user charge system has been estimated to deliver benefits of between $8 billion and $22 billion (depending on the reform model chosen and time frame for reform implementation).[8]

- **Sydney Airport efficiency:** The Australian Government should increase flexibility for aircraft movements and slot cap arrangements in the *Sydney Airport Demand Management Act 1997*. A 2013 study by Deloitte[9] found that an additional daily A380 service from China would on an annual basis contribute an estimated $388 million to Australian GDP, $233 million to Australia's household income and create an additional 5,000 jobs.

- **Remove unwarranted competition restrictions identified in the Harper Review**: Progressing unfinished competition reforms from the Harper Review would provide significant productivity improvements in industries such as taxies, pharmacies and legal services. For example, reforming pharmacy location and ownership rules are estimated to provide a net economic gain of $75 million. Finalising energy reform and recommitting to water reform are also priority areas for competition policy, as productivity improvements in these crucial sectors would provide significant economy-wide benefits.[10]

- **Coastal shipping reform:** Federal Parliament should pass the Coastal Trading (Revitalising Australian Shipping) Amendment Bill 2017. An efficient coastal shipping sector is important for lifting the competitiveness of Australian businesses that use coastal shipping in their supply chains.

[6] RBA Discussion Paper (RDP 2018-03): *The Effect of Zoning on House Prices*, p. 10

[7] Productivity Commission, *Shifting the Dial: 5 year productivity review (Appendix B)*, 2017, p. 227

[8] Transport and Infrastructure Council, *Heavy Vehicle Road Reform - What we are doing and why we are doing it*, 2017, p. 3

[9] Sydney Airport submission, *Productivity Commission research project – Australia's International Tourism Industry*, 2014, p. 2

[10] Productivity Commission, *Shifting the Dial: 5 year productivity review (Appendix B)*, 2017, p. 224

In total, we estimate that the above reforms could add more than $5 billion annually to Australia's national economy. And this is by no means an exhaustive list of potential regulatory reforms.

To reinvigorate regulatory reform, a detailed and substantive reform agenda should be developed for both the Australian Government and for an intergovernmental regulation reform agenda overseen by COAG. In addition to the Business Council's list, reform priorities should be based on the advice of the Productivity Commission and by drawing from recommendations of other independent policy reviews.

### Best practice regulation processes

New business regulations continue to be introduced with little regard to the effect on business efficiency and productivity. We cannot regulate our way to economic prosperity and if the government is serious about regulatory reform, it must stop increasing the regulatory burden. The Australian Government should avoid introducing rushed and knee-jerk regulatory proposals to emerging issues.

- All regulatory impact statements should achieve a 'best practice' assessment that requires policy makers: to fully consider the problem to be solved; justify why regulation is needed; engage in genuine consultation; and examine the net benefit of alternative options before making a decision.
- There should be a minimum period for stakeholder consultation, greater support for agencies to measure the costs of new regulation and cost–benefit analysis of all options (not only the preferred regulatory option).
- Opportunities should be sought to co-design regulation with industry and support self-regulation where it can be just as effective (such as the Business Council's Australian Supplier Payment Code, which obliges signatories to pay small business suppliers within 30 days).

### Improve regulator performance

The Business Council strongly supports the Regulator Performance Framework (RPF) and commends the government for its introduction. Now in its second year of operation, the Business Council believes that there are some areas where the operation of the RPF could be further enhanced:

- **Real time regulator performance feedback:** The government should require regulators to seek feedback from regulated entities on a continual basis throughout the year, as this will avoid time lags that lessen the quality of the feedback provided.
- **A greater focus on reducing compliance costs:** Add a requirement for regulators to ask respondents if they believe the regulator's conduct unnecessarily created compliance costs and how those costs could have been avoided or reduced.
- **State adoption of a regulator performance framework:** Using the COAG process, the federal government should encourage the establishment of a regulator performance framework in all Australian jurisdictions.

### Getting the right balance in competition policy

Vigorous competition is essential for productivity growth and maintaining Australia's high standard of living. Competition policy is an important tool for providing customers with greater choice and better products, preventing abuse of market power and ensuring that markets remain competitive.

The Competition Policy Review made a number of recommendations for injecting more competition into regulated sectors of the economy, including human services sectors, that are still to be progressed.

With respect to competition law, the Business Council is concerned about a growing tendency to use what could be described as 'catch-all' approaches to regulating business behaviour. Recent amendments to the misuse of market power provision in the *Competition and Consumer Act 2010* provides a worrying example of new legal uncertainty that risks stifling business innovation and may lead to price increases or less choice for consumers.

To provide businesses with more certainty, the Business Council has urged the ACCC's Final Guidelines for the misuse of market power provision to reflect the more definitive positions previously adopted by the ACCC that it will focus on exclusionary conduct and that it will consider legitimate business reasons.

The Business Council is also concerned that the ACCC's authorisation process is not well adapted to providing faster decisions about conduct under the new misuse of market power provision. There should be a fast-track process that has much shorter timeframes than the six months allowed under the ACCC's current non-merger authorisation process.

There are also claims that Australian markets are becoming more concentrated, based on aggregate metrics such as business revenue to GDP or product price rises relative to the CPI. None of these reliably indicates market power.

Assessment of market power needs to be informed by an assessment of barriers to entry, the degree of exposure to global price competition and the scope of the market.

If anything, Australia may need to achieve greater economies of scale in some sectors to be a competitive global player.

**Recommendation 2**

- Establish and prioritise a clear and transparent regulatory reform agenda, with progress overseen by a federal minister with accountability for reducing Australia's regulatory burden.
- All jurisdictions agree a reinvigorated program of regulation reform, leveraged by incentive payments, that prioritises:
  - streamlined major project approval processes
  - simplification of zoning restrictions
  - liberalisation of retail trading hours.

- Strengthen regulation making processes by requiring all Regulation Impact Statements to meet a 'best practice' assessment, improving cost assessments and examining the use of co-design and self-regulation.
- Strengthen the Australian Government's Regulator Performance Framework and incentivise the introduction similar frameworks in the states and territories.
- Maintain a stable competition law framework that provides clarity and certainty for vigorously competing businesses, while addressing anti-competitive behaviour.
  - Changes to section 46 ('misuse of market power') of the *Competition and Consumer Act 2010* must be accompanied by Final Guidelines that clearly define the conduct that is prohibited under section 46 of the Act.

## MODERN WORKPLACES

- Labour is by far the biggest single input in the production process. How effectively workers are deployed and how productive they are within enterprises are critical for productivity growth.
- While managers are responsible for hiring and assigning workers, governments and institutions create the broad rules within which these decisions are made.

Australia needs a modern workplace relations system that delivers a genuine safety net for workers, recognises the shared interests of managers and workers in an enterprise's success, and gives all enterprises the agility they need to compete and succeed.

However, serious problems are evident with the current system. Enterprise bargaining is at risk of becoming unworkable, as demonstrated by the significant decline in Enterprise Bargaining Agreements: from a peak of 24,469 current private sector agreements in the December 2010 quarter to 12,456 current agreements in the September 2017 quarter.

Enterprise bargaining should be about employers, employees and their representatives collectively assessing current circumstances, and coming to a collective decision in the mutual interests of the business and its workers. Immediate action is needed to address the following issues:

- The construction and current interpretation of the Better Off Overall Test now makes agreements cumbersome, challenging and risky for enterprises with large workforces.
  - The *Fair Work Act 2009* should be reformulated to better reflect the overall aspect of the test.
  - Agreements should be approved if, on an overall basis, employees covered by the agreement on the whole are better off under the agreement compared to the award.

- The content of agreements has been encroaching on the ability of businesses and managers to make decisions about business operations beyond the employment relationship.
  - There is a need to begin to limit the scope of what can be included in agreements.

The final report of the Productivity Commission's inquiry into the workplace relations system, released in December 2015, set out several broad recommendations for reform of the workplace relations system. The Business Council supported most of the reforms and continues to support their early implementation.

But there is a need for further action over the medium term to avoid being stuck with a rigid system not suited to the modern world of work. Additional reforms are required to:

- define the employment relationship in the legislation, rather than rely on legal precedent, so there is a clear set of rules about what can be included in agreements
- streamline awards to their core purpose of establishing a floor of wages and conditions
- respond to employer concerns about right-of-entry provisions, caused by inherent issues in the legislation
- understand the problems organisations face when undertaking structural change, and the barriers that the adverse action provisions present.

So long as the workplace relations framework remains ill-suited to how modern enterprises must operate, there is a significant risk that more employment relationships across Australia will default to the highly-regulated awards system.

This will leave businesses and workers worse off: Australian companies will be less able to adapt to global competitive pressures and workers will forgo the additional benefits that can flow from enterprise bargaining.

**Recommendation 3**

- The *Fair Work Act 2009* should be reformulated as a matter of urgency to better reflect the overall aspect of the test and the need to take into account the workforce on the whole in assessing whether an agreement passes the test.
- There is a need to begin to limit the scope of what can be included in agreements.
- Over the medium term, implement a workplace relations system that gives enterprises and their employees space and opportunity to improve productivity and increase wages. Additional reforms are required to:
  - define the employment relationship in the legislation, rather than rely on legal precedent, so there is a clear set of rules about what can be included in agreements
  - streamline awards to their core purpose of establishing a floor of wages and conditions
  - respond to employer concerns about right-of-entry provisions, caused by inherent issues in the legislation

- understand the problems organisations face when undertaking structural change, and the barriers that the adverse action provisions present.

# 10 RELIABLE, AFFORDABLE AND SUSTAINABLE ENERGY

- Australia's electricity and gas supplies are the cornerstone of the economy, powering our industries, our cities and our homes.
- The bulk of electricity and gas produced provides a core input for Australian businesses. Therefore, affordability and reliability of supply are crucial for supporting business competitiveness.
  - Electricity and gas inputs accounted for 53% of gross value added in basic non-ferrous metal manufacturing (including alumina production and aluminium smelting), 28% in pulp, paper and paperboard manufacturing and 22% in sugar and confectionery manufacturing.
- Substantial changes in the electricity and gas markets and policy uncertainty have increased electricity and gas prices for all customers and led to some blackouts.
  - Electricity prices have more than doubled over the past decade.
- Australian exports of energy — mainly coal but increasingly gas — exceed $80 billion a year.
- Future production and export capacity is being jeopardised by bans on gas exploration in several states as well as unnecessarily protracted and cumbersome major project approval processes.

The immediate policy focus must be to restore the security, reliability and affordability of our electricity and gas systems as we transition towards a lower-emissions economy.

To achieve this, we need a clear and comprehensive policy framework to be implemented at a national level. Companies will only invest in new infrastructure in electricity and other key industries if they can see a stable policy framework, with minimal government intervention, that will endure no matter who is in power.

The Business Council supports the development of an integrated, national and bipartisan energy and climate change policy framework that can deliver the following four key goals:

- secure and reliable energy supply
- affordable energy supply
- strong, internationally competitive economy
- meet current and future emission reduction targets.

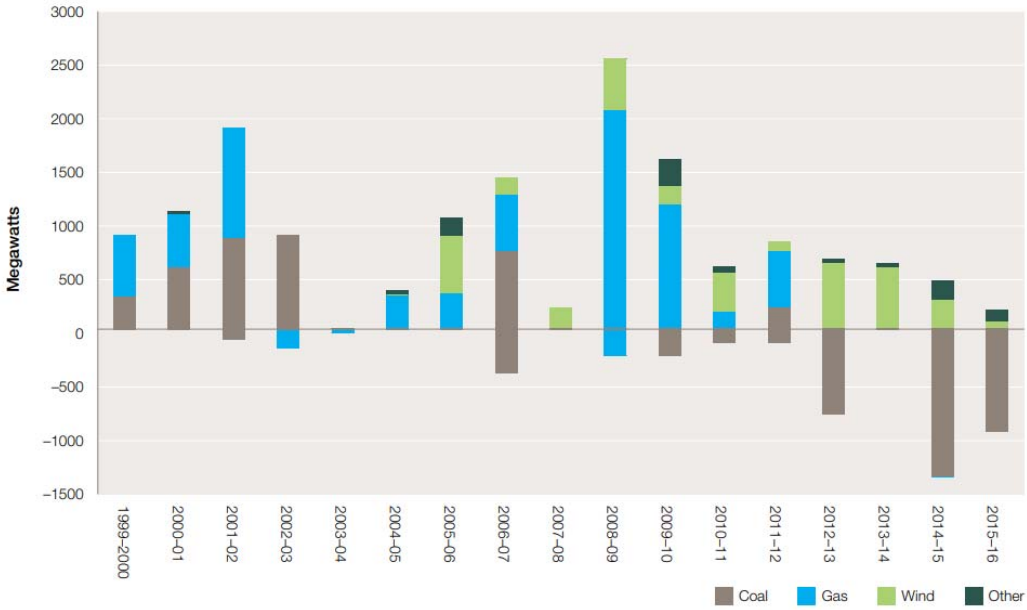
### The National Energy Guarantee offers the best practical way forward

The proposed National Energy Guarantee provides a credible pathway forward. The Guarantee has the potential to end the political impasse and policy paralysis and act as a circuit-breaker for the stale energy and climate change policy debate.

By using existing market structures and placing responsibility for meeting emissions and reliability targets on electricity retailers, the Guarantee is our best chance to drive the investment we need in the energy sector, while also meeting our emissions reduction targets.

Australia's electricity system is undergoing a major transition. An increase in the amount of intermittent technology, such as wind, solar and storage, has resulted in a fall in dispatchable coal-fired generation. Since 2012, 5,900MW of ageing coal-fired generation capacity has been withdrawn from the National Electricity Market (NEM) with a further 2,000MW scheduled to close in 2022. In contrast, since 2016, over 6,500MW of new renewable capacity has been announced under the Renewable Energy Target (RET).

**Figure 24: Investment in new generation and plant retirements (NEM)**

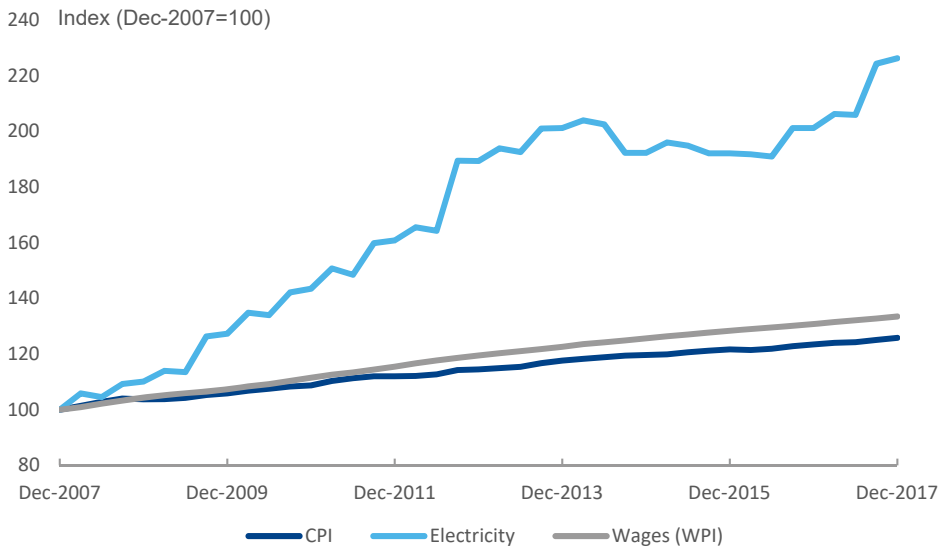



Note: Retirements exclude mothballed plant.

**Source: Australian Energy Regulator, *State of the Energy Market*, May 2017**

This changing mix of generation has increased prices and created a less stable and reliable energy system. Electricity price rises far exceed price growth across the economy and wage growth. The Guarantee seeks to manage this transition by providing a clear signal to build dispatchable electricity generation using the lowest-cost technologies to meet overall targets.

**Figure 25: Electricity prices have soared compared with the CPI and wages**




**Source: ABS cat. no. 6401.0 and 6345.0**

There remains a considerable amount of detail to work through to ensure the Guarantee is successful, as there would be in any energy plan. The Business Council welcomes the opportunity to provide feedback to the Energy Security Board on the initial design phase of the Guarantee.

### The Guarantee cannot do all the heavy lifting

The Guarantee in isolation cannot address all the challenges in the energy sector. The electricity sector cannot bear the total cost of Australia's abatement efforts — doing so will only jeopardise the affordability and reliability of electricity and gas.

A suite of energy and climate change policies is required to help contain prices and build a more reliable system. The Guarantee is just one of these policies.

Additional practical measures will provide the flexibility and capacity for Australian businesses to ensure adequate supply and meet emissions reduction targets at least cost. They include:

- lifting unscientific moratoriums on the development of gas reserves
- timely major project approval processes to ensure gas supply comes to market as quickly as possible
- access to credible international permits
- continuation of the Emissions Reduction Fund
- the development of a long-term, whole-of-economy emissions reduction strategy.

The Business Council urges Australia's political leaders to work constructively on the design and implementation plan of the Guarantee. Business stands ready to work with governments to get the design of the National Energy Guarantee right and to give the energy sector the certainty it needs.

**Recommendation 4**

- Australia's political leaders should agree to progress the design and implementation plan of the National Energy Guarantee, in consultation with industry.
- Remove state-based emissions targets inconsistent with the Guarantee.
- Unscientific moratoriums on the development of gas reserves should be lifted immediately and replaced by merit-based, case-by-case assessment of proposals.
- Major project approval processes must be streamlined to ensure gas and other energy commodities come to market as quickly as possible, to support domestic supplies and exports.
- A long-term, whole-of-economy emissions reduction strategy should be developed, incorporating access to credible international permits and continuation of the Emissions Reduction Fund.

# 11 PRODUCTIVITY-ENHANCING INFRASTRUCTURE

- Efficient public infrastructure provision and use are fundamental for well-functioning cities and well-connected communities, labour mobility and market access.
- Australia's skilled migration program brings economic benefits but infrastructure needs to keep pace with population growth to maintain liveability and reduce congestion costs.

Keeping pace with Australia's growing population will require investment in efficient, reliable infrastructure.

The Business Council endorses the reform proposals and projects in Infrastructure Australia's well-developed, 15-year infrastructure reform plan and infrastructure priority project list released in 2016. These documents should be used as a foundation for implementing:

- an infrastructure reform agenda across governments that will lead to improved infrastructure planning and project prioritisation, more streamlined and efficient planning approvals systems, and a comprehensive national road pricing scheme
- a federal infrastructure funding program that supports, over time, the roll-out of infrastructure investments on Infrastructure Australia's infrastructure priority list.

### The infrastructure reform agenda

An intergovernmental infrastructure reform agenda should be agreed at COAG that implements the planning, pricing and procurement reforms in Infrastructure Australia's plan.

The intergovernmental reforms agenda should prioritise improved long-term strategic planning by state governments to help identify future infrastructure needs in each jurisdiction. Infrastructure and land-use planning need to be fully integrated and corridors reserved to cater for future growth. Infrastructure agencies should be established in states that are independent, expert and transparent.

Infrastructure procurement in all jurisdictions should be well informed, through clear needs assessments and the use of independent cost–benefit analyses. New infrastructure projects should be assessed against options to make more efficient use of existing infrastructure, such as through the application of technology. This can promote efficient allocation of capital.

Infrastructure regulation reforms should support more efficient infrastructure provision and use. Opportunities for expanding cost-reflective pricing models into the road and water infrastructure sectors should be prioritised. Regulatory barriers that prevent, limit or hinder the efficient use of infrastructure should be removed, simplified or avoided (such as restrictions on the use of some roads by heavy vehicles).

**Making better use of our infrastructure and better decisions would increase GDP**

*Making better use of the road system*

- The Productivity Commission (PC) estimates that if Australia's road network were used more efficiently, this could lift GDP by 0.7% in the long-term.

*Improving the efficiency of road and rail freight*

- The Productivity Commission has estimated that if reforms were implemented to increase the efficiency of both the road and rail freight sectors there could be a 5% improvement in the productivity of both sectors. This could translate into an increase in GDP of just under 0.4% (or around $7 billion in today's economy)
- If more substantial reforms to road freight sector were made, the PC estimated that a 10% increase in productivity in that sector may be achievable. Combined with a 5% increase in the rail freight sector could increase GDP by over 0.6% (or over $10.5 billion in today's economy).

*Making better spending decisions*

- The Grattan Institute estimates that between 2001 and 2016 federal and state governments spent an additional $28 billion on cost overruns on transport infrastructure projects worth more than $20 million — around one-quarter of the original budgets.
- The Productivity Commission estimates that based on current levels of investment, if infrastructure cost 10% less to deliver, this would save governments around $2.9 billion each year.

Sources: Productivity Commission, *Shifting the Dial: 5 year productivity review*, 2017; Terrill, *Cost overruns in transport infrastructure*, 2016; Productivity Commission, *Road and Rail Freight Infrastructure Pricing*, 2006.

Planning approvals processes should support more efficient project delivery by moving to a 'one project, one assessment, one decision' approach. This will encourage more private sector investment, realise potential benefits sooner and reduce costs.

Governments should adopt asset governance models that encourage the efficient management of capital. Wherever possible, governments that continue to own infrastructure should seek to move towards corporatisation and then privatisation to increase the efficient operation of the asset. Capital from asset sales should be recycled into new productive infrastructure. Regulatory structures should be implemented where needed to ensure that service standards and other community expectations around service quality and pricing are met.

### Infrastructure investment to support growth

Federal government budgets in recent years have prioritised public infrastructure investment. This needs to continue if we are to meet the needs of a growing population and increase workforce participation and productivity. Infrastructure Australia should be tasked to work with the states to speed up the development of the infrastructure projects on its infrastructure priority list.

The planning approvals for these projects should be 'de-risked' by putting in place all major planning approvals and then put to the market to maximise opportunities for private investment. User charges and value-capture funding should be fully utilised to limit the funding contribution by taxpayers and to encourage efficient use of the assets.

**Recommendation 5**

- Improve the efficient provision and use of infrastructure through initiating an intergovernmental reform agenda based on the recommendations in Infrastructure Australia's infrastructure plan, with priority given to:
  - improved long-term infrastructure planning and project prioritisation
  - more streamlined and efficient planning approvals regimes
  - 'asset recycling' initiatives that incentivise state and territory governments to privatise infrastructure assets and reinvest the proceeds into new infrastructure
  - road policy reforms to link cost-reflective pricing models with road funding.
- Maintain public infrastructure funding as a priority in the federal budget and roll out a regular pipeline of infrastructure projects by:
  - adequately resourcing Infrastructure Australia to advise on infrastructure priorities
  - bringing forward 'ready-to-go' projects from Infrastructure Australia's priority project list
  - attaching performance-based conditions to federal funding of infrastructure
  - maximising funding from user charges.

# 12 HUMAN CAPITAL AND SKILLS FOR THE 21ST CENTURY

- Australia needs an integrated tertiary education and training system that enables people to upskill and reskill throughout their working lives, so they can adapt and be resilient to changing labour market conditions.
- There is a view that a vocational qualification is worth less than a university degree. Vocational education and training and higher education operate as two silos rather than one system.
- We need to ensure Australia's investment in education delivers value for money.

Developing and utilising Australia's human capital — our people — in better equipped, more efficient, more creative workplaces is central to delivering stronger growth. Having the right skills will also be critical for people's job prospects in a changing world of work.

But just spending more without regard to the outcomes is not the answer, especially when we do not know if the current investment is delivering good value for money. According to Professor Eric Hanushek, co-author of *Universal basic skills: what countries stand to gain*:

> "How money is spent is more important than how much is spent. This does not mean that money never counts, or that money cannot count. It simply means that doing more of the same is unlikely to lead to significant changes in student outcomes."

Source: Crowe, "Federal election 2016: Shorten 'misled voters' on schools boost to GDP", *The Australian*, 12 May 2016

**A more educated workforce is more productive**

- The PC estimated that the education and training reforms under the 2006 National Reform Agenda would improve productivity.
- Reforms to ease the transition from school to the workforce or further education, improve basic skills and literacy and numeracy levels of children and increase adult learning were estimated to increase productivity by up to 1.2% in 2030. The PC tentatively estimated that productivity would be 1.9% higher by 2045.
- More productive workers are good for the economy and workers also benefit through higher incomes. Each additional year of education is estimated to translate into incomes for Australians that are 5.5% to 11% higher.

**But higher spending in high-income countries is not linked to better outcomes**

- The OECD has found that once spending per school student reaches a minimum level (which all high-income countries have surpassed), "the data no longer show a relationship between the level of spending and the quality of outcomes".
- McKinsey estimates that "widespread adoption of best-practice productivity improvements over the past five years would have brought the performance of the average school system up the level of today's top-quartile education nations—at no additional cost per student".

**Open economies benefit more from a skilled workforce**

- The OECD estimates that increasing the skills of a workforce in any country is good for the economy, but it is estimated to have a much larger effect on economic growth in countries with an open economy.

Sources: Productivity Commission, *Potential Benefits of the National Reform Agenda*, 2006; OECD, *Universal basic skills: what countries stand to gain*, 2015; McKinsey, *Government productivity: unlocking the $3.5 trillion opportunity*, discussion paper, 2017.

The Business Council has outlined several reforms designed to improve skills and educational outcomes, including redesigning vocational education and training (VET) and higher education (HE) to effectively service Australians throughout their working lives.

Australia's capacity to achieve higher economic and productivity growth is, in part, dependent on our tertiary education and training system.

At the same time, we know workplaces are changing — many jobs will be different in the future, some tasks will simply disappear as new jobs and industries emerge.

As technology reshapes workplace tasks and activities, skilled workers who can harness and complement technology will have more opportunities. Low-skilled workers will be vulnerable to job displacement and may have to compete for a smaller pool of jobs.

Our tertiary education and training system is critical to preparing Australians for this new world. It enables people to upskill and reskill throughout their working lives, so they can adapt and be resilient to changing labour market conditions.

### Australia's vocational education and training and higher education sectors need systemic, transformational change

Governments make a significant investment in tertiary education, spending $20 billion per year on VET and HE subsidies and loans.

Despite this, the Business Council strongly believes the tertiary education and training system is unlikely to deliver the type of workforce — better skilled, more responsive and better matched to job opportunities — Australia will require to drive economic growth without substantial structural reform.

The education system is not oriented towards lifelong learning and VET is viewed as a 'second-class citizen' compared with HE.

Further, VET and HE operate as two silos rather than one system, leading to a distorted funding model providing the wrong incentives, and learners being treated unfairly. This biased funding model reinforces the stigma that a VET qualification is less prestigious than a university degree.

### 'Future-proofing' through education and skills

In October 2017, the Business Council released a discussion paper, *Future-Proof: Protecting Australians Through Education and Skills*, outlining a new tertiary model that would enable workers to more easily retrain and reskill over their lives.

The Business Council proposes a 'tertiary system' comprising five core components:

1. Putting the learner in charge by giving every Australian a capped 'Lifelong Skills Account' (LSA), controlled by individuals, to pay for courses at approved vocational education and training and higher education providers, over a lifetime.
2. Better market information so learners know what jobs are available, what they might earn, what courses are available, how much it will cost them, and what their loan repayment schedule would look like.
3. Maintain the unique character of the vocational education and training and higher education sectors.
4. A shared governance model clarifying the roles and responsibilities of each level of government and industry, and a new institution to manage LSAs and market information.
5. A culture of lifelong learning that encourages people to use qualifications to build a strong foundation, and then dip in and out of short, accredited modules to effectively create their own 'credentials' that allow them to upskill and retrain throughout their lives.
6. The Business Council is proposing that we start with the current funding level of $20 billion, but the funding split between VET and HE will depend on the decisions learners make.

Together, the reforms address the key barriers that limit the tertiary sector's effectiveness.

They establish a tertiary education entitlement that encourages participation by all groups, and enables Australians to retrain and reskill over their lives to keep pace with changing workforce demands.

The LSA creates a single funding system across VET and HE that removes the confused and distorted funding incentives, and places the sectors on a neutral footing. This will be supported by better market information, giving all Australians the information they need to identify a job, career or industry that best suits their talents and interests.

**Recommendation 6**

- That the government begin work to adopt the tertiary model set out in the Business Council's *Future Proof* discussion paper to establish a culture of lifelong learning centred around the needs of individuals.

# THE BUSINESS COUNCIL'S PROPOSED TERTIARY SYSTEM

## FUNDING

**Establish a single funding model that is sector neutral.**

- The centrepiece of the funding model is an entitlement for learners made up of a subsidy and an ICL that can be used across a person's working life (Lifelong Skills Account)
- All accredited providers (public and private) can seek to become an approved provider to offer qualifications with a subsidy, a loan, or both
- Potential learners can use the funding in their Lifelong Skills Account at any approved provider across VET and HE

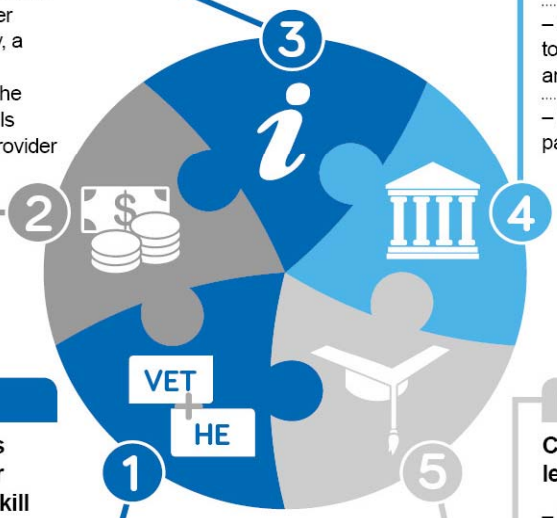
## INFORMATION

**Build a single source of market information where potential learners can find all the information they need to decide on a future career and select the best provider for their needs.**

## GOVERNANCE

**Implement a shared governance model that clearly defines the roles and responsibilities of each level of government and industry. This model will:**

- Establish an institution to manage the funding model and market information system
- Allow each level of government to manage their expenditure and priorities
- Facilitate industry leadership, particularly in the VET sector




## STRUCTURE

**Maintain the two sectors of VET and HE with their current approaches to skill development, and unique identity and mission.**

## LIFELONG LEARNING

**Create a culture of lifelong learning.**

- Maintain qualifications for people entering the labour market or a new industry
- Allow graduates to build on the knowledge and skills they have developed through their education and work, including by funding more modular learning

# 13 AN OUTWARD-LOOKING, COMPETITIVE ECONOMY

- Australia's living standards have always been, and will continue to be, underwritten by international trade and investment. Trade (imports and exports) is the equivalent of around 40% of GDP.
- Openness to global markets means more intense competition and technology transfer, driving innovation and productivity growth. Rapid growth in trade in intermediate goods has allowed even greater specialisation across countries and global supply chains.
- Ultimately it is Australian households, as both wage earners and consumers, who benefit from higher incomes and access to imported goods and services at lower cost and much greater product variety.
- The Centre for International Economics conservatively estimates that Australia's GDP is more than 5% higher today because of trade liberalisation since the mid-1980s. That translates to around $90 billion extra income a year. Average household income is more than $8,000 higher than otherwise.
- Deloitte Access Economics has estimated that a 10% increase in foreign direct investment increases real GDP by 1.2%, and generates more jobs and higher real wages.

Sources: Deloitte Access Economics, *Foreign Attraction: Building our advantages through foreign investment*, 2010; Centre for International Economics, *Australian trade liberalisation*, 2017

As a medium-sized economy, Australia's ability to trade with other countries and attract foreign investment significantly affects its economic growth.

Accordingly, our international engagement and competitiveness are more important than that of many other nations that are less reliant on foreign investment and trade, particularly as our savings continue to be inadequate to fund the projects and infrastructure required for a sound and sustainable economy.

This is why Australia stands to lose a lot from a global trading war. The response must be two-fold — continue to push back against protectionist developments while making the Australian economy as competitive as possible. Engaging in the 'war' by imposing retaliatory measures would be counterproductive.

### Continue promoting regional trade liberalisation

Australia continues to benefit from its location in the Asia–Pacific, the major contributor to global economic growth and increasing centre of global economic weight.

Australia should remain focused on building strong trade and investment relationships in the Asia–Pacific region, with emphasis on economic cooperation and our role in global value chains to:

- ensure Australia's bilateral Free Trade Area (FTA) negotiation program is effectively focused on services liberalisation, to add weight to and gain support for the counter-narrative to protectionism

- expand Australia's engagement with regional forums such as Asia–Pacific Economic Co-operation (APEC) and the Indian Ocean Rim Association
- help the G20 and APEC implement the WTO Trade Facilitation Agreement and build substantive elements that contribute to an eventual FTA of the Asia–Pacific.

The recent signing of the TPP11 is an important step forward, keeping alive the momentum for trade liberalisation in the region. The agreement, without the participation of the USA, will still cover about one-quarter of Australia's exports. It is estimated the agreement could add 0.5% to Australia's GDP and lift exports by 4.0% or $30 billion.

### Foreign investment will remain critical for economic growth

Foreign investment has always been a critical contributor to the Australian economy and the living standards of the Australian community. Foreign capital accounts for more than half of the nation's entire capital stock.

The reality is that with our relatively small population, Australians do not generate enough savings to finance all the valuable investment opportunities here, especially in our relatively capital-intensive, export-oriented mining and agricultural sectors.

Foreign direct investment is also a vital conduit for delivering new technology and establishing links into new export markets. A big payoff of foreign direct investment comes from the technology 'spillovers' — that is, the new skills and knowhow that managers and workers learn and spread across the economy.

For these reasons, having a consistent policy framework that supports inbound investment is critical for Australia's future growth.

The foreign direct investment regime could be improved through providing greater clarity and consistency for investors and for the Australian community.

The Business Council also believes that recently introduced lower screening thresholds for foreign investment in agribusiness send the wrong signal, negatively impact on investment in agribusiness and Australia's reputation as a destination for investment, and should be reversed.

To promote consistency and reflect the full national interests at stake with foreign investment, a Foreign Investment Advisory Council integrating both the investment attraction and investment regulation arms of government at secretary level should be established.

### Pushing back against threats to global trade

Australia faces a much more complex world than previously, where trade was governed by WTO and FTA rules, with trade liberalisation as the dominant narrative and championed by the USA.

It is becoming increasingly important for Australia to join with other like-minded nations to champion the benefits of open markets and a rules-based trading order.

Australia must, and is well placed to, provide leadership in countering these challenges and in promoting trade and investment liberalisation, as it did with the Cairns Group.

Australia has earned a good reputation as an advocate of trade and investment liberalisation: a position strengthened by a history of economic reform at home. We should preserve this reputation through continuing to keep our borders open by minimising trade barriers.

While Australia's average applied tariff is low, residual barriers should be reviewed to ensure that they are not unnecessarily impeding beneficial trade.

**Recommendation 7**

- Enact the TPP11 as soon as practicable.
- Reverse the lower screening thresholds introduced for FDI in agribusiness.
- Continue to champion and uphold the international rules-based trading system.
- Continue pursuing trade liberalisation opportunities within the multilateral framework and existing agreements, and by forging new agreements.
- Implement a stable and transparent foreign direct investment regime that delivers clear community benefits.
- Explore scope for further reductions in residual domestic trade barriers to facilitate trade flows and global supply chain linkages.

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