

# **Ai Group's Agenda For Making the Economy Work Better**

## **Why the economy needs to work better**

Australia's economic performance over the past decade and a half has been very strong both by historical standards and in comparison with that of most other developed countries.

While the remarkable economic successes of this period is a strong and encouraging foundation from which to look for further gains in Australian economic and social opportunities, it is clear that Australia's economic management and the political leadership now faces profound new challenges.

- Domestic bottlenecks in labour markets and in infrastructure combined with remaining imbalances in the housing market pose risks to the continuity of domestic economic strength.
- The external imbalances manifested in historically high current account deficits show few signs of abating. The high current account deficits are of particular concern because they come at a time when the terms of trade are distinctly favourable and against the background of very strong growth among our trading partners.
- There are new levels of risk in the international environment. The security outlook remains uncertain and there are significant imbalances hanging over the international economy in the form of the US budget and external deficits.

These challenges come at a time when the structure of the economy is shifting due to:

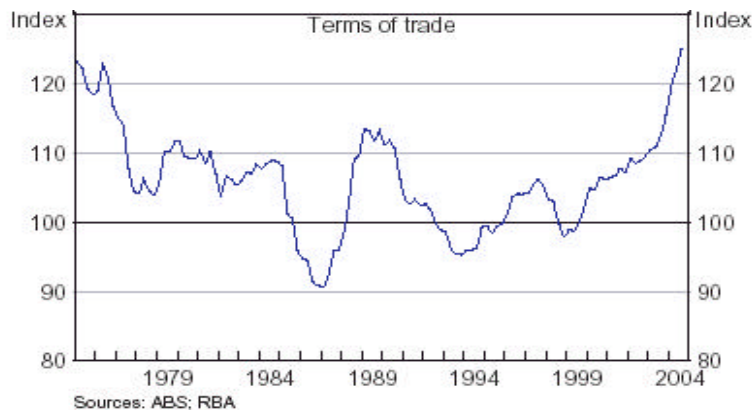
- Our ageing population with its associated pressures on future budgets and workforce participation; and
- The fundamental shifts in global patterns of economic activity - particularly due to the rapidly changing role of China in global production and demand.

These challenges are exacerbated by the fact that we can no longer count on the continuing operation of factors that have been key ingredients of the success of recent years.

- Most of the favourable productivity impacts of the liberalising reforms of the 1980s and 1990s have now run their course and, while the economy is permanently stronger as a result, the prospects of further gains in strength stemming from the previous generation of reforms has faded.

- A solid proportion of the gains in Australian living standards over the past decade can be attributed not to productivity-building measures but to the largely external good fortune of a sustained improvement in our terms of trade. This is illustrated in the graph below.

**Australia's Terms of Trade 1974 to 2004**



The terms of trade are now at 30-year highs having risen by around 30 percent since the early 1990s. While the Reserve Bank of Australia anticipates a further strengthening in the near term, it is very unlikely that its current level will persist. Certainly, there should be no expectation that the growth in the terms of trade from which we have benefited over the past decade will continue to contribute to gains in domestic living standards.

The benefits of the previous generation of reforms and our good fortune to have ridden a wave of favourable international price movements cannot be relied on to deliver further improvements in living standards in the next decade.

Instead, we need to search for, and act upon, new ways of boosting the productivity required to generate sustained improvements in living standards and opportunities.

## **How the economy can be made to work better**

### ***A. Building more productive workplaces and more dynamic enterprises***

The economy as a whole will only work better as individual workplaces become more productive and individual enterprises become more dynamic. This requires

- Improving the flexibility of work practices for employees and employers

- Giving greater attention to skill shortages and skill creation both for new workforce entrants and for existing workforces
- Reducing the heavy compliance and regulatory burden confronting businesses. Measures include:
  - Revamping approaches to regulatory impact statements improving transparency and accountability.
  - Creating room in the parliamentary timetable for an annual tax technical corrections and improvements bill to improve certainty and to reduce compliance costs for taxpayers.
- Improving the export orientation of Australia's enterprises;
- Paying greater attention to ongoing innovation; and
- Building business capabilities – particularly in small and medium sized enterprises. There needs to be a particular focus on regions and sectors challenged by competitive pressures.

### Skill Shortages and Immigration

Addressing skill shortages is a leading priority. The long-term solution requires:

- The more thorough development of national, industry-focused training systems;
- A dual emphasis on the preparation of new workforce entrants and on retraining existing workers;
- This emphasis should apply across the entire education and training system; and
- Explicit attention should be given to assessing and addressing the specific skill shortages in regional areas.

Ai Group welcomes the ongoing shift in the emphasis of Australia's immigration program towards the attraction of those with skills required in the economy.

Key elements of an improved policy include:

- Maintaining a higher level of settler arrivals in future years to build on the Government's recent decision to increase the migrant intake to 140,000 in 2005-06 from 120,000;
- Streamlining application procedures relating to short-term visas for skilled workers;
- Better recognition and utilisation of skills acquired outside Australia including through more appropriately targeted bridging courses; and
- Close cooperation with industry to identify suitable skilled migrants (Note: we acknowledge the Government's plan to outpost DIMIA staff to key industry bodies and Ai Group plans to participate in this project).

### ***More Productive Workplaces: More Dynamic Enterprises***

Ai Group proposes:

- A comprehensive modernisation of Australia's Workplace Relations system
- A national training and education system to build world-class skills for world-class industries
- A systematic assault on new and existing compliance and regulatory costs
- Upgrading of programs building export skills and facilitating market development
- An open reassessment of the effectiveness of all innovation and research programs
- A new program focused on building business skills and capabilities

### ***B. Encouraging investment, saving and workforce participation***

Reforming Australia's taxation and income support systems in order to reduce barriers to investment, saving and work is central to the creation of a better economy.

#### Taxation

Despite our recent indirect tax reform program Australia still levies a range of selective and highly inefficient indirect taxes. Both the Commonwealth's Tariff Concession Scheme and the Medieval-style business transaction taxes levied by the States and Territories are highly inefficient and deter value-adding transactions.

The top two rates in Australia's personal income tax scale apply from comparatively low levels of personal income. These rates reduce incentives to invest; they all-but preclude the possibility of earning a real rate of return on a regular savings account and they stifle the rewards from additional work.

Almost uniquely, Australia levies taxes on the flows into superannuation funds; on the investment income of funds and on the outflow of payments to people drawing on this form of saving. Australia's extra taxes on superannuation reinforce the bias against saving that is a feature of our income tax system.

#### Income support

Income support payments to people of working age have escalated over the past three decades. While the extended availability of these payments has been associated with the desire to protect those experiencing misfortune, insufficient attention has been paid to the stifling impacts of welfare dependency on direct recipients and their children.

Australia's approach to targeted income support gives rise to high effective marginal tax rates where income tests and the income tax system intersect. When subject to these rates of withdrawal, income support recipients can be deterred from seeking additional work. Addressing the disincentives arising from the intersection of the income support and taxation systems is a delicate balancing act because the number of people affected by income tests rises when the rate of withdrawal is reduced. Conversely the number of people affected by income tests falls when the rate of withdrawal is increased.

### ***Encouraging investment, saving and workforce participation***

Ai Group proposes

#### *Indirect taxes*

- Removing the Tariff Concession Scheme
- Establishing a program for the elimination of State and Territory business transaction taxes

#### *Personal income tax*

- Removing the 42 percent bracket in the personal income tax scale by extending the 30 percent bracket to \$80,000
- Lowering the top rate in the personal income tax scale from 47 percent to 42 percent
- Raising the \$21,600 threshold in the personal income tax scale to \$23,600

#### *Superannuation taxes*

- Removing the superannuation surcharge and reviewing other taxes on superannuation contributions and fund income

#### *Income support*

- Income support payments to people of working-age should be geared to encourage workforce participation. This requires the development of workable activity tests as well as encouragement to support the acquisition and upgrading of workforce-related skills
- There should be a targeted assault on the impacts of effective marginal tax rates with emphasis both on the rates of withdrawal in income tests and the numbers of people subject to income tests

### ***C. Lean, Efficient and Farsighted Government***

The size of Australia's public sector is growing faster than the overall economy. To fund this expansion, taxes keep rising and taxation as a share of GDP continues to escalate. We now have an \$800 billion economy and a nationwide tax bill in excess of \$250 billion.

#### **Restraining the growth of recurrent expenditure**

Rising expectations and costs of health care and the increase in the proportion of aged people in the population are creating pressures for even further increases in recurrent expenditures by the public sector. In the face of these pressures there is a need not only to restrain the growth of new public sector expenditures but also to review and refine existing programs.

This is not simply a matter of slashing wasteful areas of expenditure or placing a blanket ban on new programs. It is more a matter of judicious reconsideration of the need for and appropriate scope of public sector involvement and of seeking further efficiencies and faster productivity growth in public sector service provision.

### The “Future Fund”

The Government has announced the creation of a “future fund” as a means of providing for currently unfunded liabilities associated with the future superannuation entitlements of Commonwealth public servants.

Ai Group believes that it is prudent and sensible to provide for the huge unfunded Commonwealth superannuation liabilities that already exist. For liabilities that have already accrued, Ai Group would support devoting some of the proceeds of asset sales to the future fund. This would assist in relieving taxpayers from the burden of catching up on the earlier failure to provide for these liabilities.

We also support the principle of making provision for these liabilities as they accrue in the future. The fund should be at arm’s length from Government; governance arrangements should comply with generally accepted standards and investment strategies should be transparent.

### Intergovernmental relations

A prime source of savings in recurrent expenditures and improved efficiency in service delivery lies in improved intergovernmental relations. The present approach does not promote efficiency; accountability or transparency of government. There is considerable scope to reduce duplication; to improve co-ordination; to restructure the allocation of spending and taxing responsibilities and to overhaul the allocation of intergovernmental transfers.

### A more efficient public sector

Ai Group strongly supports the adoption of the recommendations of the Productivity Commission’s recently completed Review of National Competition Policy (NCP) Reforms. It is clear that there are considerable steps yet to be taken and equally important gains in public sector productivity yet to be generated.

We note that the recent OECD assessment of the Australian economy points to the particular scope for the federal government to raise its own rate of compliance with the

NCP rate both as an end in itself and in line with its leadership role in promoting greater product market competition.

### Infrastructure

There are clear signs that Australia has underinvested in critical, capacity-expanding infrastructure. Particular shortfalls appear in the areas of energy, transport and water. Three areas central to the ongoing improvement to Australia's infrastructure:

- There is considerable scope to make better use of Public Private Partnerships (PPPs). Improvements can be made in procurement; in the appropriate allocation of risk in contracts and in the management of contracts once they are in place.
- Infrastructure planning and development needs to be better coordinated across different levels of government.
- The current approach to economic management is excessively focused on reducing net public sector debt. The general framework for economic management could be strengthened with prudent levels of public sector borrowing to ensure appropriate levels of investment in Australia's energy, transport and water infrastructure.

#### ***Lean, efficient and farsighted government***

Stronger and more persistent discipline is required to restrain the future growth of recurrent expenditure. All programs – new and existing - should be subject to thorough and ongoing review.

Due to the complexity of intergovernmental relations and their connections with all areas of public sector activity, Ai Group proposes the Productivity Commission conduct a substantive and independent review of Australian intergovernmental relations including intergovernmental financial relations.

Renewed commitment to the National Competition Policy agenda as recently recommended by the Productivity Commission.

Ai Group proposes a three-pronged approach to improving the nation's infrastructure:

- Improved approaches to Public Private Partnerships
- Better co-ordination of infrastructure planning and development
- A strengthening of the approach to economic management by a greater though prudent use of public sector debt to finance appropriate public sector investments in infrastructure projects.