Australia's longer-term economic challenges

Address to the 2015 Australian Conference of Economists

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Thank you for the invitation to be here today.

My message today is rather basic, possibly boring and it is not novel.

It's also a difficult message that doesn't jell with our current economic conditions, nor with the wonderful life we live in Australia.

Put simply, I worry that we are overly complacent about our longer-term outlook and, especially so, in a region that's pushing ahead at a remarkable rate of knots and may leave us behind.

Some of this complacency can be explained by the fact that the Australian economy is now entering its 25th consecutive year of growth.

This is the second longest continuous period of growth of any advanced economy in the world[1].

And the growth continues.

There will always be doubters but the recent Budget economic forecasts still describe one of the better shorter-term economic outlooks in the world.

[1]The longest was the Netherlands from the December quarter of 1981 to the March quarter of 2008.

And data since the Budget have not given Treasury a reason to rethink the thrust of these forecasts.

The March quarter National Accounts confirm there is increasingly broad-based momentum in the Australian economy – the real economy grew by 0.9 per cent in the quarter, to be 2.3 per cent higher over the past year. [2]

And labour market outcomes have been a little better than expected.

There will always be risks to the economic outlook but, for this year, there is little reason to be a doomsayer.

But we are, of course, keeping a keen eye on international developments, particularly in China and Europe, as they may affect the global outlook and global confidence, which could have flow-on effects to Australia.

Having said this, our current and recent record should not distract us from recognising and addressing the deep challenges that lie before us.

Laying the foundations for future growth is of great strategic importance if we are going to take our full place in the fastest growing region in the world.

Sustained, long-term growth clearly requires structural reform, which I will get to.

But the other side of the equation is demand-driven growth.

We can think of these issues in two camps.

[2] ABS Cat. No. 5206.0

But they are mutually reinforcing.

One is the need to promote sufficient domestic demand and to benefit from international demand to drive us back to our longer term level of potential output.

In other words, to close our output gap.

The second is that we must also be able to take advantage of periods of stronger growth in demand for our outputs to undertake the necessary structural reforms to increase productivity and, in turn, sustained growth in real incomes.

We often think of growth purely in terms of the mining sector.

We know the story there.

But we are also blessed by a highly productive and broad-based agricultural sector that has strong potential to feed the expanding middle classes across our region and beyond.

Our resource endowments are extraordinary.

Of course, many of the factors that determine demand for our outputs are linked to the international outlook.

Importantly for Australia, the US is re-emerging as a driver of global growth.

And although the past few weeks have seen a flurry of volatility in share markets in China, we have seen many such flurries over the past ten years or so.

And, of course, the Shanghai market remains well above the levels of a year ago.

As I already mentioned, we are monitoring these developments closely.

Our dependence on international demand underlines the value of continued efforts to liberalise global trade.

One mechanism for doing that is Free Trade Agreements.

There is also room for much higher investment from and into our region.

To illustrate, our exports to the Asia-Pacific region accounted for over 70 per cent of our total exports in 2013.[3]

By contrast, inward foreign direct investment from the Asia-Pacific region in 2013 was only AUD $141 billion – less than 25 per cent of all investment into Australia.[4]

And outbound investment into the Asia Pacific region was a relatively modest $AUD110 billion – with over half of that figure into New Zealand.[5]

Aside from demand, the other side of the growth equation is undertaking supply-side reforms to ensure that we continue to improve our productivity and living standards.

[3]Department of Foreign Affairs and Trade (see http://dfat.gov.au/trade/resources/trade-statistics/Pages/trade-time-series-data.aspx)
[4]ABS Cat. No. 5352.0
[5]Ibid

Today, we approach any reform task better prepared and with stronger economic fundamentals than we had at the start of the 1980s, precisely because of the reforms undertaken back then and subsequently.

Reforms such as the floating of the dollar, financial market deregulation and the move to enterprise bargaining as well as the oft-forgotten reductions to the top personal marginal tax rate over the mid-to-late 80s.

It is very hard to overestimate the magnitude of those changes and they continue to set the benchmark for us today.

In order to achieve reform, we built a political consensus but, more importantly, a community consensus that things had to change and that a delay would make matters worse.

These reforms underpinned a terrific period of sustained productivity growth.

Australia’s multifactor productivity growth over the period of the late 1990s outperformed many European countries as well as the US, UK and Canada.

We showed that we could compete internationally.

Once the mining boom came along though, we could have been accused of having become complacent.

And some in our community now seem to have accepted ever-increasing government spending as a legitimate path to sustainable growth.

It is not.

There are few, if any, examples in recent times of developed countries spending their way to long-term prosperity.

The Intergenerational Report – or IGR – highlighted the challenges that now lie before us: an ageing population, a challenging budget repair task and ever-increasing expectations around social expenditure.

Now we need to remember that the growth projections in the IGR are underpinned by an assumption that we will achieve the same 1.5 per cent annual productivity growth over the next 40 years as we have over the past 30 years[6].

That period, of course, included the dividends of the reforms of the 1980s and 1990s.

Since the turn of the century, our productivity performance has waned, both by our own standards and relative to our international peers.

Current rates of average labour productivity growth remain well below the rates – around 2½ per cent – experienced in the late 1990s and early 2000s.[7]

Since the terms of trade peaked in the September quarter of 2011, real per capita income has fallen by 1.6 per cent. [8]

Given the economic outlook, the best way to improve the material living standards of Australians over the long term is by improving our productivity performance.

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[6]2015 Intergenerational Report *Australia in 2055* (March 2015)
[7]ABS Cat. No. 5204.0 (Note: Based on five-year compound growth rate)
[8] ABS Cat. No. 5206.0

Other countries are not standing still in this regard. Spain, as it emerges from the GFC, has embarked on a wave of ambitious reforms to support growth.

This includes liberalising its labour market, broadening its tax base and reducing tax rates for both companies and individuals.

Recently, we had a visiting international delegation out here looking at the Australian economy.

I was struck that when we talked about economic reform they said our labour market conditions were really good.

And then I realised that their point of comparison was Europe!

Closer to home, countries in our region are also pushing ahead with major structural reforms.

India's economic outlook has been bolstered by policy reforms including the introduction of a GST and a staged reduction in the rate of company tax, significant reduction of foreign investment barriers in key sectors, and new investment initiatives to develop new industrial corridors and smart cities.

Unless we lift productivity growth, through reforms across all sectors of our economy, we face a future of stagnant and possibly declining living standards – a bequest to our children and grandchildren which no other generation of Australians has left.

Clearly, one of the most pressing reform priorities is the tax system.

Unashamedly, I believe we are better-placed as a lower-taxing country than a higher-taxing one.

That is a choice that we must make as a society.

If society chooses to go down the high taxing, high spending route then that’s fine but the consequence will, I believe, be lower growth.

The tax reform debate should also consider our international competitiveness – and that means looking at both our relatively high rates of tax and the tax mix.

Reform-focused efficient taxes with a less mobile base will move us towards a better tax system than the current 1950s model.

As a general rule, taxes impose a degree of dead weight loss on the economy.

That is, the output lost to the economy by imposing the tax can be significant and may be even more than the revenue raised.

That’s why a well-designed tax system is so important.

Stamp duties, for instance, are one of the most inefficient and distorting taxes, yet the states and territories remain heavily reliant on them as a source of revenue.

At around 26 per cent of total state tax revenue, reliance on stamp duties is at a near-record level in modern times.[9]

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[9]Derived from forecasts published by the states and territories in their respective 2014-15 state and territory budgets

Tax reform can also play a key role in fostering economic growth and innovation.

Lower taxes provide a great conduit for new investment and entrepreneurship.

The competitive tax environment in Singapore, for instance, is a driving factor in that country becoming a hub for global finance and trade.

And having been a senior executive of a global bank, I know that lower personal taxes help to attract and retain top talent.

Two recent studies from the respected National Bureau of Economic Research in the US support this view.

One study found that with a 10 percentage point reduction in a country's top tax rate, that country retains one per cent more domestic inventors, while also attracting 38 per cent more foreign inventors who choose to move to the lower-taxed country.[10]

And in exploiting big differences in top earner tax rates among US states, the other study found that, in the long term, a one per cent increase in after-tax income in the destination state relative to the state of origin draws in 1.7 per cent more star scientists to the destination state.[11]

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[10] Akcigit, Baslandze and Stantcheva 2015, *Taxation and the International Mobility of Inventors* (NBER Working Paper No. 21024), page 4.

[11] Moretti and Wilson 2015, *The Effect of State Taxes on the Geographical Location of Top Earners: Evidence from Star Scientists* (NBER Working Paper No. 21120) pages 3, 4. (Note: 'star scientists' were defined as the top 5 per cent of patenters.)

As you would be aware, Australia's top income tax rate of 49 per cent[12] applies at incomes greater than $180,000, which, at 2.3 times the Australian average full-time wage, is a relatively low threshold. [13]

The fact of the matter is that the top income earners already make a large contribution to Australia's tax take.

Currently, the top one percent of taxpayers who pay the top marginal rate contribute 17 per cent of all personal income tax.

And the top 10 per cent contribute 46 per cent of all personal income tax.

Over the next decade more Australians will move into the top tax brackets.

The proportion of taxpayers in the two highest tiers is expected to increase from 27 per cent to 43 per cent in 2024-25.[14]

By comparison, Hong Kong has a top marginal tax rate of 15 per cent on incomes above HKD$120,000; and Singapore of 20 per cent above SGD$320,000.[15]

As the classical labour economists will tell you, decisions in this space are often driven by the work versus leisure trade-off.

For example, whether you choose to work a four- or a five-day week.

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[12] The statutory rate is 45 per cent. The Medicare levy of 2 per cent also separately applies to most taxpayers' total taxable income. The Temporary Budget Repair Levy is payable at a rate of 2 per cent on taxable income over $180,000 between 2014-15 and 2016-17.
[13] *Re:Think Tax discussion paper* (March 2015) p46
[14] Ibid p22
[15] KPMG Individual Tax Tables (see http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/individual-income-tax-rates-table.aspx)

If you are facing a high marginal tax rate, then the marginal utility equation may very well tip in favour of spending the fifth day on the beach.

These are not the incentives we want to be creating.

It's also widely understood that the high top personal income tax rate in Australia encourages innovative, complex and costly tax planning.

This is one area where Australia has a world-leading industry – but surely something is fundamentally wrong with our tax system when the community at large responds by spending so much time and money on gaming the rules.

Lower-income secondary earners also face decisions as to whether to be in the labour force or not.

For them, the intersection of the tax and transfer systems can be very important and can create high effective marginal tax rates.

We also mustn't forget that Australians legitimately want equity in the tax system.

So this sense of fairness has to be balanced against the potentially detrimental economic effects of high marginal tax rates.

More broadly on our tax mix, as other economies move more towards indirect taxation, we must consider our relatively heavy reliance on company tax compared with some of our peers.[16]

Company tax has always been an inefficient tax because the true economic cost of raising revenue is much higher than for most other taxes.[17]

There is sometimes a perception that lowering the corporate tax rate is mainly a free kick to multinationals.

This is not the case.

Lower company tax makes investing in Australia more attractive for all companies, large or small.

We must also think about indirect taxation in the context of a declining proportion of our population being in the workforce in coming years.

And for those in the workforce, workplace relations reform is crucial in harnessing our human capital and driving productivity growth.

Regulations in this space have been progressively and substantially reformed in recent decades.

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[16] Australia's corporate tax rate remained unchanged at 30 percent since early 2000 while Canada, Singapore and UK have lowered their corporate tax rates in recent years (to 26.5 per cent, 17 per cent and 20 per cent respectively).

[17] Modelling released by the Treasury in April 2015 suggests that raising an additional dollar of net revenue through the company income tax has a welfare cost (marginal excess burden) of around 50 cents. See: Cao, Kouparitsas, Mullaly, Rimmer, Shi, Stark and Wende (2015) *Understanding the economy-wide efficiency and incidence of major Australian taxes* (Treasury Working Paper 2015-01) p20

Many of the fundamental reforms were undertaken in the 1980s and 1990s, particularly the shift from centralised wage fixing to enterprise bargaining.

These reforms delivered substantial benefits.

But it is an open question whether our workplace relations system remains well suited to the workplaces of Australia's future.

As the Productivity Commission has noted[18], despite previous reforms, Australia appears to give more weight than other English-speaking countries to elaborate rules for workplace relations processes.

That's why the Productivity Commission's Inquiry into the Workplace Relations Framework is timely.

The Harper Review, too, points to some key areas for reform.

Competition reform is a major productivity driver.
But it is difficult.

And as Harper made clear, it requires close cooperation between all levels of government.

One thing the Harper Review focuses on is exploring ways to meet the challenges of an ageing population with high quality services tailored to their needs.

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[18] *Workplace Relations Framework - The Inquiry in Context,* Productivity Commission Issues Paper 1 (January 2015)

Harper's emphasis on consumer choice and diversity of providers would allow for more responsive human services in areas like aged care and health.

Reforms in this area have already begun.

For example, under the National Disability Insurance Scheme or the NDIS, funding for disability support will follow individual service users rather than providers, allowing individuals to choose the service providers they want.

Road reform is another area of great potential, with the IMF recently noting that Australia's transport and distribution sector has the most scope for productivity-boosting reforms.

The cost of congestion in our capital cities, estimated at $16 billion in 2014, is expected to more than triple over the next 15 years.[19]

As a country, we have made some good first steps in the right direction in these areas.

These reforms need to be carefully thought through and will take time to fully implement.

Not least because many of the important recommendations of the Harper Review are in the shared Commonwealth-State space.

We shouldn't rush these reforms.

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[19] Bureau of Infrastructure, Transport and Regional Economics (2007) *Estimating urban traffic and congestion cost trends for Australian cities*, Working paper 71, Canberra, p109.

But neither should we succumb to the view that they are ‘too hard’ – and leave them for another generation to handle.

More broadly, the Financial System Inquiry has put forward some good reforms ideas.

I have to say, David Murray has done a great job in a very complex area.

There is very little in the report I would disagree with.

Of course, in Australia, like Canada, we have benefited from the response to the financial turmoil in the early 90s.

The reforms that came out of the Wallis Inquiry have, without a doubt, contributed to a much stronger financial system.

But clearly the financial market instability in some international markets over recent weeks has highlighted again the importance of a strong and resilient financial system for our overall economic prosperity.

Our ability to implement these productivity-enhancing reform is inextricably linked to Budget repair.

We would be unwise to simply wait for growth to fix the Budget.

As a country we will be in a better position to face economic and strategic challenges if we confront them with a growing economy and a strong fiscal position.

Some of these issues are very clear-cut: for example, ensuring that government net debt levels are sustainable, particularly as interest rates will not remain this low forever; and meeting the inevitable funding pressures on critical services such as health, aged care and the Age Pension.

Worthy programs to support the most vulnerable in our society – like the NDIS – have significant and growing costs.

So being proactive about addressing the funding gap in the medium term is also important.

Reforms should also deliver an economy which generates jobs.

I genuinely believe this is the best outcome from a social point of view.

During my time in the UK, I saw impressive results from some of the labour market programs introduced by the Cameron Government to move people off welfare and into a job.

Finally, we also need to remember our duty as Australians to look after the most vulnerable people in our society, such as the disabled and those who are denied the opportunity to work.

This is a real driving force for us in Treasury.

These are all good reasons to prosecute the public case for reform.

But the reforms I've outlined today require us to look beyond our own nose and accept that structural change is sometimes painful.

We don’t have the luxury of choosing only reforms that don’t have losers.

We all need to play our part.

To quote John Stuart Mill: ‘everyone who receives the protection of society owes a return for the benefit’.[20]

In making the case for reform, we all need to talk to a broader range of people to build support for change.

Economists who champion these reforms need to be at the centre of the debate.

This applies equally to big business, which is often perceived – fairly or unfairly – as self-interested.

There is a clear role for industry – big, medium and small – to speak up for reforms of national importance, even if they don’t align directly with its immediate interests.

And, at its best, the media too is critical in providing a platform for informed debate and helping the public engage meaningfully with these issues.

Thank you again for this opportunity today.

I’ve been in this job for almost six months now and have had the pleasure to work with a lot of good people who have a real commitment to delivering better policy.

[20] *On Liberty* (1859)

I’ve spoken about many important issues today that will fundamentally shape Australia’s future and I assure you we at Treasury will keep coming back to these issues - as we must.

Thank you.