RESPONSE TO A SLOWING ECONOMY

The following describes a strategy that the Government may use to respond to an economic downturn. The strategy is based on a broad scenario in which the downturn is not apparent until past its onset (due to information and forecasting lags) and it is not clear whether the downturn is shallow or deeper seated.

The strategy is predicated on the assumption that the Government will wish to respond, and that there will be significant pressures for spending from within government and from stakeholders with various objectives. As such, there will be significant pressures on both fiscal discipline (in a medium term sense) and quality of expenditure/revenue raising.

An effective strategy needs to assist the Government to manage both the economic pressures as well as the political economy of an economic downturn. Australian Government is in a sound position to respond to an economic downturn, based both on the benefits of widespread regulatory reform and fiscal consolidation. The quality of the Australian Government's balance sheet and accounts are such that it can credibly undertake a fiscal response to a downturn as long as the response is seen as consistent with sound medium term economic management - fiscally credible, efficient regulation, consistent with medium term demographic trends.

The essential features of the proposed strategy are:

- spending that can be ramped up (and down) as the economic cycle evolves;
- a story to link the spending initiatives together which gives the Government flexibility to adjust fiscal initiatives as information on the downturn accumulates, while supporting fiscal and policy credibility
- initiatives containing sufficient features to assist the Government to manage vested interests
- initial spending initiatives designed to flow quickly through to aggregate demand
- where the cycle is judged to be deeper seated, then larger scale infrastructure reform or investment projects that the Government wishes to undertake should be used - initiatives that have a medium to longer term payoff, but for which Government's often do not have the fiscal room . Such projects, while having significant fiscal impacts, will maintain the quality of expenditure and crowd out poor proposals (which are often small and sectionally focussed).

What follows is a draft of a possible briefing note and an outline of some potentially viable initiatives that could be further developed as and when required. Clearly it would need to be supplemented with up to date information and judgements about any particular situation. In particular, more detailed specific policy proposals would be required. However, these would by their very nature tend to be situation specific.

In examining specific options we found work was underway looking at many of the areas we had identified. Attached are some papers that further explore specific options in the tax and infrastructure funding areas. The work associated with the demographic taskforce provides the basis for advice on potential welfare and benefit changes to "improve" the incentives in the system.

Work was also carried out to examine the potential for import leakage and consumption ratios of different groups. Analysis of the most recent HES data suggests that, as expected, households with lower earnings (and more children) tend to have a higher propensity to consume. This work also suggests that there is little differences in the import leakage by income group with around 16 per cent of consumption being made up by imports in each income quintile. A copy of this work is attached.

It is recommended that this work be maintained and updated as appropriate by MPD in consultation with DED, BPD and other interested areas of the Treasury.

POSSIBLE BRIEFING NOTE: RESPONSE TO A SLOWING ECONOMY

Key Points

- The National Accounts for the last quarter indicate negative economic growth, employment growth has slowed and unemployment has risen indicated ongoing weakness in the economy. It is not clear how sustained the slowdown will be.

- An economic package may be appropriate to stimulate aggregate demand. However, careful design and management of such a package will be required to maintain the Government's record of responsible economic management and facilitate an exit from the package as economic conditions improve.

- The main features of the proposed strategy are:

  - A package that is scalable up and down in response to economic conditions

  - A framework based on a medium term development agenda to provide coherence to a range of initiatives

  - An initial focus on increasing aggregate demand quickly, with the option to move to larger initiatives should low growth conditions persist

  - A risk management strategy to maintain the Government's fiscal credibility.

A Strategy

The recent slowing of the economic activity means the government faces a number of risks that will need to be managed.

There is a risk that this is the start of a prolonged period of economic weakness. While periods of slower growth may play a role in the ongoing development and health of the economy, prolonged periods of economic weakness come at a high human and economic cost. The combination of monetary policy and automatic fiscal stabilizers play an important role in reducing this risk but they do not eliminate it.

However, discretionary fiscal action where the economy is going to rebound anyway will simply reduce the freedom for future fiscal action and may result in interest rates higher than they would otherwise have been.

We cannot know now with any degree of certainty if this is simply a short term slowdown or the start of a prolonged period of economic weakness. However, by the time we are certain that we face a deep recession the cost in both human and financial terms would be beginning to rise calling for very rapid action.

It is difficult to react rapidly with policies that will have an immediate impact, are sensible in the medium to longer term and do not simply lock in a higher level of government spending. The impact of the spending may also be less once it becomes clear that we face a deep recession. Equally, a series of small uncoordinated packages are unlikely to be effective running the same risks as the package developed when a deep recession has already taken hold.

This suggests acting early to develop and begin to implement a package of initiatives that would both reduce the risk of a deep recession and act to support economic growth in the medium to long run. This is, in essence, taking out an insurance policy while still getting value for money for the expenditure.

But insurance comes at a cost. The costs in this case include a higher level of government debt, the risk of a structural budget deficit that will need to be corrected in the future, and deteriorating perceptions of the government's longer term fiscal management. Where government debt is high or there is not a track record of high quality fiscal management such costs could be high and, potentially, outweigh any benefits from fiscal action. However, this is not the case for Australia where debt levels are low and fiscal credibility has been built over a number of years. Careful management can further reduce these costs.

One way to further reduce the costs of action is to carefully communicate the government's strategy and rationale for action. This would include how the budget will be brought back into surplus and how debt will be returned to minimal levels. Supporting this would be ensuring the package was primarily temporary in nature and could be seen as demonstrably supporting growth both in the short term and into the future.

The composition of the package is crucial for this strategy to work. Measures to improve the supply side of the economy will have the most positive impact on medium to long term growth. However, there are considerable design and implementation lags associated with such supply side measures meaning a package comprised of these solely runs a substantial risk providing a stimulus that is too late. This suggests that a package should effectively combine supply side measures with short term measures designed to support demand through the provision of funds to those with a high propensity to consume or to target areas of weakness.

The size of any package will also be important. A very large package increases the costs and risks previously outlined. However, too small and it will be seen to make little difference and pressure may rise to have another package. An uncoordinated series of packages is likely to raise both the overall economic and longer term fiscal costs (Japan's experience in the 1990's illustrates the risks of indecisive and uncoordinated fiscal responses).

All this suggests that, if a deviation from the current approach of small fiscal surpluses is deemed necessary, the risks around discretionary action are best managed through a package which can be expanded or curtailed as the economic situation becomes clearer.

Careful design of fiscal interventions and a history of quality economic management reduce the risks to credibility of potentially large scale discretionary spending while increasing the likelihood of a positive contribution. Statistics and our knowledge of the economy help to tell us when the probability of a sustained downturn is higher and thus the need to scale up expenditure.

Process within government will also be important. The downturn has already generated pressures for spending on a range of proposals of varying quality and effectiveness in generating aggregate demand. A robust process to review proposals will be required to manage pressures and maintain the quality of expenditure.

The approach suggested involves introducing a package early that is designed for a slowing economy. If the economy then does slow this does not imply that further packages would be introduced – the policies to deal with this situation are already in place. If the economy turns out worse, flexibility to adjust some of the specific actions already in the package depending on the path of the economy could be built in. Such actions could be considered at the time of the Budget and mid-year updates.

If the economy rebounds, as we would all hope, this would reduce the budgetary costs to be borne and the associated increase in debt. The introduction of a large fiscal package will severely constrain the freedom of the Government (and spending Ministers) to undertake additional spending not consistent with the aim of combating the downturn. At the same time, having a scalable fiscal package provides the Government with fiscal room should the economy turn up sooner than expected.

Communictions of a coherent strategy

In order obtain the biggest lift in economic activity it will be important that the initiatives are seen as a concerted approach to the downturn, rather than a disparate set of initiatives. The benefits of a fiscal programme derive both from the direct economic impact, and also from confidence effects, which can foster additional consumption and investment expenditure. Given that the extent of the downturn is initially unknown, so also is the appropriate size of intervention, and thus a number of initiative may be required.

The Government has built a reputation for sound management of the economy and developing a medium term focus for policy – in particular in response to demographic change and improving welfare. A number of the initiative required to move the related agenda forward require significant expenditure and regulatory action.

The above suggests that an 'agenda for the future' based on a medium term framework could be used to link initiatives in a communication strategy and to provide a filter for spending proposals. Such an approach would also support policy and fiscal credibility.

Risk management

A robust process is required to manage the pressures already building for spending to ensure timely adoption of effective initiatives. The elements of this process could include:

- A small group of senior ministers managing the process in consultation with the Prime Minister
- A group of senior (Treasury and Finance) officials to coordinate bureaucracy
- An expenditure review and monitoring process – possibly based on the Budget processes
- A process to enable Ministers and backbenchers to quickly put forward proposals for consideration.

The overall process should avoid undue delay and bureaucratic complexity while maintaining the focus of the package.

The shape of possible initiatives

The design of specific initiatives will play an important role in the success of the package both in the short run in supporting demand and in the longer run in supporting ongoing growth.

The optimal policies are those that are quick to implement, do not lock in higher government spending, support the productivity and efficiency of the economy and can be adjusted for changing circumstances. Given this, we consider initiatives requiring substantial cooperation from state governments would not be effective.

Unfortunately, no one policy meets this specification. That is why a package is required. The goal in building the package is to have a set of policies that meets these tests.

In building the package, policies to avoid are those that take a long time to implement, lock in higher government spending, do nothing to support the ongoing productivity and efficiency of the economy, and cannot be adjusted to changes in circumstances.

There are three main types of initiative that could be included in any package:

- spending that supports private demand
- tax changes to encourage either investment or consumption
- government investment in infrastructure

Spending to support private demand

The primary options here are through the benefit system. They can be characterised as either permanent changes or one off payments.

Permanent changes with a focus on changes that would improve the efficacy of the system in providing social support while minimising the incentive impacts could be seen as an important element of such a package. However, they tend to have some considerable design lags so it would depend at least in part on the extent to which proposals that have already been developed can be brought forward. There may be either some short term impacts that may be negative or a permanent increase in spending. In designing the package ways to offset these would need to be found. It is also difficult to wind these sorts of initiatives up and down in size. Work associated with the Demographic task force provides a solid basis for the development of initiatives of this type.

One off payments can have a significant temporary impact on demand. They can be implemented quickly and have the flexibility to be adjusted in size as required. They are also, by definition, temporary increases in spending. However, they make no contribution to improving the productivity and efficiency of the economy and hence will not support ongoing growth. These payments are most easily made when associated with an existing eligibility criteria. The negative costs of such a payment are also reduced when it is done in a way that does not create incentives for people to change behaviour so as to be eligible.

Using the tax system

Changes to the tax system can involve significant risk. Often governments around the world have given tax cuts on the assumption of future growth. When that growth does not eventuate significant structural budgetary problems can result. However, with careful design and implementation tax options may be an important element of any package.

Principle options here are:

- lowering personal income tax rates or raising thresholds

- lowering company tax either through the rate or enhanced investment allowances.
- temporary change to the GST rate

Income tax changes tend to be permanent (or create design and administration challenges if temporary). They can feed through quickly to activity and have the potential to improve incentives for participation. An option might be to bring forward the "fiscal drag" tax cuts but this has risks to the fiscal position if trend growth is lower than expected for a sustained period. These sorts of changes tend to be relatively easy to increase and much harder to reduce in size.

Lowering the company tax rate could be expected to support the investment climate but the immediate effects are questionable.

A temporary cut in the GST could stimulate consumption but might also lead to disruptive swings in consumption at the start and end dates.

Government investment in infrastructure

There are almost always a series of infrastructure initiatives that could be funded by government. If carefully selected and managed these have the potential to lift the supply potential of the economy and support long run growth. As such they are likely to be integral to any major package. They can also be defined as one off expenditures and hence are not likely to create long run structural budget difficulties. However, they take a long time to implement and hence have little influence on activity in the short run. There is some flexibility to increase the size of such initiatives if required but it may not be as easy to reduce them.

Land transport is a traditional area of focus. A number of both road and rail projects can be identified. In some cases these lead to ongoing Federal government responsibilities.

In the communications area some potential exists to partially fund the establishment of some broadband networks or the development of applications, particularly those that help provide services across considerable distances.

The whole package

The precise mix of initiatives will depend on the size of intervention desired. To have an influence in the short run the package would need to contain either some one off payments, income tax cuts, or a combination of these. To support long run growth the package would be best focussed on infrastructure investment.

A substantial package that had some (small) tax cuts combined with one off benefit payments/ changes over the first couple of years combined with some infrastructure investment involving spending mainly in the second and subsequent years and a credible path back to budget balance could be seen to comprehensively address the risks associated with a slowdown of the economy. If the downturn is more sever than initially thought additional one off spending would be possible. If the rebound is rapid then the path back to fiscal balance will be quicker.

FISCAL PACKAGE: LAND TRANSPORT PROJECTS

The attached proposal details possible spending packages for rail and road of up to $3.0 billion. For rail, two packages are put forward in order of priority with a combined expenditure of over $1.0 billion. For road, three packages are also proposed in order of priority with a combined expenditure of over $2.0 billion. The packages can be readily adjusted downwards. Given the lag time involved with major infrastructure projects the proposal should be viewed over a four-five year time frame.

The Australian Government, through the Australian Rail Track Corporation (ARTC), intends to upgrade the interstate rail track, particularly over the next five years. The Commonwealth also funds upgrading and maintenance of the National Highway System and contributes to State upgrading of certain Roads of National Importance under the National Highway and Roads of National Importance programme (expected to spend $3.2 billion over period 2003-04 to 2005-06).

Outside of identified additional projects, additional funding may be used to accelerate existing Australian government spending commitments under this programme.

The Department of Transport and Regional Services administers both these areas and should be consulted (in particular with a view to what is 'achievable' within the desired timeframe, given the construction lead times on projects) prior to finalisation of a proposal.

ASSESSMENT AGAINST DESIGN CRITERIA

Does the initiative support ongoing "supply" in the economy?

Yes. The projects would support interstate and international trade by reducing transportation costs. Greater interstate trade would help to more fully realise economies of scale in domestic industries, and decrease prices or increase choices for consumers by facilitating competition among interstate producers.

Are the initiatives consistent with policy directions and not introduce significant distortions in resource allocation or reductions in efficiency?

Yes. The projects are consistent with a proposed national land transport infrastructure plan (AusLink), and are expected to increase transport efficiency and increase national economic welfare overall. All projects are considered under a cost-benefit framework. The railway projects may also help to slow the growth of greenhouse gas emissions and reduce maintenance costs of the National Highway System.

Does the initiative deal with current spending pressures where action is likely in any case, and is it fiscally discrete?

Yes. The Minister for Transport and Regional Services intends to go to Cabinet in October/November seeking agreement to release of the Auslink White Paper, and in that context in principle agreement to increased funding of $2.4 billion over five years for the National Land Transport Network (including the National Highway System and Interstate Rail Network).

By their nature, road and rail projects are one-offs and unlike AusLink (which envisages on-going shared Commonwealth/State responsibilities) the initiative would be fiscally discrete (but note: upgrading one part of either network may increase usage to an extent that justifies upgrading another part of the network).

Also, see below in relation to ramping the projects up or down.

Are the initiatives quick to implement – minimal delays through negotiation and set-up costs and likely to influence activity quickly. Such influences on activity could be through

- **Announcement effects which could bring forward spending such as those sometimes associated with tax changes**

- **Cash flow effects.**

Most of the projects would not be quick to implement. Smaller projects or maintenance works may be undertaken relatively quickly, but any major project would be put to tender and detailed design work would be required. A lag of at least several months might be expected between the announcement of projects and the commencement of construction.

While the Commonwealth retains funding responsibility for the National Highway System, the States act as agents for the Commonwealth in upgrading and maintaining the roads, thus Memoranda of Understanding would need to be signed. If the project is a road of national importance (eg the Pacific Highway) or in an urban area it is also necessary to secure State Government or private sector funding (as a public private partnership). Typically a road project could take two years or longer from initial concept stage to start of construction. Large projects might take four years to complete.

Major interstate rail projects within NSW would be unlikely to commence before 2004 because a Memorandum of Understanding about the ARTC's control of NSW rail track remains to be signed.

Induced investment

It is quite likely that substantial spending by train operators (eg, the purchase of new locomotives and rail wagons) would be precipitated by an announcement of major improvements to the interstate rail track. The dominant interstate train operator has stated that rail's share of freight on the Melbourne-Sydney-Brisbane route would double if the track were significantly improved. Such a transformation would require the operation of many more trains.

As road transport is a more diverse business, it is less likely that there would be an announcement effect from increased investment. Instead, demand for and volume of transport service provided would be expected to increase as relative prices fall.

Does the initiative leverage private sector activity eg FHOS

Yes. As mentioned immediately above, spending on rail track would induce investment by transport operators.

There is scope for some public private partnerships on urban portions of the national highway. However, it is unlikely that a PPP project would commence in the next two years (for example the

Western Sydney orbital to F3 link, currently subject to a feasibility study, if supported is expected to commence in 2007).

Are they able to be ramped up or closed down both technically and politically

- **Once a policy or payment is established it is often hard to reduce or eliminate it, just as it is often difficult to raise tax rates.**

Yes. It is expected that the interstate rail track would become largely self-funding when it has been upgraded to a suitable standard. The ARTC could operate that track on a commercial basis, earning sufficient fees from train operators to pay for track maintenance. A suitable standard for the interstate rail track would enable trains to compete more effectively with trucks, particularly on the Melbourne - Sydney - Brisbane route. In general, the higher the standard of rail track, then the lower the transit (journey) times for trains. Lower transit times would mean that trains could compete for more time-sensitive, higher value freight.

The projects can be ramped up. A larger scale of investment would enable rail tracks to be improved sooner. The attached spreadsheet shows two indicative railway investment programs, the larger roughly double the scale of the smaller. In general, the smaller scale program would address the most immediate investment needs, and may have a higher average benefit-cost ratio.

As noted above, road capital projects are one off projects. Expenditure in the roads programme is often reprioritised to fit fiscal needs and deal with project delays.

What is the impact on activity – this will depend on a number of things including:

- **The propensity of those receiving a payment to spend it – those who are liquidity constrained are likely to spend the majority of any increase. This can change with economic circumstances and peoples confidence in the future.**

- **The sorts of things people are likely to purchase – the higher the import content the less impact on activity.**

The projects would have a slower effect on activity than most other spending proposals due to the probable extended lag between announcement and construction. However, they would have a low import content and, when completed, would facilitate interstate and international trade. These attributes suggest that the eventual effect on activity may be relatively great and relatively sustained.

The projects would be undertaken predominantly in rural and regional areas, which generally have higher unemployment rates. They would require substantial construction-related resources and therefore increase the demand for construction-related materials, labour, and equipment.

The projects would also expand the tradeable goods sector (to the extent that lower transportation costs increase international competitiveness).

POTENTIAL INFRASTRUCTURE: COMMUNICATIONS

The sector has a high level of ongoing investment and the basic telephony network is extensive. Mobile phone networks also cover about 98 per cent of the population, largely as a result of private sector investment decisions but also reflecting government assistance for establishing coverage in some smaller communities. Nevertheless, expenditure on elements of the communications system's infrastructure may offer medium to long-term benefits.

One area that might usefully be considered for funding is broadband infrastructure. Broadband take-up rates are low. This reflects a number of factors: primarily the absence of 'killer' applications that would drive demand; untimed local calls (which reduce the relative cost of dial-up access); and in some areas lack of infrastructure. There are in time potential benefits from increased productivity if broadband infrastructure was more widely in place, particularly in regional areas. Depending on the mechanism chosen, there may also be synergies with education and health policy goals were funding directed towards broadband infrastructure projects in these areas.

34 (3)

Coordinated Communications Infrastructure Fund (CCIF)

The Government's response to the RTI allocated $24 million over four years to establish the CCIF. This fund is to accelerate the roll-out of broadband into regional Australia in concert with the demand aggregation brokers, as part of the National Broadband Strategy.

- Funds will be strategically allocated to link projects and the States and Territories will be asked to at least match this funding dollar for dollar.
- The CCIF has a wider brief than the $50 million National Communications Fund (NCF) it builds on, with the intention to fund communications projects more broadly than just those in the education and health sectors in regional and rural Australia.
  - The NCF received 59 bids requesting $400 million in total. Funds were allocated through a competitive bid process. The $50 million of Commonwealth funding leveraged a further $66.8 million in contributions from state governments and other consortium parties.

34 (3)

Funding for the CCIF could be increased.

34 (3)

Health

34 (3)

It would have facilitated the connection of all aspects of the health system, including hospitals, health centres and health services providers, such as pathology laboratories, to an integrated broadband network.

- The expanded broadband capacity flowing from this would enable more rural areas to access electronic commerce (eg. electronic prescribing, electronic Medicare claims and payments), deliver services through telemedicine, communicate electronically and electronically store clinical information.

- This funding would complement existing health communications programs such as the GP Network, Health Connect and the initiative undertaken by the Health Insurance Commission.

Education

34 (3)

Other proposals

34 (3)

- **Extending the long haul capacity of the higher education infrastructure network** from major cities to regional centres to act as a regional hub for regional telecommunications service providers to improve broadband infrastructure in regional areas.

- **Developing a nationwide intranet for content and curriculum interaction among schools, training and key cultural institutions.** This would reduce the potentially significant inhibitor of content downloading costs, while ensuring high-quality e-mail and web browsing services are available. To establish a coordinated and nationwide content intranet there would need to be Commonwealth involvement.

GOODS AND SERVICES TAX (GST) AND DOWNTURN OPTIONS – GEM

During an economic downturn, an alternative discretionary counter-cyclical fiscal policy tool to personal income tax cuts may be to lower the GST rate from its current level of 10 per cent. This option is designed to stimulate consumption by changing the relative price of consuming now versus in the future.

This paper is designed to provide some key issues for consideration. A more detailed paper is currently being prepared by ITD.

Issues to consider

- Size of the Cut. By how much would the GST rate need to be cut in order to have the desired impact on consumption? Some examples:

Saving from GST rate change

		Fridge	Car	New House
		$1,443	**$32,000**	**$380,000**
Cut GST rate by	1% point	$13	$291	$3,455
	2% points	$26	$582	$6,909
	3% points	$39	$873	$10,364
	4% points	$52	$1,164	$13,818
	5% points	$66	$1,455	$17,273

- Announcement of the Cut. How much time should businesses be provided in order to adjust for the rate cut?

- Duration of the Cut. For how long should the GST rate cut last? Should the Government announce a specific end date? (The Charter of Budget Honesty requires that we specify that the measure is temporary and how it will be reversed.)

  - Clear end dates could lead to significant swings as consumers may only change their behaviour close to the end date.

- Effect on consumption behaviour. A temporary change in the GST rate may lead to significant swings in consumption, at the time the rate cut is introduced, and again at the time the rate is reversed to its original level.

  - This was evident in the motor vehicle and housing sectors at the introduction of the new tax system (see attachment).

- Commonwealth-State relations. The unanimous approval of the State and Territory governments is currently required for a change to the GST rate. The Commonwealth would need to pass amendments to the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* to make this change unilaterally.

- Lag effects. Seeking approval from the States and Territories and passing a legislative amendment may involve considerable lags. In addition, a change to the rate may need to coincide with the beginning of the GST quarter. Furthermore, a GST rate cut may take a while to flow through the entire supply chain (as GST is collected throughout the chain and not just at the retail point).

- <u>Various rates?</u> An alternative to an across-the-board tax cut may involve selectively targeting rate changes at a particular subset of goods or services, such as more expensive and discretionary items like motor vehicles and electrical goods. However, this may raise significant compliance costs and draw comparisons with the wholesale sales tax regime.

Compliance and administration costs

- <u>Adjusting systems</u>. As the GST systems are already in place, it is arguable that businesses should be able to temporarily lower the GST rate without huge compliance costs.
  - However, it is unclear what changes would be required for software and businesses would need to reprice stock on hand (in some cases manually). This may impose large compliance costs on small businesses, in particular.
    - : Note that for the introduction of the new tax system, the Government provided $500 million to small and medium businesses in start-up assistance to upgrade their systems.
  - There will be two sets of compliance costs. This will occur at the time the rate cut is introduced, and again at the time the rate cut is reversed. Is the Government willing to provide assistance at both points in time?
- <u>Claiming input tax credits</u>. The ATO would need to ensure that businesses claimed the appropriate input tax credit for this stock (that is, at the rate that reflects when the inputs were purchased).
- <u>Enforcing pass-through of the rate cut</u>. How would we enforce the cuts when the price impact is likely to be small? Would we need Australian Competition and Consumer Commission prices monitoring (and therefore funding)?
- <u>Education and Assistance</u>. Significant advertising may be required to ensure that businesses are aware that the change is coming and are well prepared. This may also require further ATO resources to assist businesses.

ATTACHMENT

CONSUMPTION BEHAVIOUR IN THE CHANGE TO THE NEW TAX SYSTEM

- In the lead-up to and following the introduction of the new tax system, consumption patterns diverged due to anticipated price changes, particularly in the motor vehicle (net tax decrease) and housing (net tax increase) sectors.
  - *Tax Reform – Not a New Tax, A New Tax System*, released in August 1998, indicated that the prices of new homes were expected to rise under a GST. It also noted that the price of cars would generally fall as a result of the change from a wholesale sales tax to the GST.
  - In May 2000, the Australian Competition and Consumer Commission released a publication, *Australia's Everyday Shopping Guide with the GST*, which indicated that motor vehicle prices were expected to fall by as much as 8 per cent and prices of new homes may increase by about 7.8 – 9 per cent.

Motor vehicle industry – reaction to an anticipated price fall

- The motor vehicle industry had raised concerns that consumers would not purchase cars in the lead-up to the new tax system. Consequently, the Government announced that it would phase-in input tax credit entitlement for vehicles, effectively smoothing the reduction in tax (and therefore prices) (from 22 per cent WST to 10 per cent GST) for registered buyers.
  - In the first year (2000-01) registered entities were not entitled to input tax credits on motor vehicle purchases.
  - In 2001-02, registered entities would be entitled to 50 per cent of input tax credits for motor vehicle purchases.
  - Full input tax credits would be available for these purchases from 1 July 2002.
- In practice, the industry discounted prices of their trading stock in the lead up to the new system and sales remained fairly steady, although there was some deferral of purchases.
- The Government announced on 22 May 2001 that it would bring forward entitlement to full input tax credits (over a year earlier than announced).

Housing sector – reaction to an anticipated price rise

- In contrast, dwelling investment had strong growth in the lead-up to the new tax system as consumers brought their house purchases forward, but experienced a sharp decline in the September and December quarters of 2000.
- In response, the Government doubled the grant available under the First Home Owners Scheme for new houses purchased between 9 March and 31 December 2001.
  - A significant temporary GST rate cut may lead to a similar boom-bust cycle in the housing sector (especially if the end date were pre-announced).

TAX OPTIONS

As part of the current Fiscal Package Development project, we have been requested to formulate personal income tax cut options targeting low to middle income earners. We have produced indicative estimates of the likely cost to revenue for each option – the figures are ballpark estimates only, not accurate costings.

We have also examined each option in combination with a $100 increase in the Low Income Tax Offset (LITO).

All options have been calculated to commence from 1 July 2004.

The three different options that have been examined are listed below:

Option 1	Decrease tax rates	17%↓15% and 30%↓28%
Option 2	Raise tax thresholds	$21,600↑$25,000 and $52,000↑$55,000
Option 3	Raise tax thresholds	$21,600↑$25,000 and $52,000↑$62,500

Option 2 could be a first year step to Option 3. In Option 3, the current 42% tax rate is effectively eliminated.

Table 1 (see attached) shows indicative estimates of the likely cost to revenue of each option.

Table 2 (see attached) shows the estimated reduction in tax liability for each option, for individuals on various levels of income. Tax reductions are shown as annual figures ($), weekly figures ($) and percentages, for annual taxable incomes from $10,000 - $80,000.

We have not included any options which lower the top marginal tax rate or raise the top tax threshold, due to our brief to target low to middle income earners. The following "rules of thumb" would apply for any increase in the top threshold or decrease in the top rate:

	Income year impact ($million)			
	2004-05	2005-06	2006-07	2007-08
Raise $62,500 threshold by $1,000	-50	-100	-100	-100
Decrease 47% tax rate by 1%	-650	-850	-900	-1,000

We will be doing further work in the coming months to examine other, wider, options regarding rates and thresholds. Our work will be informed by the results from a number of Revenue Group projects (eg results concerning labour market participation effects, and the progressivity of the tax system).

Current Thresholds 2003-04	
$0-$6,000	0%
$6,001-$21,600	17%
$21,601-$52,000	30%
$52,001-$62,500	42%
Over $62,500	47%

TABLE 1

	Income year impact ($million)			
	2004-05	**2005-06**	**2006-07**	**2007-08**
Option 1 17% to 15% and 30% to 28%	5,000	5,500	6,000	6,000
-Plus LITO increase of $100	5,000	6,000	6,000	6,500
Option 2 $21,600 to $25,000 and $52,000 to $55,000	3,500	4,000	4,000	4,500
-Plus LITO increase of $100	3,500	4,500	4,500	4,500
Option 3 $21,600 to $25,000 and $52,000 to $62,500	5,000	6,000	6,000	6,500
-Plus LITO increase of $100	5,000	6,000	6,500	7,000

*Note: althought LITO increases from 1 July 2004, this is delivered through the annual tax return and hence does not ha

A TEMPORARY [18 MONTH?] INVESTMENT ALLOWANCE [10 TO 20%?].

- Major drawbacks are that it:
  - could be pro-cyclical (depending on the timing of the measure and the length of the downturn); and
  - may provide tax benefits predominantly for investments that would have occurred in the absence of the measure (although some bringing forward of activity could be expected).
- No regrets? — adds in a potential distortion to investment decisions, but only in the short term. Could send a positive signal to businesses.
- Fiscally discrete? — using ABS data, combined with past experience, it could be costed within relatively small margins of error.
- Quick to implement? — Can be announced and implemented quickly. The law could be based on past investment allowances.
- Leveraging private sector? — perhaps, but possibly only in terms of bring forward of activity. Note, however, that the impact on private activity falls as the output gap and excess capacity grow.
- Deal with current spending pressures? — possibly, if business is arguing for a return of accelerated depreciation.
- Ramped up or closed down? — yes
- Impact on activity? — could result in some bring forward of investment activity, but with a lag, noting that the impact on private activity falls as the output gap and excess capacity grow.

(It would be helpful if an assessment of the effectiveness of past investment allowances could be undertaken so that appropriate advice could be provided.

CUT IN THE COMPANY TAX RATE

The major drawback it that it could increase the gap between the company tax rate and the top marginal rate.

Any such measure could be presented, not necessarily as a short-term fix, but as a measure to increase the competitiveness of the Australian for FDI.

- No regrets? — Could send a positive signal to businesses and the investment community. Depends on whether the Government had predisposition in this direction.
- Fiscally discrete? — the fiscal impact would depend on the size of the cut. There would be a partial claw back (with a lag) through the decline in the value of imputation credits.
- Quick to implement? — Can be announced and implemented quickly.

- Leveraging private sector? — Depends on the overall investment climate. Could be an attracter for FDI.

- Deal with current spending pressures? — possibly, if the business sector was arguing for a return of accelerated depreciation as compensation for increased effective lives (resulting from the Commissioner's review). A company tax rate would be preferable on tax policy grounds as it maintains the base and lowers the rate (rather than distorting investment decisions through base narrowing).

- Ramped up or closed down? — yes

- Impact on activity? — unlikely to result in any short-term pick up.

25 July, 2003

CONSUMPTION RATIOS AND IMPORT LEAKAGE BY DIFFERENT GROUPS

Findings

Analysis of the most recent Household Expenditure Survey (HES)[1] data indicates that households with lower earnings tend to have a higher marginal propensity to consume. Households whose income is predominantly from unemployment benefits and other government pensions and allowances also have higher marginal propensities to consume. The number of children in the household does not appear to make a significant difference, possibly except for single parent families (higher consumption rates) and couples with non-dependant children (lower consumption rates). Potential problems associated with using HES data for this analysis are noted below.

There does not appear to be significant differences in import consumption rates between households of different incomes, as indicated by the available data.

Attachment A contains tables outlining these results. Attachment B contains a brief discussion of the One-Off Family Payment Allowance from the 1992 One Nation package.

Using HES to estimate the marginal propensity to consume

Given the lack of alternatives for assessing the marginal propensity to consume, the HES expenditure data has been compared to the HES income data to provide a guide to the marginal propensity to consume across income groups. There are, however, problems with basing an analysis of consumption and savings rates on HES data, in particular:

- There is a timing difference between income and expenditure estimates – income is on a usual receipts basis and income estimates for different income sources are for different periods; expenditure estimates for different items also refer to different periods.

- Aggregated HES data significantly underestimates savings, by comparison to national accounts, although this difference has narrowed significantly over the last 10 years. The 1998-99 HES savings rate estimate is 0.5% whilst the national accounts estimate is 2.4%[2].

- The lower decile is often excluded from analysis as unreliable. ABS can provide data by deciles, rather than the published quintile data (for a charge). At this stage the information has not been sought.

- HES shows estimates of current expenditure and income. This analysis assumes that current spending patterns are indicative of how additional income would be spent, but this may not be the case. For instance, people in the lower income quintiles may be dis-saving as a response to frictional unemployment, running down assets in the expectation of future income when they get a job. In such cases, additional income may be saved, rather than consumed, even though they currently have negative overall savings rates.

Whilst these problems may reduce the reliability of using HES to calculate marginal propensities to consume, they do not necessarily render comparative analysis unreliable.

[1] Household Expenditure Survey, 1998-99, ABS Cat. No. 6530.0

[2] Australian System of National Accounts, 2001-02, ABS Cat. No. 5204.0 (using data from 1998-99)

- It is not clear that the problems affect some groups more than others. If it is assumed that the problems affect all groups equally, then the data is comparable across groups, even though absolute values are inaccurate. Thus lower quintiles are expected to spend significantly more of any extra income than the higher quintiles, although the amount their spending will increase is unclear.

The results are largely supported by a Melbourne Institute study,[3] which uses an independent survey of household savings. They find that current income is the most important determinant of consumption rates, with lower income earners consuming more relative to saving. Other factors that increase consumption rates are the age of householders (older people consume more, when adjusted for incomes), and the level of economic optimism. Whereas the HES analysis found the number of children to have no discernible effect, the Melbourne Institute study found that households with more children are more likely to consume more of their income. The difference in results, by comparison to the HES analysis, may be due to the Melbourne Institute adjusting for incomes when assessing the effects of children.

Import leakage

The HES data does not distinguish between consumption of imports versus locally produced goods and services, so the degree of leakage between different groups is difficult to determine. Calculations, using Australian National Accounts Input-Output Tables,[4] did not indicate any significant differences across income groups.

Import leakage estimates were calculated for each income quintile by taking the quintile's expenditure share for each of the 13 HES consumption categories, and multiplying this by import content estimates taken from the Input-Output Tables. As there is limited variation in how different quintiles allocate spending to different HES consumption categories, there is no significant variation in import leakage estimates.

These results do not take into account that, in a given HES consumption category, import penetration is unlikely to be the same for households of different income levels. For instance, when a higher income household spends money on transportation, it may purchase more expensive fully-imported cars whereas lower income households may purchase less expensive, locally-produced vehicles.

Payment method

The payment method may impact upon recipients' marginal propensity to consume additional income. The permanent income hypothesis suggests people would be expected to save more of a one-off lump-sum payment than an on-going, smaller payment. This may not affect the relative consumption proportions across groups, just the actual consumption proportion that is observed.

Strategy and Group Services Unit (SGSU)

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[3] Harris, M., J. Loundes, and E, Webster (1999) "Determinants of Household Saving in Australia" Melbourne Institute Working Paper No. 22/99. The hypothesis that lower income levels correspond to higher propensities to consume is supported in many other articles. See, for example, Quiggin, J (1992) "Fightback and One Nation: A comparative analysis" Australian Tax Forum 9(2) 12754; and Tobin, J (2001) "Fiscal Policy: Its Macroeconomics in Perspective" Cowles Foundation Discussion Paper No. 1301.

[4] Australian National Accounts Input-Output Tables, 1996-97, ABS Cat. No. 5209.0

Attachment A

CONSUMPTION RATES RESULTS

Source: Household Expenditure Survey, 1998-99, ABS Cat. No. 6530.0

By income quintile		Percentage of income consumed
Lowest 20%	\$0 - \$300	217 %
Second quintile	\$300 - \$552	123 %
Third quintile	\$552 - \$884	107 %
Fourth quintile	\$884 - \$1373	96 %
Highest 20%	> \$1373	80 %
All households		99.5%

*Actual all household consumption rate is about 91 per cent.

By principle source of household income	Percentage of income consumed
Employee income	92 %
Own business	96 %
Total earned income	92 %
Other income - superannuation receipts, interest receipts, compensation, etc	136 %
Unemployment/sickness/education allowance	144 %
Age/disability pension	113 %
Other government pensions and allowances	120 %
Total government pensions and allowances	119 %

By household composition	Percentage of income consumed
couple no children	99 %
couple, one child	97 %
couple, two children	101 %
couple, three or more children	103 %
couple, dependent and non-dep children	100 %
couple, non-dependent children only	91 %
One parent, dependant children	110 %
Lone person households	101 %

IMPORT CONSUMPTION RATES RESULTS

Sources: Household Expenditure Survey, 1998-99; Input-Output Tables, 1996-97

By income quintile		Percentage of income consumed in imports
Lowest 20%	\$0 - \$300	15.9 %
Second quintile	\$300 - \$552	16.3 %
Third quintile	\$552 - \$884	16.4 %
Fourth quintile	\$884 - \$1373	16.9 %
Highest 20%	> \$1373	17.1 %
All households		16.7 %

Attachment B

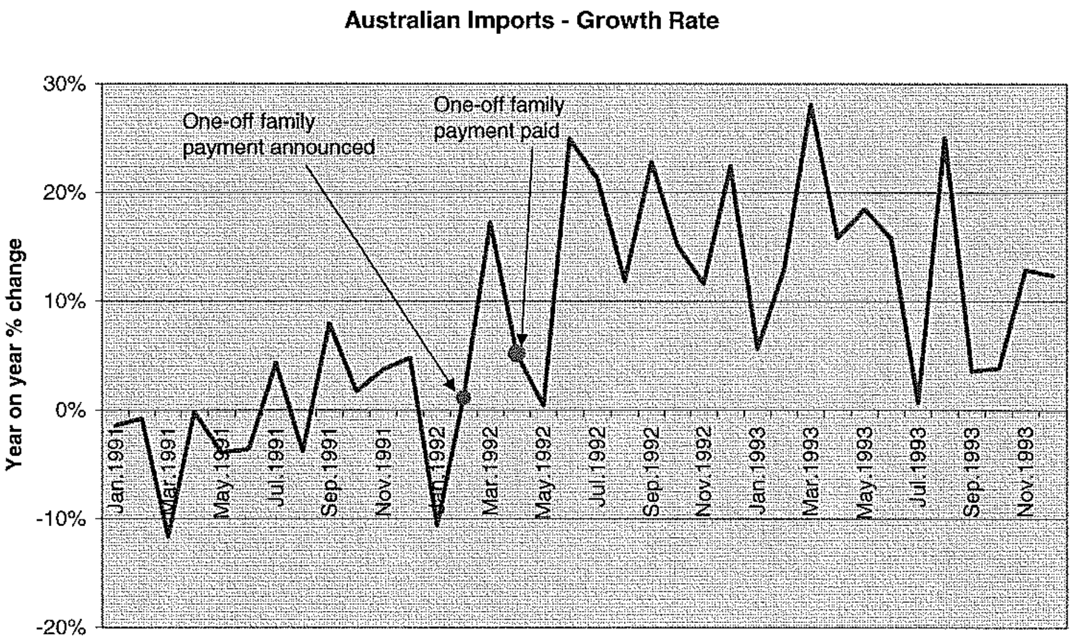
ONE NATION ONE-OFF FAMILY ALLOWANCE PAYMENT

The payment

The 'One Nation' statement of 26 February, 1992, included a commitment to make a one-off lump sum payment to all families to whom Family Allowance was payable. The payment was made on 2 April 1992 and ranged from $125 for a family with one child up to $250 for families with five or more children. The total cost of the measure was estimated at $317 million.

We have not been able to find commentary and analysis specific to the One-Off Family Allowance Payment. Therefore we cannot substantiate the assertion that these funds were spent largely on imports.

Effect on imports



The total bonus ($317 million) was equal to about 8% of monthly imports in the first half of 1992. Monthly imports are liable to change by this much from month to month due to their natural volatility. This means it would be difficult to identify any effect on imports arising from the one-off payment, even if the payment was completely spent on imports in the one month.

In addition, retailers use of inventories and possibly delayed consumption by families mean any effect on imports would be likely to be diluted over several months, further complicating identification.