



economic and political overview

2012



Economic and Political Overview 2012

About this publication

Economic and Political Overview 2012

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Page 18: Reserve Bank of Australia, Governor, Glenn Stevens, CEDA Annual Dinner, Melbourne, November 2010.

Political chapter front page: Bill Shorten and Joe Hockey, CEDA State of the Nation, Canberra, June 2011, Tony Abbott, CEDA event, Economic Challenges Facing Australia, Melbourne, August 2011, Julia Gillard, CEDA event, Address by the Prime Minister, Julia Gillard, Melbourne, February 2011.

Page 35: Peter Slipper at Parliament House in Canberra, Fairfax Media Syndication/Alex Ellinghausen, Bob Brown during a press conference in Canberra, Fairfax Media Syndication/Andrew Meares.

Page 47: CEDA event, Gender relations: Looking below the surface, Melbourne, September 2011.

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About CEDA

CEDA – the Committee for Economic Development of Australia – is a national, independent, member-based organisation providing thought leadership and policy perspectives on the economic and social issues affecting Australia.

We achieve this through a rigorous and evidence-based research agenda, and forums and events that deliver lively debate and critical perspectives.

CEDA's expanding membership includes more than 900 of Australia's leading businesses and organisations, and leaders from a wide cross-section of industries and academia. It allows us to reach major decision makers across the private and public sectors.

CEDA is an independent not-for-profit organisation, founded in 1960 by leading Australian economist Sir Douglas Copland. Our funding comes from membership fees, events, research grants and sponsorship.

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committee for economic development of australia

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The content in the 2012 Economic and Political Overview was up-to-date at the time of printing. Due to rapid changes in the current economic and political environment, it may not address the most recent developments.

CEDA's Economic and Political Overview series, taking place around Australia at the time of the publication's release, will provide the latest analysis from the report authors and business and political leaders.

foreword



CEDA's Economic and Political Overview and the series of events held around Australia to coincide with its release aims to inform our members of the opportunities and challenges that lie ahead for Australia in 2012.

The 2012 edition marks 30 years since the EPO was first published. Like its predecessors, this edition continues the strong tradition of providing leading-edge objective analysis and opinion on the key issues affecting Australia's economy in the year ahead.

Highlighting the foresight of analysis in CEDA's EPO publications, many of the issues identified in 1982 have again become key topics in 2012. For example the 1982 EPO included sections on the impact of the exchange rate on the Australian economy, industrial relations and resource development, including asking the question, do we need a resource rent tax? These are all issues discussed in this edition.

The economic chapter by Alan Oster and Alexandra Knight examines Australia's likely economic position in light of the European sovereign debt crisis and our multi-speed economy.

They conclude that the economic reforms of the 80s and 90s have ensured that Australia has been able to capitalise on opportunities such as the China boom and also weather international economic turmoil, ensuring we enter 2012 in a relatively strong position.

However, there has been a hiatus from the difficult reform decisions that are necessary to ensure Australia can maintain its strong economic position, as identified in Saul Eslake's productivity chapter.

This year presents a key turning point – if we are to insulate Australia from future economic downturns and international shocks then the political and public appetite for reform must be reignited.

In the face of incredible international uncertainty, it is now more important than ever to have policy settings that allow industry and households to respond and adapt to these economic events as they emerge.

We need to be considering reforms around removing inefficient taxes and improving the regulatory environment. Some examples of the type of reforms we should be considering are highlighted in Garry Addison's federal/state financial relations chapter, which identifies a range of tax reform options that are worthy of further consideration in 2012.

However, as identified by Peter van Onselen in the political chapter, driving a reform agenda will be difficult given we have a minority government that is likely to be focused on consolidating reforms from 2011 rather than introducing new platforms, and a Senate now controlled by the Greens.

While the EPO provides an important analysis of the year ahead, CEDA recognises that to continue to drive national debate around the important issues identified in this publication, ongoing discussion is required. That is why CEDA has planned a robust schedule of expert analysis, research and forums for 2012 that will continue to examine the issues identified in this year's EPO as new developments occur, ensuring our members remain abreast of emerging opportunities and challenges.

On behalf of CEDA I would like to thank each of the authors for their contributions and also CPA Australia for their support of this year's publication. It is support from member organisations such as this that allows CEDA to continue its important work of providing thought leadership and leading-edge research on the critical economic and social issues affecting Australia.

I hope this publication provides a valuable resource for our members and CEDA looks forward to continuing to provide expert analysis and research in 2012.

A handwritten signature in black ink, appearing to be 'S. Martin'.

Professor the Hon Stephen Martin
Chief Executive, CEDA



Alex Malley FCPA is the Chief Executive Officer of Australia's largest accounting and finance body, CPA Australia. Alex is passionate and influential on issues that matter globally to the accounting profession, business and the government sector and is particularly focused on the role CPAs have to play in the Asian region.

In addition, Alex hosts his own national television program, *evoTV's The Bottom Line*, on Australia's Channel 7's 4ME Digital. The program sees him interview recognised leaders about their lives, business philosophies, personal insights and career highs and lows. Alex currently serves on a number of boards and government sector committees, including the Audit and Risk Committee of the Office of Police Integrity, Victoria.

CPA Australia and the Committee for Economic Development of Australia (CEDA) share a rich history in providing thought leadership on Australian policy issues. Between us we have more than 175 years of disseminating information and facilitating policy debate in Australia.

This publication provides an overview of influences for the year ahead in social, economic, business and public policy that are expected to impact Australia. It presents independent research and knowledge for Australian business and community leaders who have Australia's best interest at heart.

It is precisely for these reasons that CPA Australia supports CEDA's Economic and Political Overview (EPO). Our involvement stems from taking a thought leadership position by proactive representation of our members, dedicated to driving Australia's productivity and prosperity.

By association, Australia has in the past aligned itself with the OECD. A greater focus is required to align ourselves with our neighbours, trading partners and competitors in Asia. This should be Australia's economic priority.

CPA Australia believes we need to be thinking at least 20 years ahead and laying the foundation on which we can build a diverse and sustained partnership with Asia. If Australia is to benefit from the opportunities presented by the Asian Century, we need to develop a comprehensive approach beyond economic transactions and political partnerships.

We firmly believe that engaging with the world's most dynamic economic region requires involvement beyond business and finance. What is needed are relationships established on a foundation of mutual cultural understanding and respect.

CPA Australia can speak from experience having had a successful presence in Asia for close to 60 years. During this time we've established offices throughout the region, including China, Vietnam, Singapore, Malaysia and Indonesia. As a business, one of the main lessons learned is the importance of developing relationships based on the long-term in establishing or expanding operations in Asia.

Undoubtedly, the evolution of digital communications has enabled people to do business from almost anywhere. Given our geographically diverse organisation, this is something CPA Australia has wholeheartedly embraced; however, personal, face-to-face interactions will continue to be at the core of maintaining quality member service. This too will be how Australia will thrive in the Asian Century.

But more factors affect the Australian economy than relationships with Asia. Insights to be shared in this forum include productivity and federal/state relations, the political climate in Australia and the impact of global economics.

We are fully supportive of the approach to independent research CEDA undertakes and concur with the strategy for debate and discussion of the issues and policy challenges that are ahead in 2012.



economic OVERVIEW



Alan Oster is NAB's group chief economist. Alan joined the bank in 1992 from the Federal Treasury where he worked for 15 years. He has a first class honours degree in economics from Newcastle University and a masters in economics from ANU.

Before joining the bank, Alan was the Treasury's senior adviser on economic forecasting and modelling. In 1987 he was seconded to the Organisation for Economic Co-operation and Development in Paris.

As group chief economist, Alan is responsible for NAB's global economic and financial forecasts. He is also a highly respected and much quoted commentator on Australian and global economic trends and policy issues.



Alexandra (Ali) Knight is an economist in NAB's Australian Economics Division.

Alexandra has been a macroeconomic analyst and forecaster for four years, with experience in government and

the private sector.

She joined the bank in early 2011 from the Reserve Bank of Australia, where she worked for three years analysing various segments of the Australian economy. Her experience at NAB includes analysing and reporting on business survey data and commodity markets and economic forecasting.

Alexandra completed a Bachelor of Commerce (with honours in economics) at the University of Melbourne.

Introduction

At the time of last year's CEDA Economic Overview, the recovery from the global financial crisis appeared to be gaining some momentum and the fortunes of major economies looked more assured. However, 2011 rapidly became a year of great uncertainty, with the severity of European sovereign debt problems exposed and speculation of a double-dip global recession intensifying. Growth in the developed economies is likely to have slowed to around 1.7 per cent in 2011 from 3.1 per cent in 2010, while growth in the emerging economies is likely to have softened to 7.2 per cent in 2011, from 8.5 per cent in 2010. Global growth remains heavily dependent on growth in the big emerging economies.

European sovereign debt problems evolved rapidly during the second half of last year and remain the key focus of major economies. The risk of contagion from an indebted European country default remains elevated and, while various austerity measures and political accommodations devised by European leaders to delay the onset of an "event" have engendered bursts of optimism, financial and equity markets remain nervous. Borrowing costs in Europe surged over the second half of last year and are still high, with 10-year government bond yield spreads particularly striking in Greece, Ireland and Portugal. While coordinated central bank action and prospects for a new European compact appear to have restored some calm in financial markets recently, continuing fears of a European credit crisis are likely to keep financial markets unstable.

The slowing in private sector demand across many developed economies reflects a number of common themes. Household saving rates rose notably during the global financial crisis as a result of intensifying consumer caution and they remain elevated. Consequently households are de-leveraging, significantly slowing demand for credit. Furthermore, asset prices generally deteriorated across the developed world, holding down household wealth and compounding the reduction in demand. These trends were also evident (albeit to a lesser degree) in those economies that had escaped the financial crisis relatively unscathed.

As well as weakness in private sector demand, the fundamental problems engulfing the European banking sector mean that a rapid recovery in global

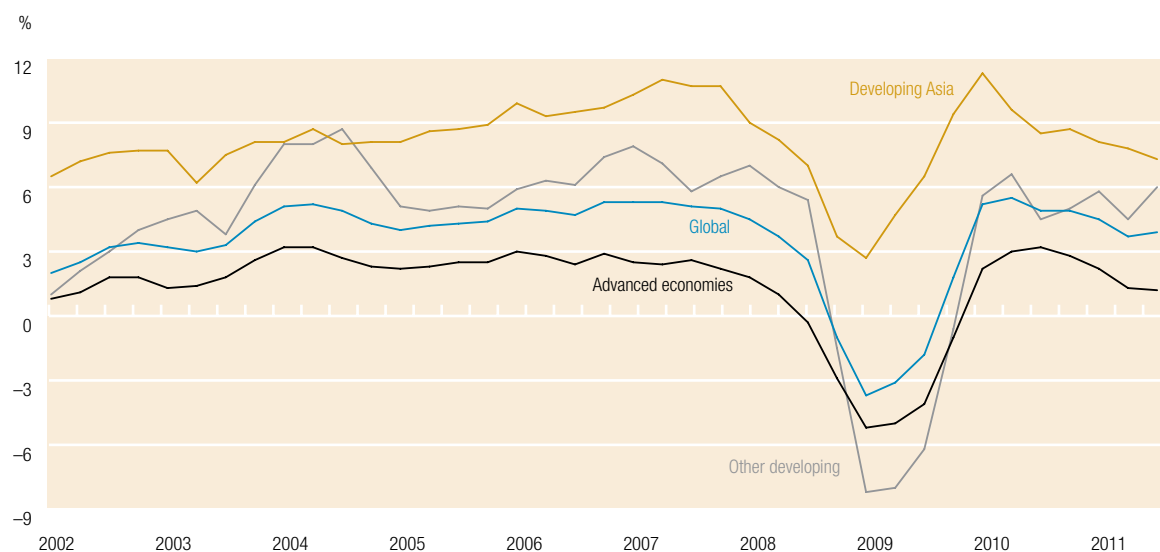
demand – especially in the developed world – is unlikely. Indeed, history shows that downturns caused by problems in the financial sector often tend to last longer and be deeper than normal cyclical episodes, so the nature of the current downturn implies there will be even stronger headwinds to the recovery emanating from Europe.

Governments in the developed economies utilised enormous amounts of fiscal and monetary policy stimulus during the height of the global financial crisis to strengthen demand and to restore financial stability in the banking system, leaving most of them now less able to support demand. Official interest rates in many developed economies are currently close to zero, while public debt burdens have swelled to the highest levels since the 1940s. Policy makers have had to resort to less orthodox measures to stimulate demand, including quantitative easing and manipulating the yield curve.

The Australian economy has remained relatively resilient to the adversity that has plagued most of the developed economies since the global financial crisis. Commodity prices surged over most of 2011, largely driven by the continued industrialisation of China and India, although they have turned down over recent months. Australia is fortunate to have an abundant supply of commodity reserves and growing export capacity, allowing our resources sector to benefit significantly from increased demand from China and India. While the devastating floods and cyclone Yasi that swept through Queensland and the eastern coast of Australia in early 2011 proved a significant setback for the economy over the first half of last year, the Australian economy has staged a remarkable turnaround and the outlook for growth remains relatively strong. Just as importantly, Australia still has significant fiscal and monetary policy flexibility, were global events to turn out more damaging than currently envisaged.

This overview examines interregional differences in the global recovery and looks at some of the risks currently facing the global economy. The majority of our discussion is focused on Australia; in particular, we will examine the performance of the economy over the past year, what uncertainties lie before us and the outlook for growth over the next year and beyond.

Graph 1
Global GDP growth (year-ended percentage change)



Source: IMF; Thomson Datastream; NAB

The global economy

After staging a modest recovery through 2010, global growth is expected to slow to around 3¼ per cent over 2011. The slowing in global activity has largely resulted from the worsening European financial crisis, which has damaged European confidence, disrupted financial markets and slowed demand throughout the rest of the world. Global growth in 2011 was characterised by significant disparity across regions and was heavily dependent on growth in the developing economies. These economies have big internal markets and a solid industrialisation momentum, especially in China and India, which should continue to support global demand.

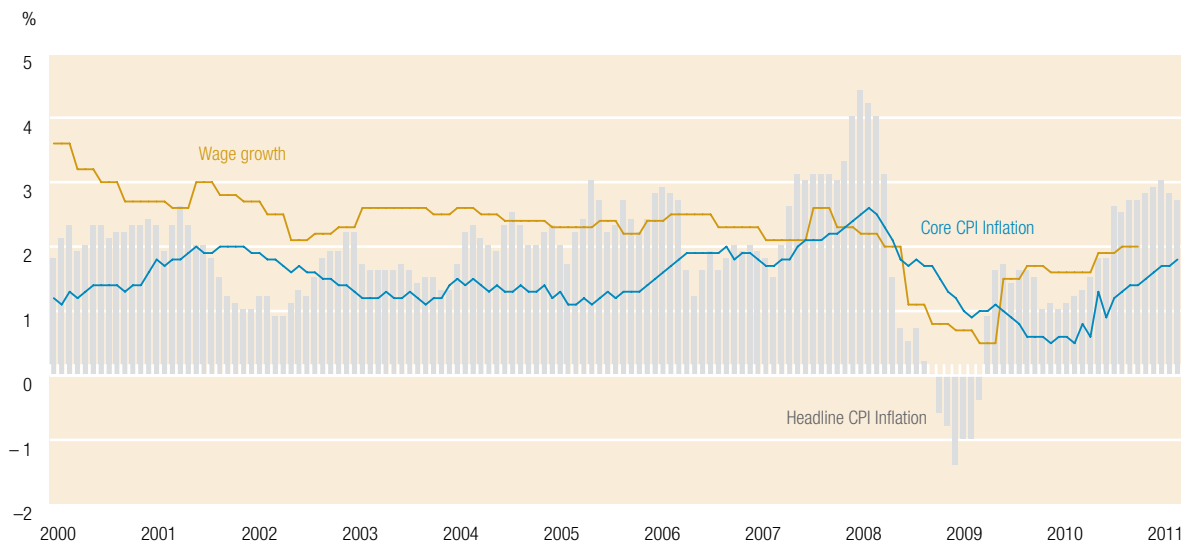
Conditions in many advanced economies remain weak and continue to under-perform the emerging economies. The weakness in the advanced economies has stemmed from worryingly large budget deficits in the context of public debt levels, highly restrictive funding conditions and persistently high levels of unemployment, which are all acting to retard growth. Over 2011, the increase in GDP in the advanced economies will be shown to have been below two per cent, notably weaker than the 3¼ per cent expected globally, and it is highly likely that conditions over the next two years will remain subdued.

The experience of many of the developing economies, which have resumed the process of

industrialisation following the global financial crisis, has been markedly different to the experience of the advanced economies. In the developing regions, there has been a vast expansion in investment and urbanisation, which has helped to support continued employment growth and rapidly improving living standards. Furthermore, the generally healthier public financial positions of the developing economies have helped to support further growth in these regions. However, they have not been immune to the slowdown in the developed world, just as they were not immune during the financial crisis. During 2011, there were clear signs of slowing growth in these regions, although some softening in the pace of growth in China, India and Brazil was only to be expected as their central banks have progressively tightened policy to dampen inflationary pressures. Given the commodity intensity of economic development in these rapidly expanding regions, some advanced economies with large endowments of natural resources have benefited greatly from the developing world expansion. In particular, Australia and Canada have been the main beneficiaries (along with emerging economies like Brazil and South Africa).

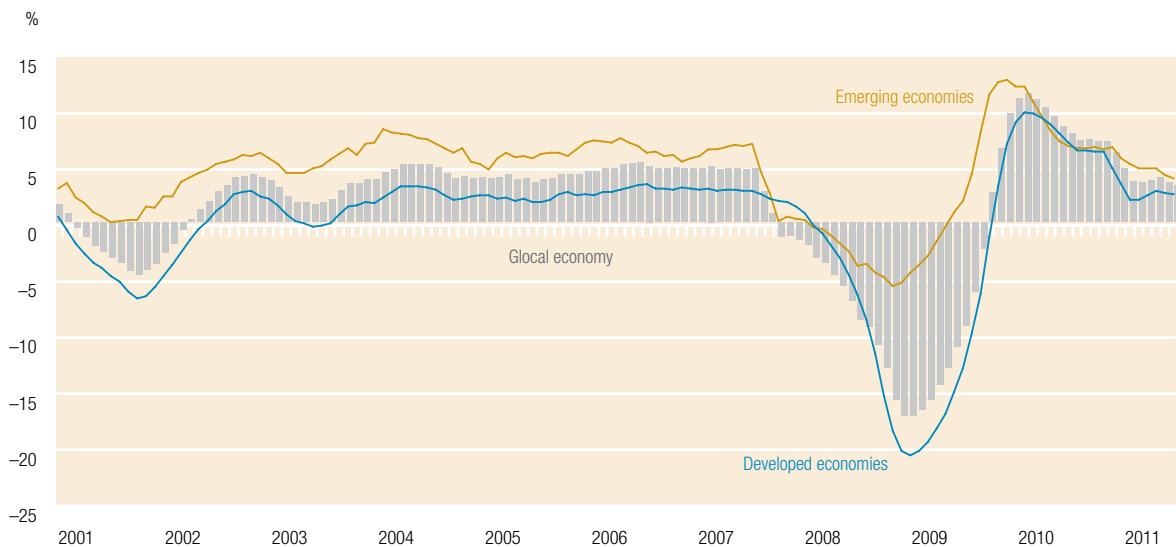
Inflation in developing nations remains a key focus of central banks across the world, though the disparity in the pace of growth between the emerging and developed economies has led to large differences in inflation rates between these groups. Global inflation has generally softened over the past year, dampened

Graph 2
G7 consumer inflation and wages (year-ended percentage change)



Source: IMF, Thomson Datastream; NAB

Graph 3
Industrial production (year-ended percentage change)

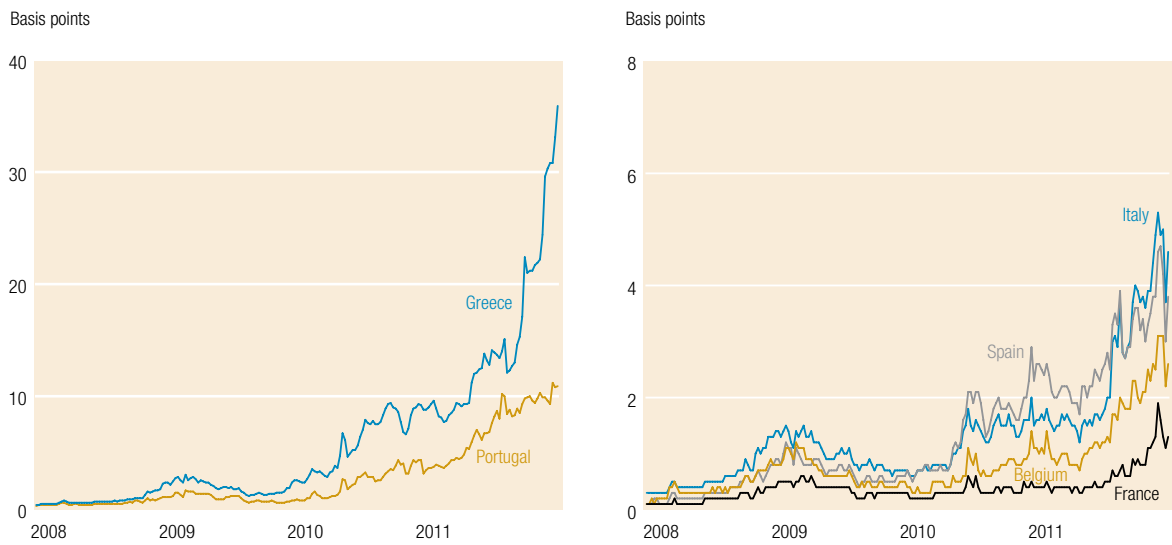


Source: IMF, Thomson Datastream; NAB

by slower commodity inflation, excess productive capacity and restrained private sector demand. While inflationary pressure in many of the developed economies has begun to rise over the past year or so, it remains contained, enabling policy makers to maintain expansionary policy settings to enable more growth. While the developed economies have not needed to

tighten monetary policy, some central banks in the emerging world continue to be worried about an inflationary episode. Steadily rising inflationary pressures in China, India, Brazil and the East Asian tigers has meant that policy makers in those countries have had to intervene by tightening policy, and this appears to have been successful. Chinese policy makers have

Graph 4
European 10 year bond spreads to Germany (hundred basis points)



Sources: Thomson Datastream; NAB

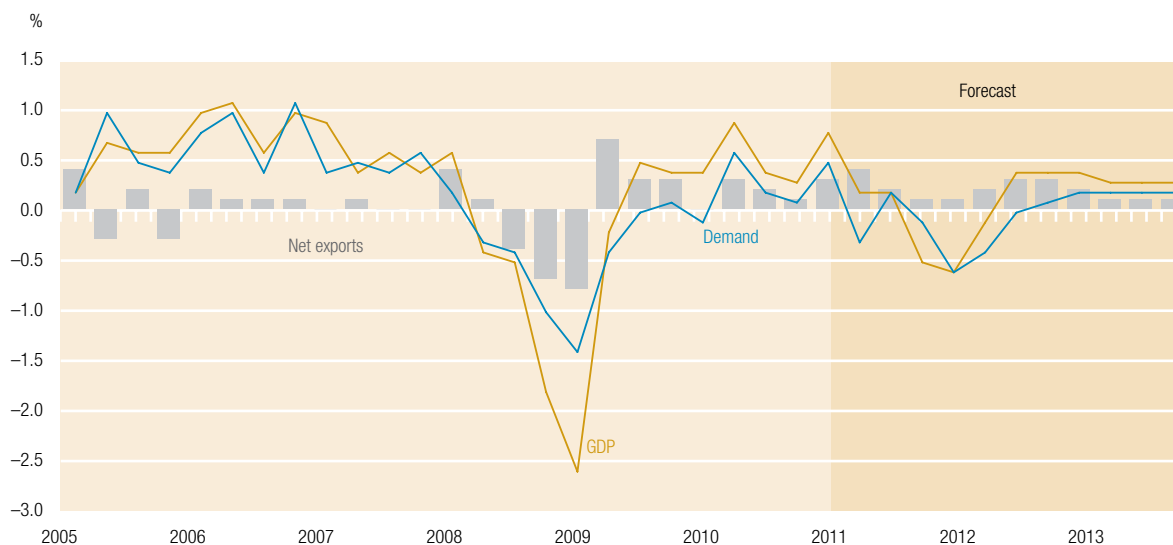
indicated their belief that inflationary pressures have peaked by easing policy settings more recently. Similarly, the tone of statements of monetary authorities in non-Japan Asia has softened recently, with some (including Singapore and Indonesia) moving to loosen policy. After a run of rate rises, Indian monetary authorities now appear to be on hold. Much of the change in tone here relates to the impact that a

new recession in Europe is having on global trade, to which these economies are heavily exposed.

The following provides a more detailed discussion of recent developments in the European Union, US and Chinese economies. As well as being key to global economic prospects over the past few years, their economic development has particularly important ramifications for Australia.



“Inflation in developing nations remains a key focus of central banks across the world...”

Graph 5**European GDP demand and net exports (quarterly percentage change and contribution)**

Sources: Thomson Datastream; NAB

European Union

Weakness in growth in the European Union persisted throughout 2011, as the unravelling of European debt problems damaged business confidence and forced policy makers to implement fiscal austerity measures – including increased taxes and lower public spending – in order to convince markets that their fiscal positions would be sustainable into the future. While the core European economies showed resilience compared to the peripheral economies over the first half of 2011, the disruption of euro-zone financial markets has had an adverse effect on confidence, causing a softening in activity in the core regions towards the end of last year. Greece, Ireland and Portugal were the weakest of the member states, with these economies shrinking on an annual basis in the September quarter 2011.

The euro-zone banking system faces a raft of problems and it is not yet clear whether a banking crisis can be avoided. Regulators have estimated that around €115 billion is required to meet the capital adequacy targets set for mid-2012. The European Central Bank is helping to alleviate these funding pressures by offering euro-zone banks access to lower yielding short-term funds, provided they post collateral; almost €500 billion of this new funding was accessed in the first operation. While far from resolving Europe's debt problems, this facility should help to prevent a funding squeeze on euro-zone banks in the first half of this year.

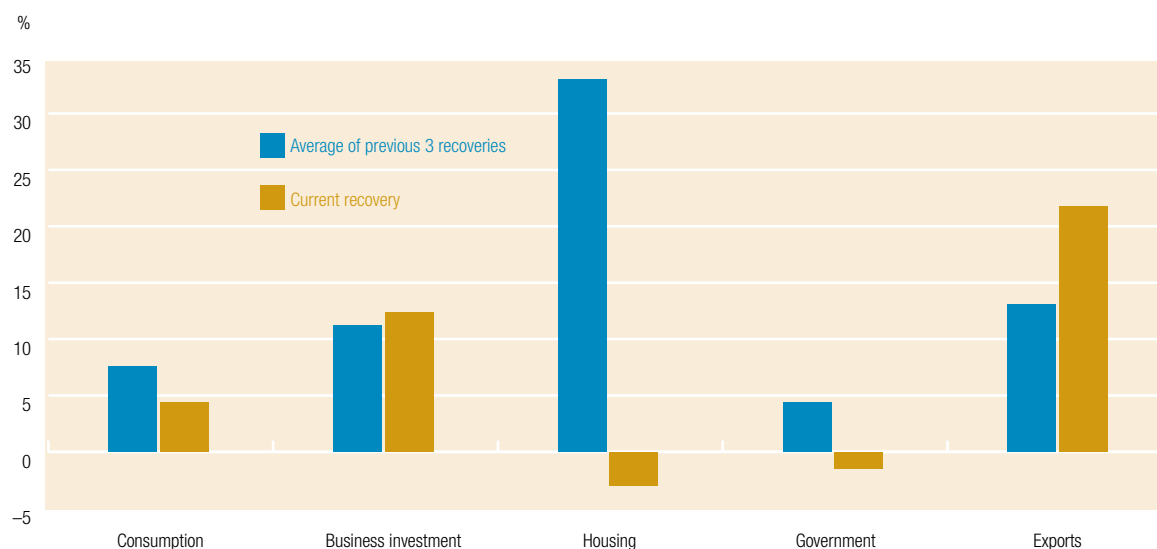
The eventual outcome of the sovereign debt and banking issues in the euro-zone will have a major

impact on the economic outlook. Data is expected to confirm that Europe entered a recession in late 2011, as volatility in financial markets impacted seriously on consumer and business confidence and activity levels. A new negative dynamic now emerging in Europe is renewed credit rationing. This largely reflects banks preferring to shrink their balance sheets rather than attempt to raise new capital (to meet EU capital requirements).

Currently the growth outlook for the euro-zone remains very depressed. While the anticipated recession is likely to be milder than the global financial crisis, a significant recession is still in prospect – with an expected peak to trough fall in activity of around 1¼ percentage points (not much better than the falls during the early 1990s). That of course occurs from a starting point of EU unemployment of around 10 per cent.

While all of the above points to a very depressed European outcome, the central issue for the global (and Australian) economy is whether a European inspired global banking crisis can be avoided. Our key assumption is that such a global crisis will be avoided. Markets still, however, remain unconvinced. Our view is that a combination of new fiscal austerity measures, more decisive action to maintain future fiscal credibility and short-term liquidity relief will all help. Ultimately, however, the European Central Bank will probably also need to be more aggressive in buying sovereign debt. Clearly, the European malaise will not be a short-term problem but rather, it will require a number of years of very subdued growth before it is overcome.

Graph 6
Comparison of US recoveries (percentage change over first two years of recovery)



Sources: US Bureau of Economic Analysis

United States

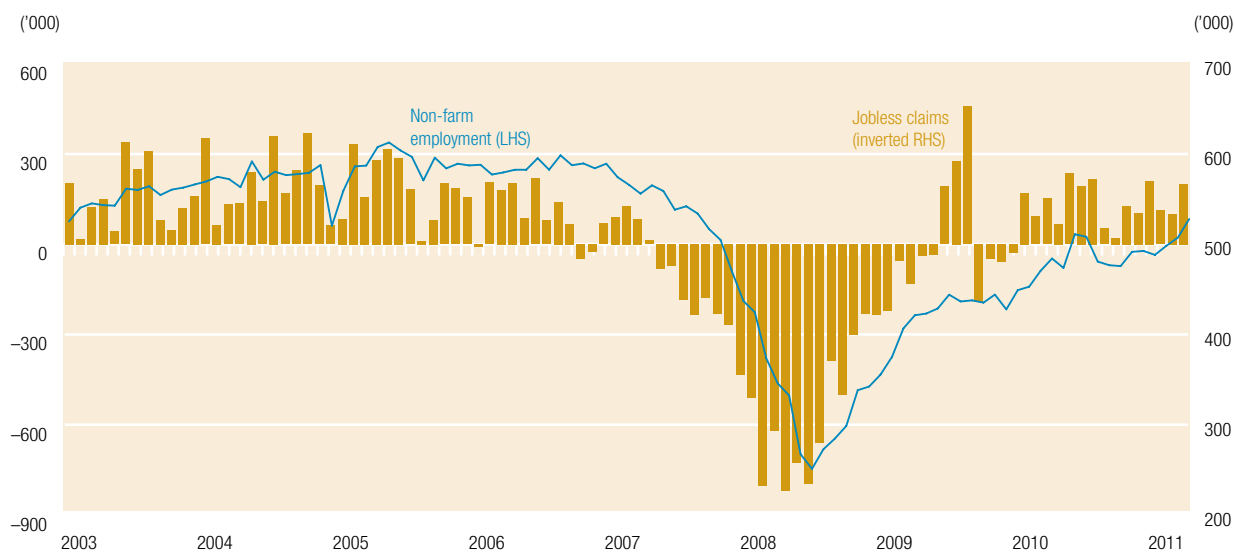
While the United States continues to slowly recover from the global financial crisis, the performance of its economy since the slowdown has been episodic and relatively weak compared to previous post-recession periods. With the recession the result of a housing bust and financial crisis, the drivers of recovery have been different this time around. With a large overhang of vacant properties, significant declines in house prices (making new builds uncompetitive) and a major tightening in bank lending standards, housing construction has failed to provide the boost to the economy it has in past recoveries. There have been additional headwinds in the form of households needing to repair damaged balance sheets and state and local government cutbacks (and, more recently, by the Federal Government) reducing public demand. Business investment and exports have been important drivers of the recovery.

Nevertheless, after gaining some momentum during 2010, there was a sense of optimism early in 2011 as a pick-up in employment growth raised hopes of a self-reinforcing cycle of employment growth supporting consumption which in turn would support further employment. However, the underlying headwinds on the economy were joined by a series of shocks that slowed the economy in the first half of the year. These included supply disruptions resulting from the tsunami and earthquakes in Japan, extreme weather events and a spike in oil prices.

With the data pointing to very weak growth, the second half of 2011 began with a confidence sapping debt ceiling debate, followed by Standard & Poor's downgrade of the US credit rating. With large falls in share prices and continuing European sovereign debt problems, fears of a double-dip recession were high.

Despite this, the economy strengthened in the September quarter 2011, although growth was still only a modest 1.8 per cent (annualised rate). While in the September quarter some regional business survey measures (most noticeably the Philadelphia Fed manufacturing survey) fell to levels associated with downturns, the broader national Institute for Supply Management (ISM) manufacturing Purchasing Managers' Index (PMI) (as well as ISM's non-manufacturing survey), while declining, remained at a level consistent with continuing expansion.

In recent months the ISM PMI has strengthened modestly. Improvement has also been reflected in a range of other economic indicators, pointing to a further strengthening of GDP growth in the December quarter 2011. Consumption is growing, there are signs of life in housing construction, and US exports are holding up. Further, in the short term the inventory cycle looks set to contribute to growth. While business equipment investment appears to have slowed down, recent business surveys of capital expenditure intentions have shown some bounce back. Non-farm employment finished 2011 on a positive note, with 200,000 jobs created in December – only the fifth time the 200,000 barrier has been reached since mid-

Graph 7**Jobless claims and non-farm employment (monthly change –'000's)**

Source: Thomson Datastream, NAB

2007 (excluding Census workers). The unemployment rate also declined, down to 8.5 per cent at the end of 2011, from 9.4 per cent at the end of 2010, although this is partly due to a fall in workforce participation.

Part of the strengthening in activity reflects a rebound from some of the temporary shocks early in the year. The rebound from the Japanese supply disruptions is evident in the auto sector where light vehicle sales declined by 13 per cent between February and June but have since grown by 17 per cent. Vehicle sales are now at levels not seen since mid-2008 (excluding the one-off impact from the end of the Cash for Clunkers program in August 2009).

The higher vehicle sales, however, probably not only reflect the end to the supply disruptions but also a large degree of pent-up consumer demand due to households putting off discretionary purchases for a significant period of time. Another support to the recovery is the continued growth in corporate profits, which are at record highs. Historically, profits have led to investment by business in fixed capital and labour. Furthermore, credit conditions have been slowly improving, with private non-financial sector debt growing in each of the four quarters to the September quarter. While the Federal Reserve Board's Senior Loan Officer Survey suggests that the confidence sapping events of July/August led to a pause in the relaxation of lending standards, credit data from commercial banks suggest that any impact on lending was short-lived. Monetary policy is also extremely accommodative and will likely remain so for an extended time.

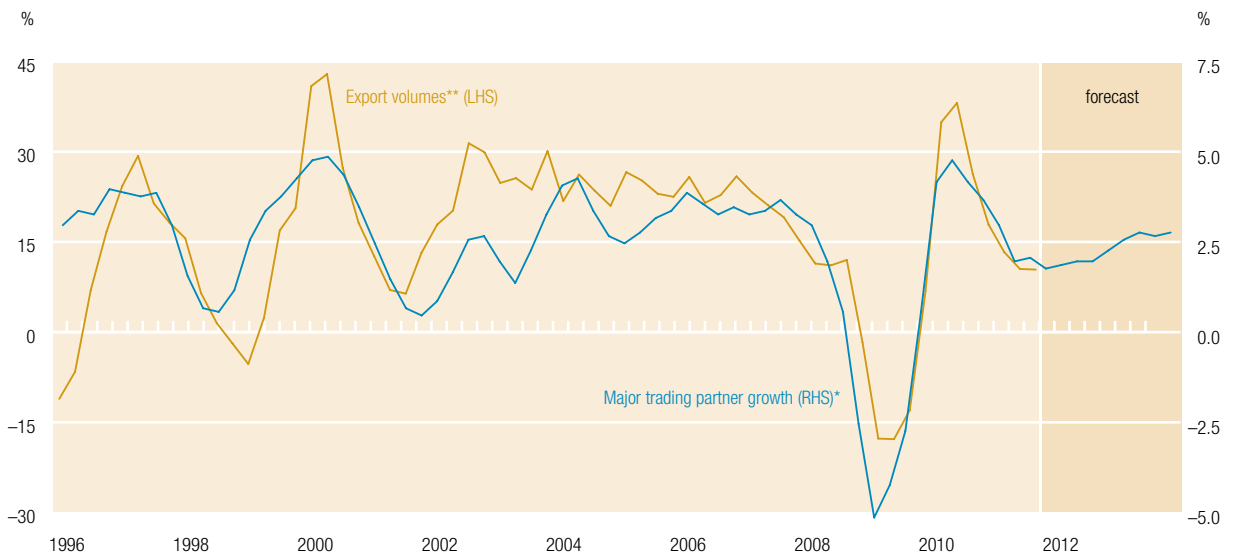
However, we do not expect a further acceleration in GDP growth heading into 2012, although growth for the year as a whole will still be at around trend 2½ per cent, an improvement on 1¾ per cent in 2011. This reflects the ongoing constraint from the various headwinds including constrained income growth and weak balance sheets for households, the depressed housing market, government fiscal consolidation and the slowdown in the global economy.

This view of continued modest growth in 2012 is supported by NAB's US macro model, which incorporates information embedded in various factors including interest rates, equity markets, the exchange rate, oil prices and house prices. This model suggests that the recovery will continue to be a drawn out one.

China

Though still strong, economic momentum in China has steadily slowed since the middle of 2009, reflecting the unwinding of fiscal stimulus as well as the tighter stance of monetary policy aimed at curbing inflation throughout 2011. While the aggregate Chinese economy has slowed in an orderly manner, there are some pockets of weakness such as the banking and property sectors. Year-ended Chinese GDP growth eased from 9.1 per cent in the September quarter 2011, to 8.9 per cent in the December quarter. While the risks appear to be on the downside – including external risks stemming from sovereign debt problems

Graph 8
China – major trading partner growth (year-ended percentage change)

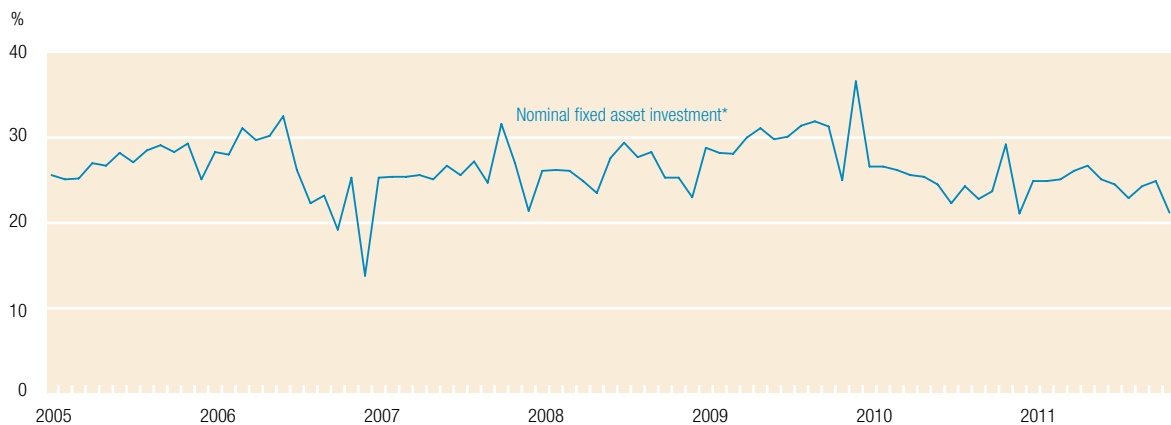
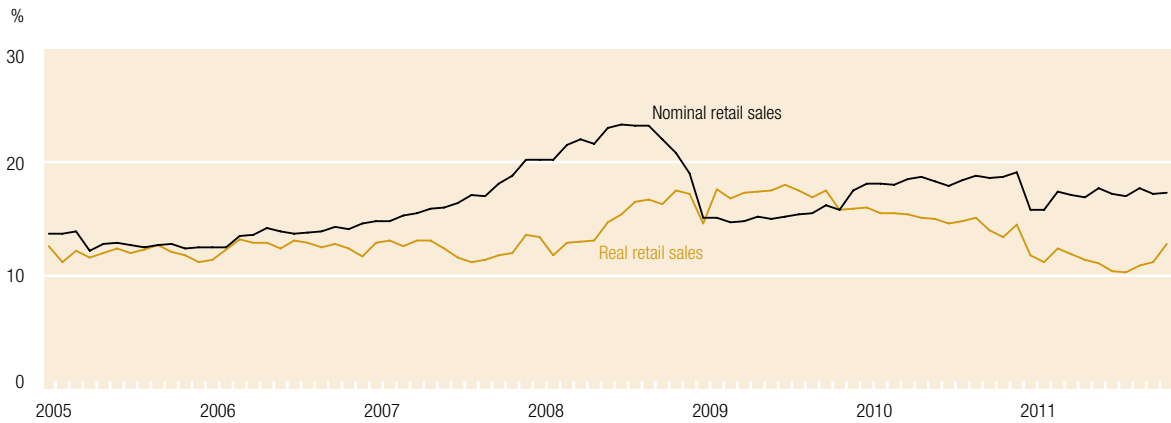


* Adjusted for Hong Kong re-exports; covers roughly three-quarters of Chinese exports

** Deflated by Hong Kong re-export prices up to 2000, Japanese/Euro prices of Chinese imports between 2000 and 2005, and the Chinese export price index thereafter.

Sources: CEIC; NAB; Thomson Reuters

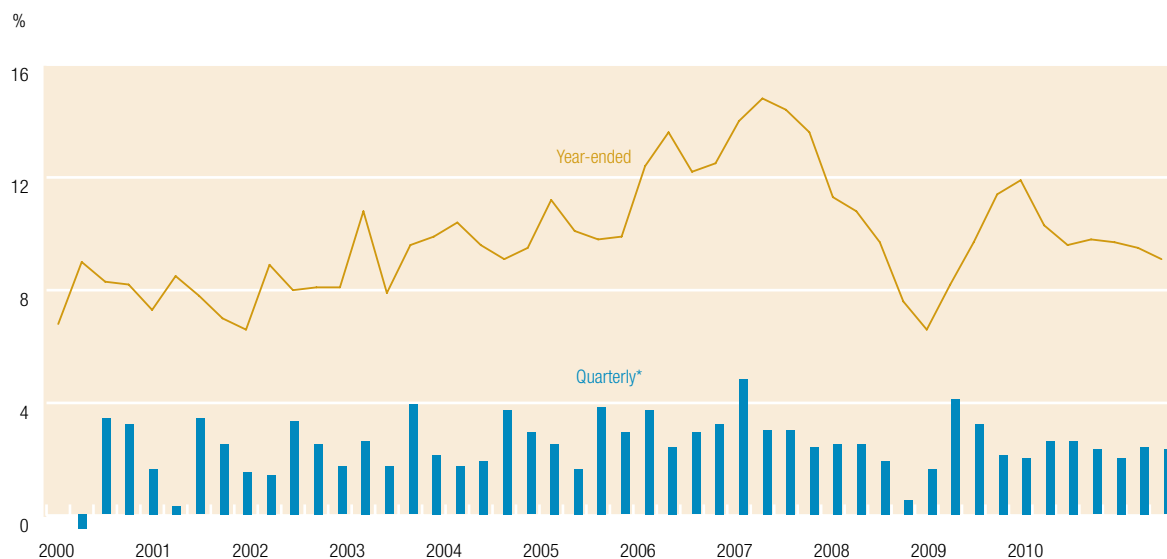
Graph 9
China – domestic retail demand (year-ended percentage change)



* Estimated by NAB

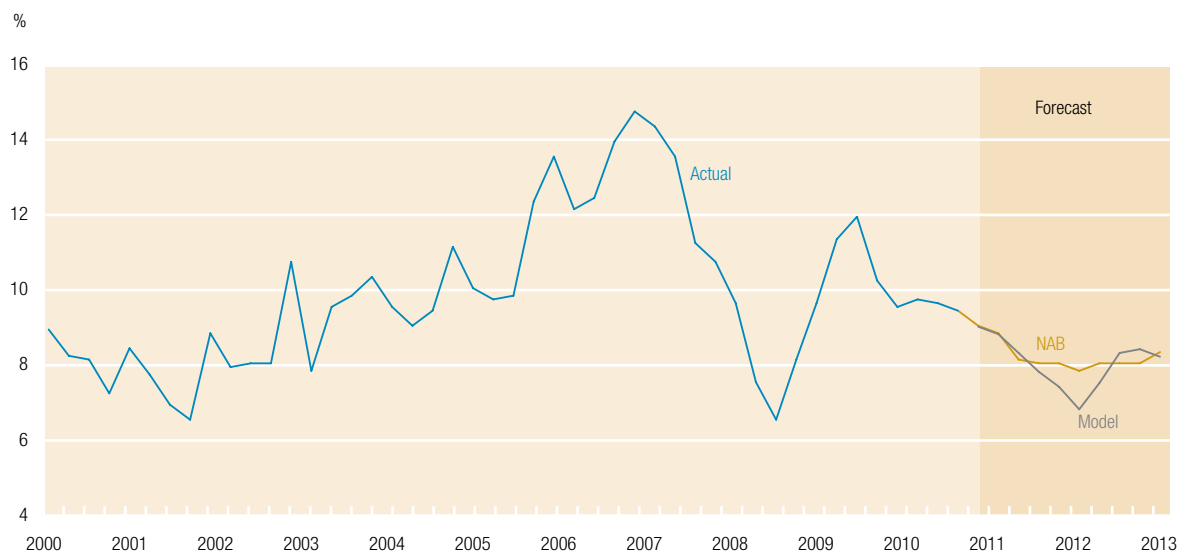
Sources: CEIC; NAB

Graph 10
China – real GDP (percentage change)



* Backcast between March quarter 2007 and September quarter 2009. Prior data are estimated by NAB.
Source: CEIC Database; NAB

Graph 11
China real GDP growth (year-ended percentage change)



Sources: CEIC; NAB

in Europe and the risk of slower growth in the United States – the Chinese economy should avoid a hard landing. The economy will slow further over coming years but growth should remain consistent with potential (around eight per cent over 2012 and 2013).

The sovereign debt problems in Europe appear to have directly contributed to a slowing in Chinese exports in recent months (over 20 per cent of Chinese exports are destined for Europe and around one-

quarter of GDP depends on exports).

Thus, a slowing in the developed economies will have a material impact on growth, as was seen during the global financial crisis. However, given that the Chinese economy is continuing to undergo a process of industrialisation and urbanisation, it should continue to be supported by underlying strength in internal demand over the long term. Furthermore, monetary policy in China has been tightened considerably over

the past two years and is well positioned to provide stimulus if required. Chinese demand for commodities should be supported by stimulus measures such as affordable housing investment. Authorities have also signalled an intention to employ greater fiscal stimulus if necessary. There are, however, a number of significant domestic risks related to China's property and banking sectors and local government debt, which could intensify in the face of a protracted global recession. The government's fiscal position is not as strong as it was during the GFC, as the stimulus provided in 2009–10 left local governments with considerable debt, while a property slowdown has threatened future government income.

The global outlook: Looking forward

The recovery from the current downturn will be slow compared to previous recessions. We expect to see further slowing in the euro-zone, as weakness

in confidence flows through to softer activity. The Japanese economy should continue its recovery from the impact of the tsunami and earthquakes earlier last year, which resulted in substantial supply disruptions to the rest of the world. However, the United States appears to be on track for positive growth over the medium term, although the United Kingdom economy is likely to remain weak, reflecting continued soft private sector demand and its weak fiscal position. Overall, we expect to see the developed economies continue to struggle with high levels of unemployment and continued de-leveraging. While China and the other emerging economies will soften, largely reflecting the effect of previous policy tightening and slowing exports as a result of the weakness in Europe, they will continue to contribute to global growth. We expect global growth of around 3¼ per cent in 2012, before rising above 3½ per cent in 2013, although the risks to our forecasts are heavily skewed to the downside.

Table 1
Key global GDP forecasts (calendar years)

| Country/region | IMF weight | Per cent change | | | | | | | |
|------------------|------------|-----------------|------|------|------|------|------|------|------|
| | | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
| United States | 20 | 2.7 | 1.9 | -0.3 | -3.5 | 3.0 | 1.7 | 2.3 | 3.1 |
| Japan | 6 | 1.7 | 2.2 | -1.1 | -5.5 | 4.5 | -0.5 | 2.8 | 2.1 |
| Euro-zone | 15 | 3.3 | 2.9 | 0.2 | -4.2 | 1.8 | 1.5 | -0.6 | 1.3 |
| United Kingdom | 3 | 2.6 | 3.5 | -1.1 | -4.4 | 2.1 | 0.9 | 0.7 | 1.7 |
| Asian Tigers | 5 | 5.7 | 6.0 | 3.2 | 0.2 | 7.7 | 4.3 | 3.6 | 3.9 |
| Latin American 4 | 9 | 5.3 | 5.6 | 4.2 | -2.1 | 7.1 | 4.7 | 3.5 | 3.1 |
| China | 13 | 12.7 | 14.2 | 9.6 | 9.2 | 10.4 | 9.2 | 8.0 | 8.2 |
| Canada | 2 | 2.9 | 2.5 | 0.4 | -2.8 | 3.2 | 2.1 | 2.0 | 2.8 |
| India | 5 | 9.6 | 9.7 | 7.5 | 7.0 | 8.8 | 7.1 | 6.2 | 5.9 |
| Africa | 2 | 6.1 | 6.3 | 5.5 | 2.8 | 5.3 | 4.7 | 5.5 | 5.0 |
| CIS | 4 | 8.2 | 8.6 | 5.5 | -6.4 | 4.6 | 4.6 | 3.7 | 3.8 |
| Eastern Europe | 4 | 6.7 | 5.7 | 3.0 | -3.6 | 4.5 | 5.1 | 1.3 | 2.4 |
| Middle East | 5 | 5.7 | 5.9 | 5.1 | 2.6 | 4.3 | 3.0 | 3.6 | 3.6 |
| Other advanced | 8 | 4.5 | 4.7 | 1.7 | -1.1 | 5.8 | 3.3 | 2.7 | 3.2 |
| Global total | 100 | 5.5 | 5.6 | 2.9 | -0.7 | 5.2 | 3.7 | 3.2 | 3.7 |

Australia

Australia still is, in fundamental terms, one of the strongest advanced industrial economies in the world. It has benefited from a combination of prudent fiscal and monetary policies that have avoided public debt issues while maintaining a non-inflationary growth environment, a strong financial regulatory environment and banking system. It has benefited from fortuitous proximity to the industrialisation of China. Australia, however, has not been immune from the uncertainties surrounding the euro-zone, and has suffered disruptions from severe weather events in early 2011. However, the terms of trade are likely to remain historically high, driving a substantial restructuring of the Australian economy that carries the risk of significant adjustment costs. Overall, the medium-term outlook for the Australian economy remains one of solid growth.

Since the post-flood recovery found traction midway through last year, we have seen encouraging signs that the domestic economy is finding its feet. Economic growth was dampened by the impact of the flood-induced slowdown at the beginning of last year, which caused significant disruptions to the export and production of coal, and impaired conditions in a number of other industries. The flood recovery was slower than initially anticipated. During 2011, we saw the transition from public sector stimulus to accelerating private sector demand. While parts of the private sector remain soft (in particular retail, manufacturing

and housing) private sector investment – largely investment in the resources sector – and consumption of services strengthened markedly during the year.

The multi-speed nature of the Australian economy is likely to continue into the forecast horizon. In particular, the historically high terms of trade is driving growth in mining and related industries, but the associated high Australian dollar, high interest rates and cautious behaviour of consumers – reflecting global uncertainties – continues to weigh adversely on other sectors.

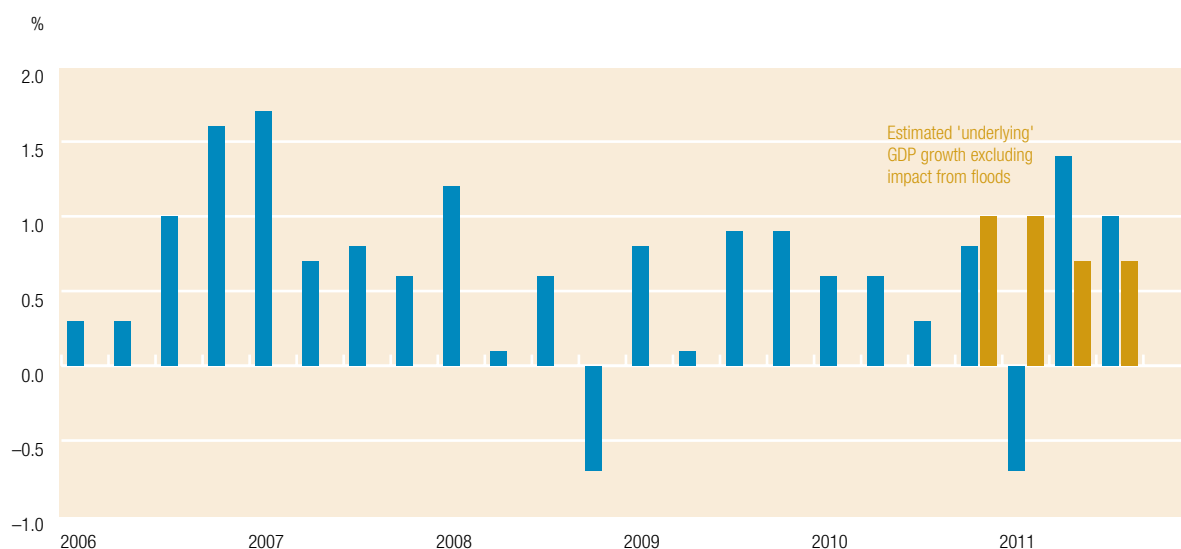
The underlying strength of the Australian economy was highlighted by the September quarter national accounts. Australian GDP was reported to have risen by one per cent in the quarter, following growth of 1.4 per cent in the June quarter. While the strong growth outcomes in the June and September quarters partly reflect the recovery from the floods at the beginning of the year, the underlying strength of the Australian economy appears to have re-emerged.

Looking through the volatility in the quarterly numbers, the Australian economy appears to have grown at a rate of two per cent over the year to September, compared to growth of 2.7 per cent over the same period of the previous year.

If we abstract from the impact of the floods, it is likely that growth would have been close to potential. This is a remarkable outcome given how poorly most developed economies have performed over the past year. One thing that we have learnt in the aftermath of the global financial crisis is the durability of the

Graph 12

Australian GDP growth (quarterly percentage change)



Source: ABS; NAB

emerging Asian economies, led by China, and the extent of Australia's economic leverage to the region. It is because of this leverage that the Australian economy has been largely shielded from the weakness across the developed world. Australia is currently experiencing a once-in-a-century commodities cycle, which has resulted in the terms of trade rising to levels unseen since Federation. While the terms of trade appears to have peaked in the September quarter 2011, and demand for commodities from Asian economies will continue to slow, the terms of trade will remain at very elevated levels, thus underpinning strong growth in national income for many years to come.

Provided Europe does not degenerate into a global banking crisis, it is likely that the key focus for policy makers will be managing a strengthening but multi-speed economy – where the differences are only likely to further diverge. History has shown that challenges arise for countries that experience a natural resources boom particularly in the form of the emergence of excessive domestic cost pressures.

Australia's leverage to China also represents a key vulnerability. So long as Chinese growth and

commodities demand persists (and that is our central case) Australian incomes will benefit. These challenges may be more problematic for Australia given there is relatively limited spare capacity in the economy at present. Were the worst to develop in Europe (not our core assessment), at least policy makers in Australia have significant policy flexibility given low levels of public debt and broadly neutral monetary policy.

The Australian story so far

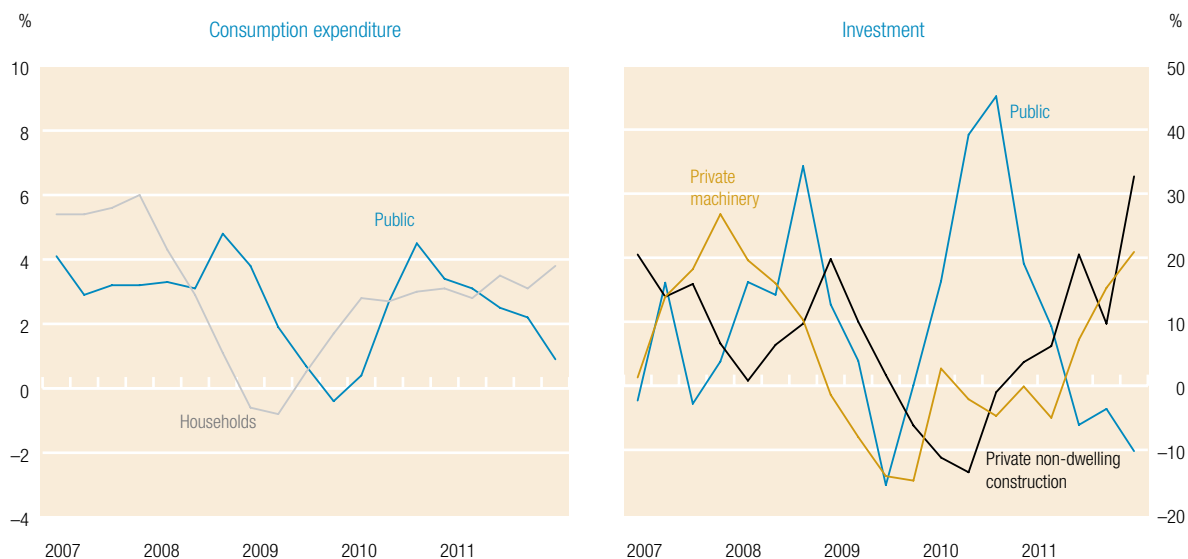
The Australian economy was fairly resilient to the global financial crisis, with its performance underpinned by strong demand for our minerals and resource exports from China in particular as well as the favourable net debt position of the government. More recently, the sovereign debt problems in Europe have remained the dominant focus of major economies. While not immune, Australia is better positioned than most advanced economies to withstand the impact of a European default because of its limited exposure to European finances, its strong financial sector and its strong ties with the Chinese economy. While that economy is currently experiencing slower growth in exports and manufacturing, it still has significant scope to ease policy (especially monetary policy) and hence maintain reasonably robust levels of internal demand. Furthermore, although Australia's cash rate is being characterised by the Reserve Bank of Australia as broadly neutral in domestic terms, it is currently high by advanced economy standards (4.25 per cent). The RBA has the ability to stimulate the economy by adjusting monetary policy settings if required. While international factors pose real downside risks to both the global and Australian economies, the medium-term outlook for domestic growth remains reasonably strong. This largely reflects the anticipated boost from the rapidly expanding mining sector and continued recovery from the flood-induced slowdown at the beginning of 2011. However, economic activity is very uneven across sectors and managing Australia's laggard consumer-dependent sectors will remain a key focus for policy makers.

The global financial crisis prompted the Australian government to inject the second largest discretionary fiscal expansion relative to GDP of any government in the world except China. The immediate effects of this stimulus have dissipated over the past year or so and the transition from public to private demand is well underway. This is evidenced in the revival in household consumption and private investment growth, after being subdued for some time following the global financial crisis. On the investment side, private machinery investment has staged a rapid



“...although Australia's cash rate is being characterised by the Reserve Bank of Australia as broadly neutral in domestic terms, it is currently high by advanced economy standards...”

Graph 13
Public and private demand (year-ended percentage change)



Source: ABS, NAB

recovery over the past year (up around 20 per cent in underlying terms), after being anaemic for some time prior, while private non-dwelling construction (mainly mining) is booming. That is, private demand appears to be continuing its recovery. Conversely, public sector investment and consumption has slowed sharply, unwinding following the impetus from government fiscal (infrastructure) stimulus injected into the economy immediately following the global financial crisis. This pattern can be seen in the component contributions to year-ended GDP growth in the September quarter 2011.

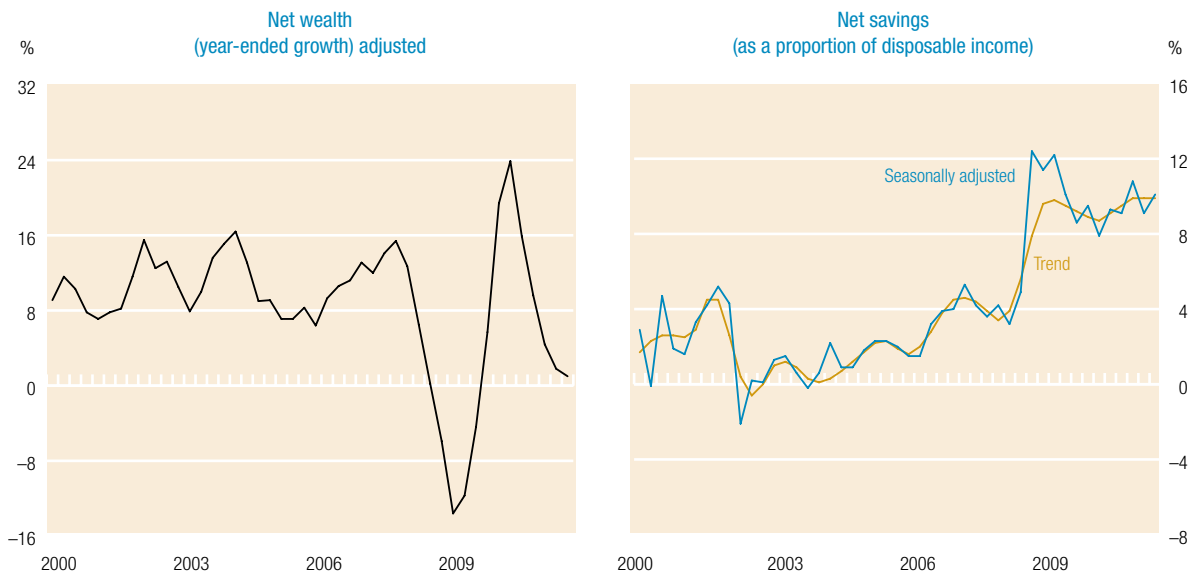
While the Australian economy performed relatively well during 2011, the path of growth was not without interruption. Severe weather events in early 2011 had a notable impact on domestic production, particularly coal mining, agriculture and tourism and especially in Queensland. Coal mine production has recovered more slowly than expected and was still providing a significant boost to domestic activity from the June quarter 2011 to date.

One noteworthy feature of the composition of Australian GDP growth is the strength in business investment reported in the national accounts, heralding the start of the long-awaited mining investment boom. The outlook for business investment remains very strong – largely due to investment in the resources sector – which should continue to support growth for many years ahead. In contrast, dwelling investment growth has been fairly subdued over much of 2011, and is expected to remain soft for the first half of this year.

While some support began to be provided to interest sensitive sectors of the economy following the RBA's decision to lower the cash rate by 25 basis points in both November and December 2011, the outlook for the global economy will continue to weigh on domestic confidence for some time. Since the global financial crisis, households have exhibited a heightened degree of conservatism and businesses, outside mining, have reserved their investment decisions (although this may also be attributable to uncertainty about government policy decisions). Speculation of further rate cuts may allow households and businesses to relax their consumption and investment decisions. However, the possibility of a banking or credit crisis in Europe continues to pose serious risks for the global and Australian economies.

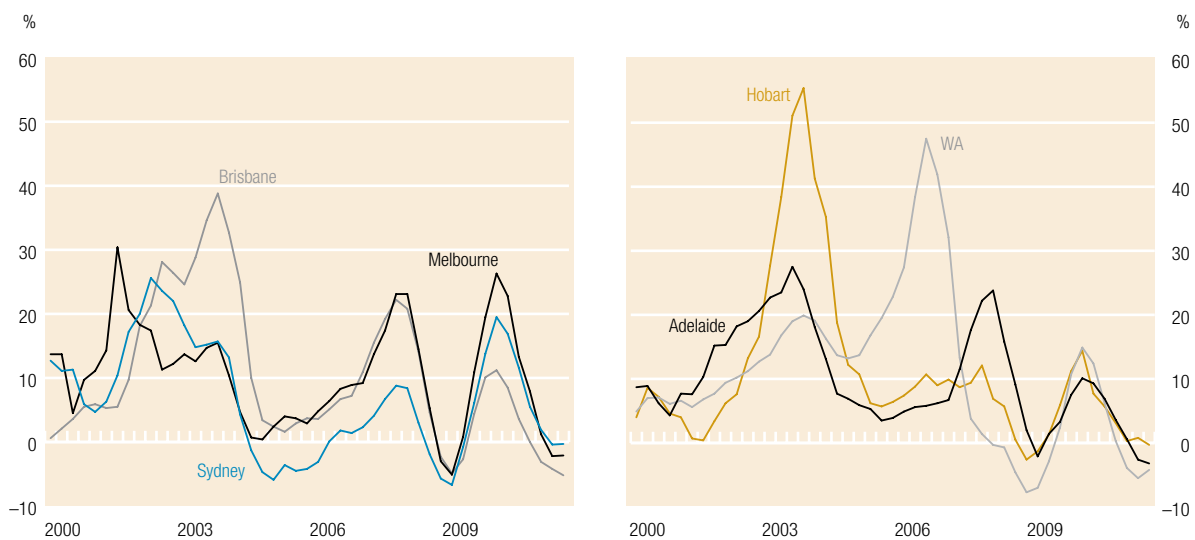
Consistent with volatility in financial markets and a decline in dwelling prices, household net wealth accumulation has slowed since the beginning of 2010. The onset of the global financial crisis sent financial markets into turmoil and resulted in the worst performance of Australian superannuation funds in history. Recent fluctuations in household net wealth have contributed to an increase in labour force participation, with more people – particularly those entering retirement age – forced to stay in work for longer. Households also increased the proportion of their disposable income allocated to savings to shield themselves from further adversity. While difficult to measure precisely, the shift in household behaviour can be neatly summarised by the sharp rise in the household saving ratio over the past few years.

Graph 14
Household assets and savings



Sources: ABS; RBA

Graph 15
House price index (year-ended percentage change)

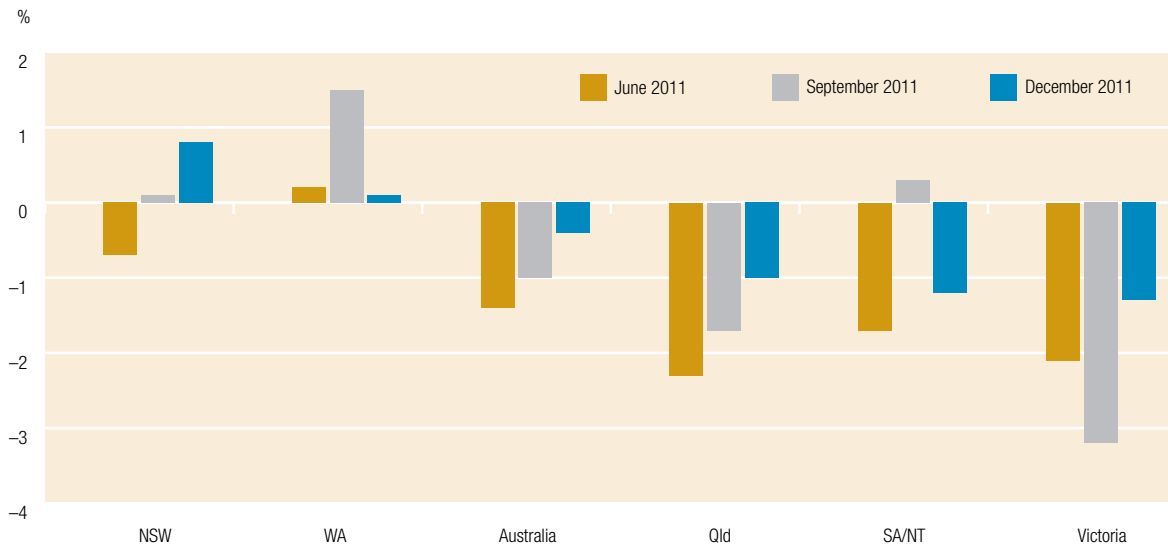


Source: ABS, NAB

The sharp decline and subsequent rise in household net wealth accumulation can largely be explained by asset prices. Residential property prices experienced a slight dip immediately after the financial crisis, before staging a rapid surge over 2009. According to the ABS, established house prices across Australia rose by around 20 per cent from early 2009 to early 2010, which is consistent with a sharp increase in household net wealth.

More recently, dwelling prices appear to be moderating – partly reflecting a correction in previous price increases – and housing affordability has improved. NAB’s property survey shows that house prices are expected to fall further over 2012, although expectations have become less pessimistic.

While we expect to see some further slowing in the residential property market, underlying fundamentals remain sound. Australia currently has an undersupply

Graph 16**House price expectations (Next 12 months)**

Source: NAB Property Survey

of housing, recently projected by the National Housing Supply Council to be over 200,000 units in mid-2011, and while the labour market is currently in a soft patch, the unemployment rate remains relatively low and incomes are expected to rise over 2012. As such, we believe that underlying demand for housing will remain firm over the year ahead, and while we may see further moderation in prices, the housing market should strengthen over the medium term.

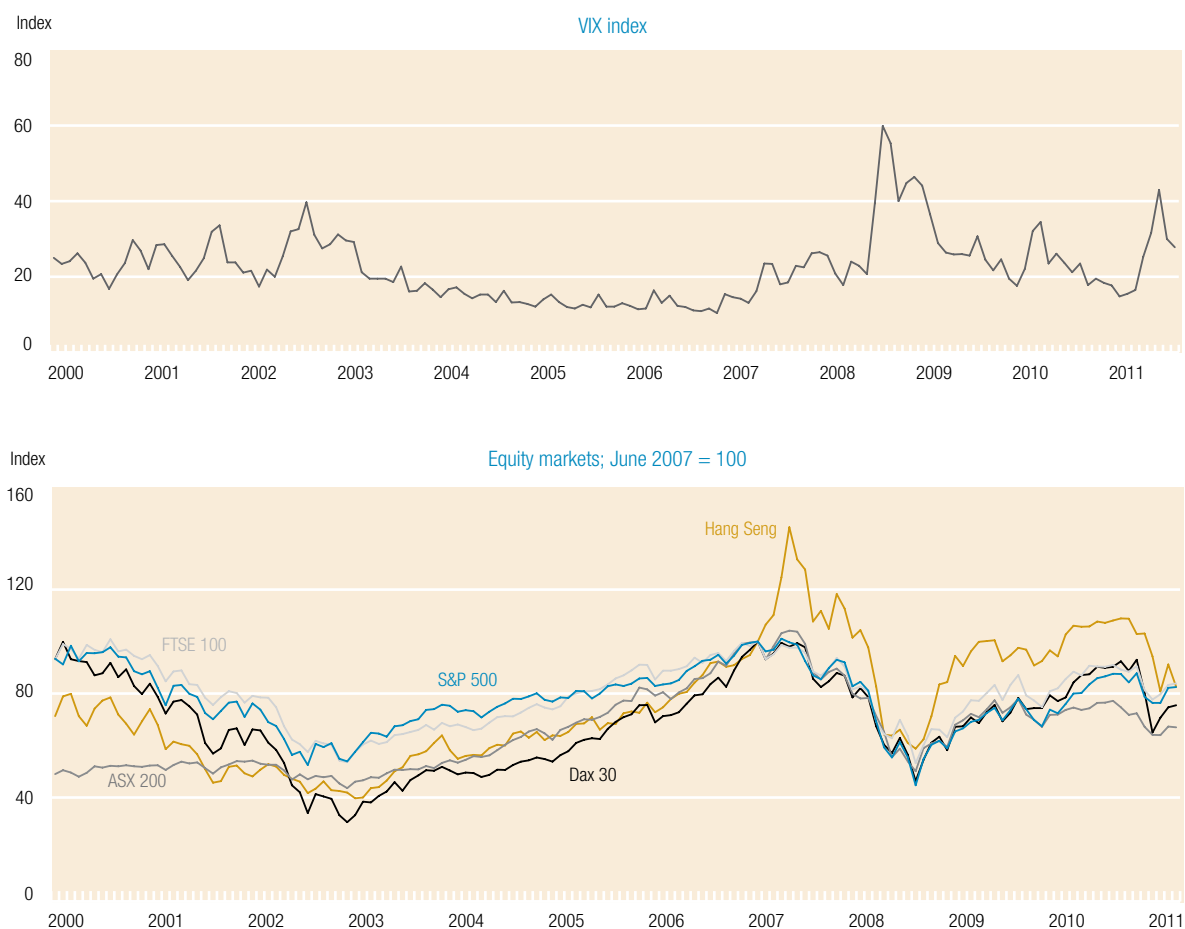
Reflecting global uncertainties, Australian equity prices have fallen heavily through 2011. The last few years have seen unprecedented volatility in equity markets (as per the VIX index) and despite a better economic performance, Australian equities reflected global equity markets. The path ahead for equities is likely to remain highly volatile, reflecting continued fears stemming from European sovereign debt concerns. Nonetheless, given the solid fundamentals of the Australian economy, there should be scope for Australian equity prices to begin to recover towards the end of this year.

The NAB Monthly Business Survey highlights the difficult conditions that have plagued retail, wholesale trade and small transport businesses in Australia over recent years. The average consumer has become increasingly cautious since the onset of the global financial crisis, limiting their consumption of discretionary items in order to help de-leverage their balance sheet. It is this sudden shift in consumer behaviour that is largely responsible for the weakness in retail trade over recent years. Moreover, the weakness

“...along with wholesale trade and small transport, the retail sector remains a drag on growth and is one of the main enclaves struggling to recover in the face of continued global economic uncertainty.”



Graph 17
Financial markets



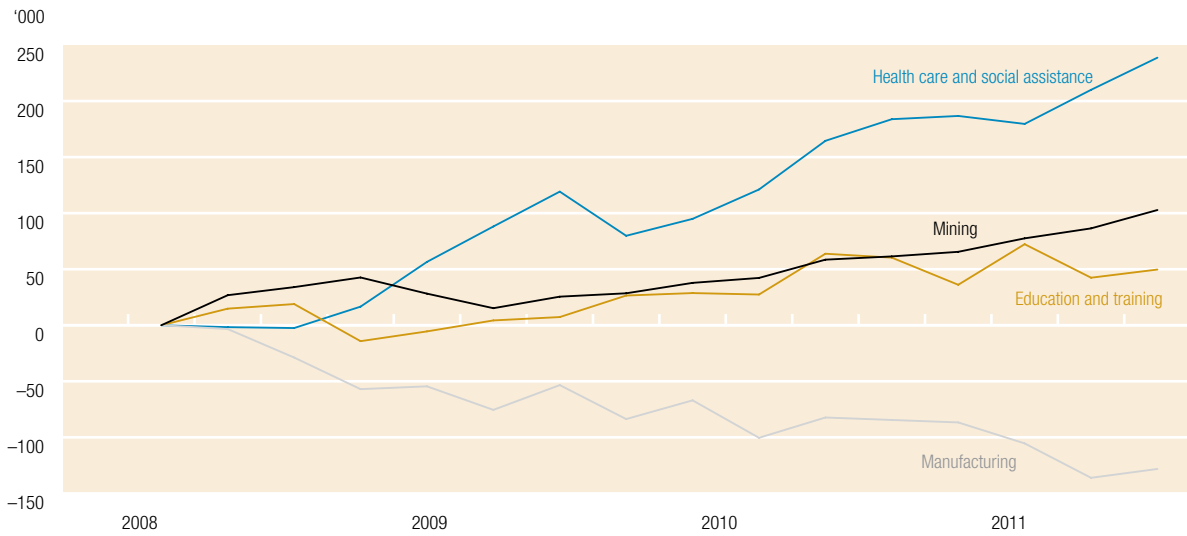
Source: Thomson's Datastream

in domestic retail spending cannot be explained by overseas internet sales; although growing rapidly, overseas transactions still represent a very small proportion of total retail sales. During 2011, retail again weakened in the face of falling confidence about global prospects and reduced employment growth. This was particularly evident in the retail trading index in the NAB survey. However, while retail trade continues to suffer, the purchase of consumer services has been more resilient in the face of economic uncertainty over recent years (as reflected in personal and recreational services in the NAB survey). This has resulted in a boost to overall consumption as reported in the national accounts. Nonetheless, along with wholesale trade and small transport, the retail sector remains a drag on growth and is one of the main enclaves struggling to recover in the face of continued global economic uncertainty. That said, the weakness in the

domestic economy is most pronounced in manufacturing where business conditions ended the year at near recession levels and job shedding was evident.

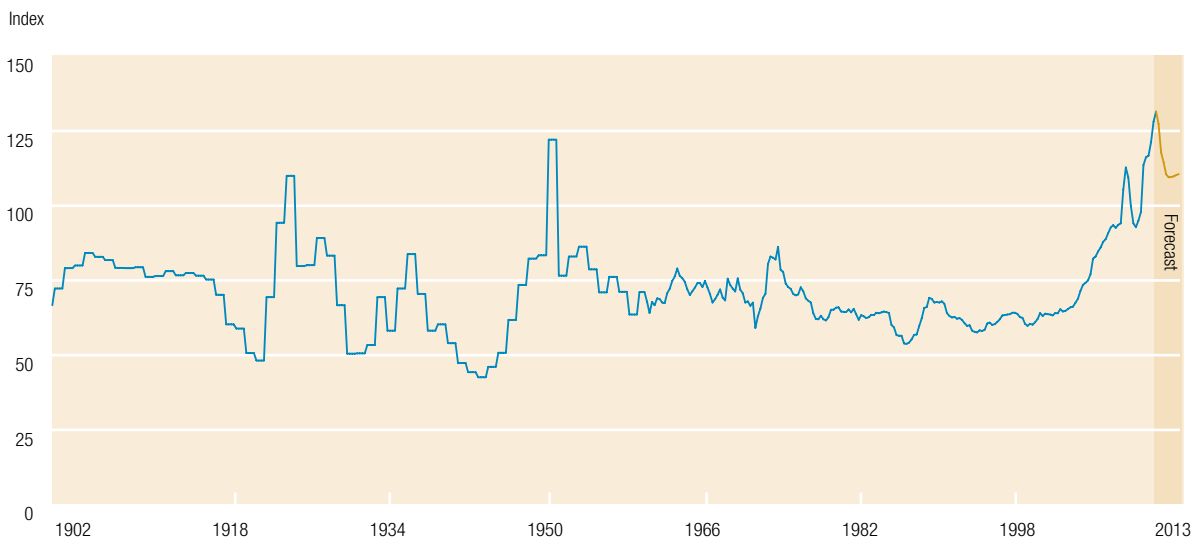
Clearly the dual speed economy is very evident in the labour market. At the aggregate level, while the pace of employment growth has eased following its rapid expansion over 2010, implying some softening in the labour market, growth in total hours has slowed a little less rapidly, suggesting that firms have been making greater use of existing employees. It appears that firms have been delaying hiring additional workers due to the heightened degree of uncertainty in the economy. This is consistent with the recent softness in job ads, vacancy rate data and business surveys, and contrasts with developments during the wake of the global financial crisis. The rate of unemployment has steadily risen from its most recent low of 4.9 per cent in early 2011, to 5.2 per cent in December.

Graph 18
Employment (change since March quarter 2008)



Sources: ABS; NAB

Graph 19
Terms of trade

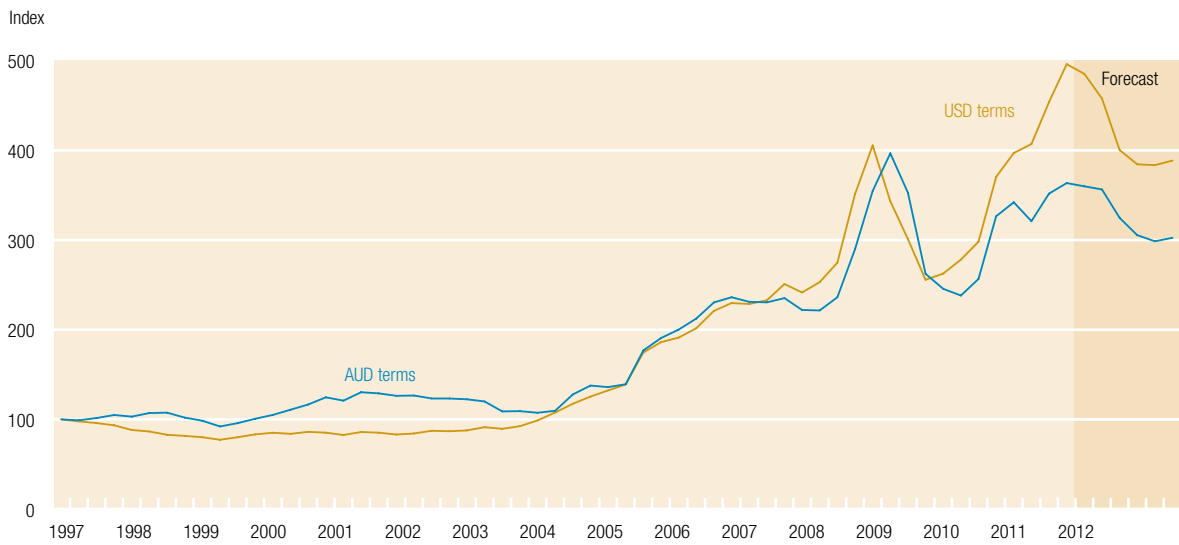


Source: ABS, NAB

While the medium-term outlook for the Australian economy is strong, variations in sector performance have become increasingly divergent over recent years. Specifically, consumer dependent and trade-exposed sectors of the economy have languished while mining and service-based sectors are embarking upon a rapid expansion in activity. This shift in demand appears

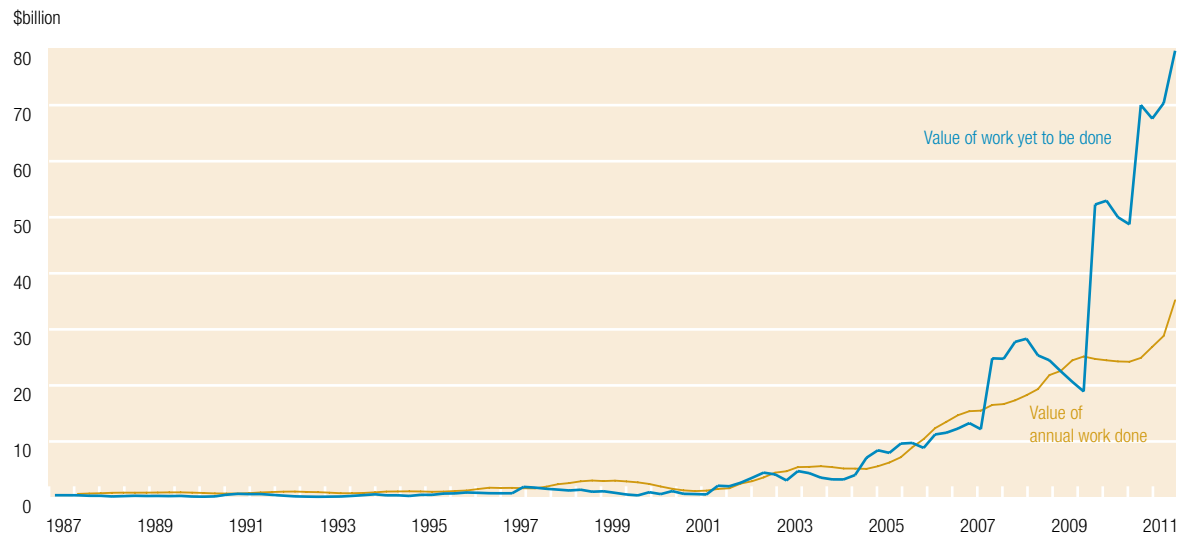
to have been running ahead of the capacity of the labour market to adjust. While job losses in the manufacturing sector since the beginning of 2008 have approached 150,000, employment in large service sectors – including healthcare, social assistance and education and training – has expanded rapidly over the same period.

Graph 20
NAB Non-Rural Commodities Price Index (Sep 1996=100)



Sources: ABS; ABARES; Bloomberg; NAB; Thomson Datastream

Graph 21
Mining engineering construction

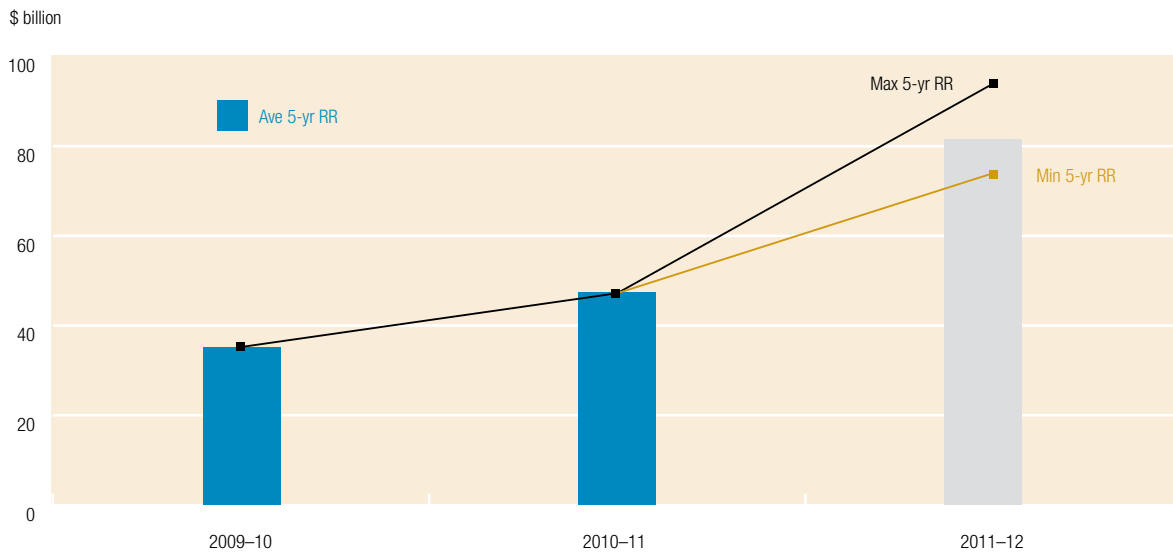


Source: ABS

While some parts of the economy remain weak, the mining sector has embarked upon its largest and most rapid expansion in post-colonial history. It is also the case that larger transport operators and supporting service-based sectors have become beneficiaries of the increase in the value of minerals investment. The success of mining in Australia can be largely attributed to the current phase of industrialisation in China. The

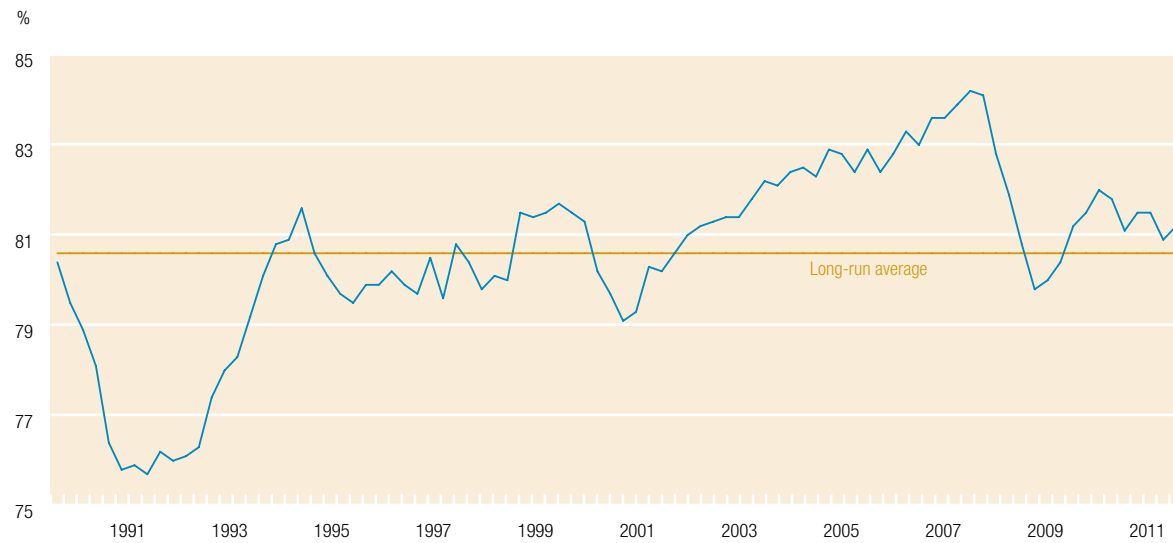
rapid rise in Australia's terms of trade largely reflects a rise in iron ore and coal commodity prices, which have been boosted by these developments in China. Despite China holding substantial domestic reserves of iron ore and coking coal, it is a net importer of these raw materials as its own resources are relatively inaccessible and there is inadequate infrastructure to make production financially viable. Furthermore,

Graph 22
Mining capex



Source: ABS and NAB calculations

Graph 23
Capacity utilisation (seasonally adjusted)



Source: NAB Quarterly Business Survey

Chinese reserves have a lower iron content compared with Australian reserves, which also makes the cost of production more expensive.

We expect the terms of trade to retreat from their peak in the September quarter 2011, consistent with the subsequent softening in commodity prices. Nonetheless, commodity prices are expected to remain elevated relative to history, keeping the terms

of trade high, and supporting continuing investment in Australia's mining sector. Since midway through last year, commodity markets have experienced extreme price volatility, largely reflecting concerns over European sovereign debt problems and slowing global growth. Iron ore spot prices have come off particularly sharply since late September, in part reflecting softer demand from Chinese mills, declining



“The pipeline of mining engineering construction work continues to expand, signalling the capacity constraints in the resources industry that have begun to emerge.”

steel prices and the withdrawal of credit lines from some European banks. In the near term, we expect global volatility to drive minerals and energy prices, but overall commodity prices are expected to decline by around five per cent over 2012.

Commodity prices are a key driver of the AUD. NAB modelling work suggests that – based on a model that reflects commodity prices, relative levels of activity (proxied by unemployment rates), the strength of the USD, and relative equity market performance – the Australian currency is currently good value at around parity ± 5 cents. Clearly, as risk rises out of Europe, the currency can fall below that level, which we expect to be the case in the early part of 2012. But in the longer run, as the “global recession fear” abates, we would expect to see the AUD returning to around parity by the end 2012, before gradually moving down in the outer years driven mainly by modest weakening in commodity prices. Overall, however, the AUD is expected to remain relatively high over the forecasting period, adding further pressure to the structural changes currently occurring in the multi-speed economy.

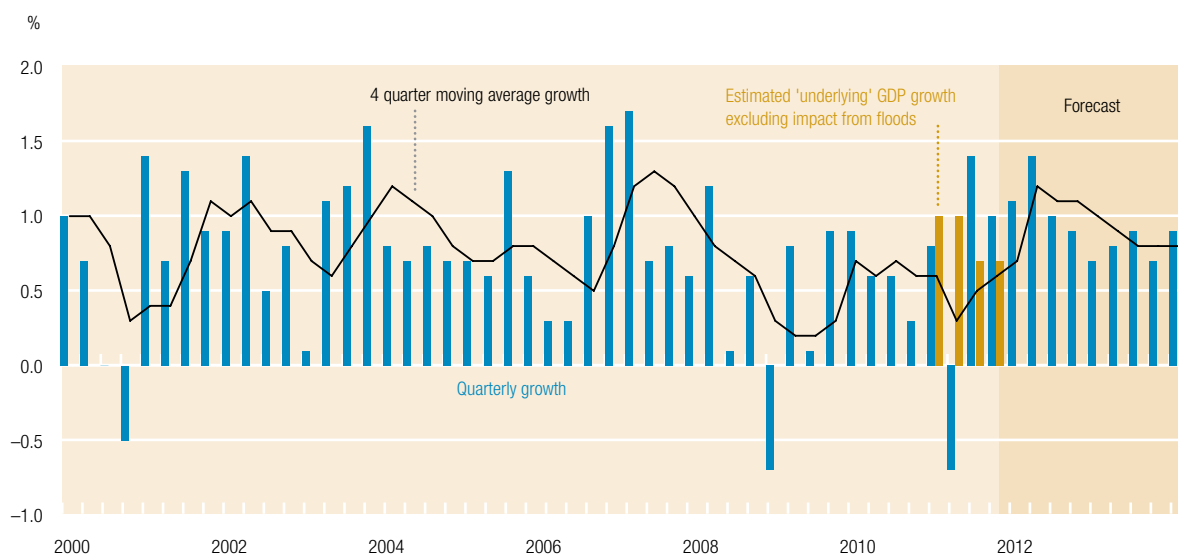
Beyond the currency effects, the terms of trade affects the Australian economy in several ways. At the broader level, there are income, wealth, investment and export effects. The income effect is most apparent from increased revenues generated by the mining sector. The strength in mining income will be reflected in the market value of mining companies, which will boost household wealth via share portfolios, and eventually flow through to increased household spending on domestic goods and services

outside of the mining sector. The higher terms of trade also increases the rate of return on capital invested in mining projects. We have seen this effect encourage further investment in the resources sector, and as this investment becomes more productive, it will cause a rise in the volume of exports.

The September quarter national accounts heralded the start of the long-awaited revival of the mining boom. Business investment growth surged higher in the quarter – largely reflecting investment in the resources sector – while the value of engineering work yet to be done continued to rise. Given Australia’s exceptionally high terms of trade and the strong demand for our resources and minerals from China, mining companies view the outlook for growth in the sector as very favourable and have increased their investment intentions accordingly. The Bureau of Resources and Energy Economics (BREE) estimated that the value of advanced projects at the end of last year (either underway or committed) soared to \$232bn, from \$173bn six months earlier, which is around 17½ per cent of GDP.

The boost to the ever-growing list of resource projects largely reflected several additional large-scale LNG projects, which could expand Australia’s production capacity by up to four fold over the next few years and take export capacity from 20 mtpa currently to around 50 mtpa by 2016 (based on advanced projects). While the boost to capacity in the resources sector will place some downward pressure on commodity prices in the medium term, prices should remain elevated relative to history.

Graph 24
Australian GDP growth



Source: ABS

The pipeline of mining engineering construction work continues to expand, signalling the capacity constraints in the resources industry that have begun to emerge. Up until the end of 2007, the value of completed work broadly kept pace with planned construction but the pipeline has expanded at a rapid pace over the past two years or so and is now two and a half times the rate of annual construction activity. The strength in mining intentions can also be seen using five-year average realisation ratios, which is expected to rise by a further 84 per cent in 2011/12. The data imply particularly solid increases in mining capex over the next two years, after increasing by more than seven-fold since 2004-05. Even using the five-year minimum realisation ratio, mining capex is projected to increase by around 57 per cent in 2013. When constructed, these projects will compete for existing labour and capital resources, placing material pressure on these markets.

While resource production represents a major boost, as noted previously, other parts of the economy continue to struggle. Thus, consistent with the recent rise in the unemployment rate, the NAB Quarterly Business Survey shows that the level of capacity utilisation has fallen over 2011 to be a little above its long-run average. A lower level of utilised capacity reduces the risk that inflationary pressures will emerge in the near term, as a softer labour market should allow wage pressures to be contained.

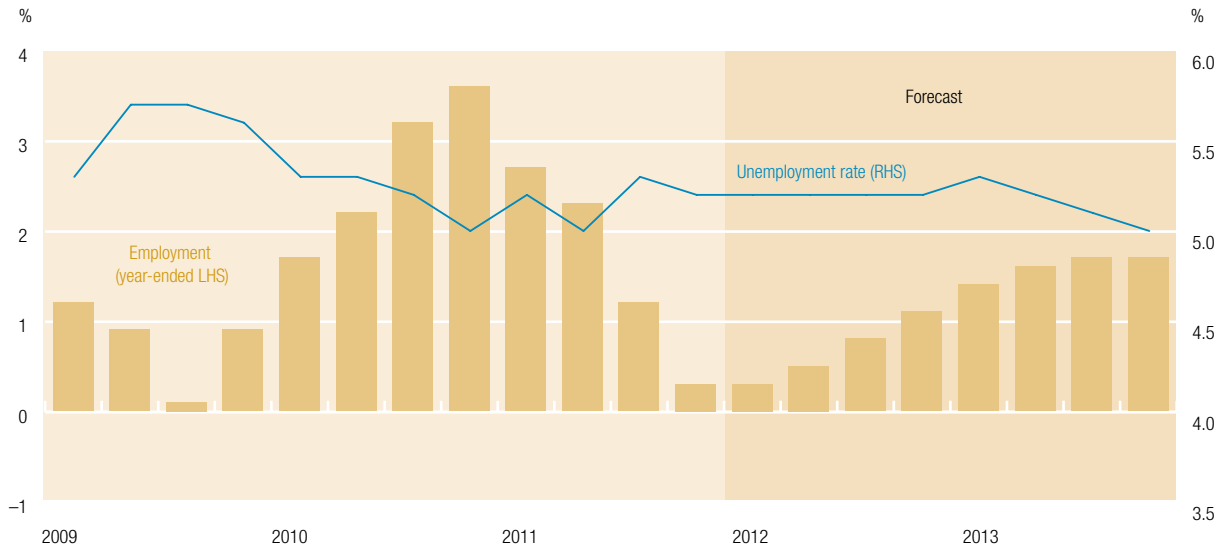
Moving forward

In the longer term, we expect Australian GDP growth to rise to 3¼ per cent in 2012, followed by around trend growth of 3¼–3½ per cent in 2013. These forecasts encompass the impact on Australian GDP growth from the devastating Queensland floods at the beginning of last year – in particular the recovery in coal mine production – as well as the significant rise in mining investment and strong consumption growth that we expect to continue into this year.

Stronger growth in the years ahead will lead to further tightening in factor markets. Employment is expected to rise by 1–1¼ per cent over 2012, which implies very little improvement in the unemployment rate, which should remain at around 5¼ per cent over 2012. Given the soft outlook for the labour market, wage pressures are expected to remain reasonably contained, which is likely to see price inflation remain low in early 2012. However, given the rapid pace of expansion in resource related investment, there is likely to be a diversion of productive resources into the mining sector, which will cause some capacity constraints to emerge in other sectors of the Australian economy, and may increase inflationary pressures in the medium term.

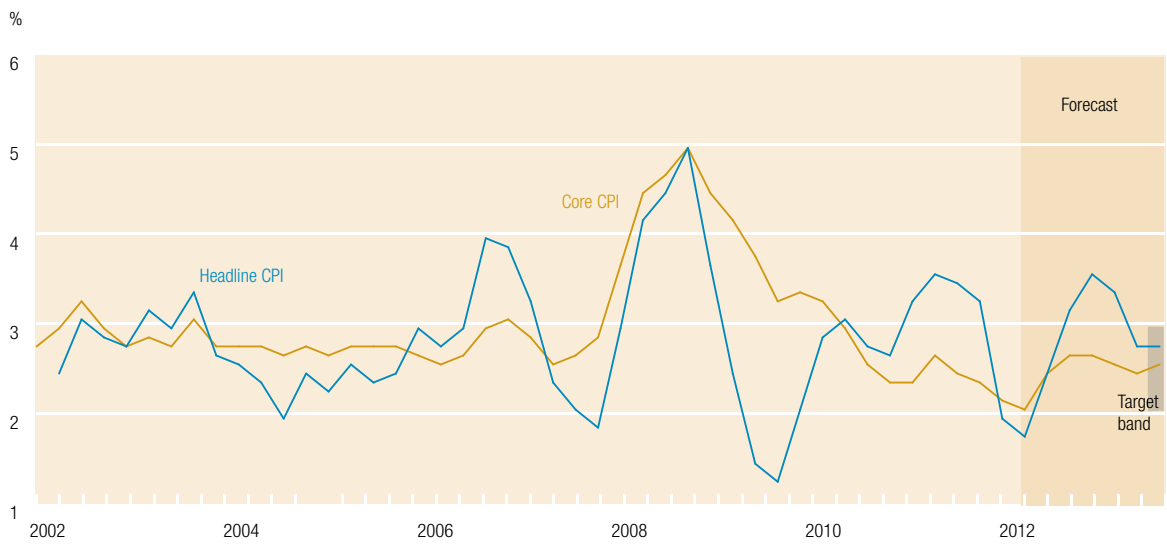
We expect core consumer price inflation to remain very benign over the first half of this year and to remain consistent with the target band over the forecast horizon. Our expectation for softer near-term inflation largely reflects weakness in credit lending,

Graph 25
Australian labour market



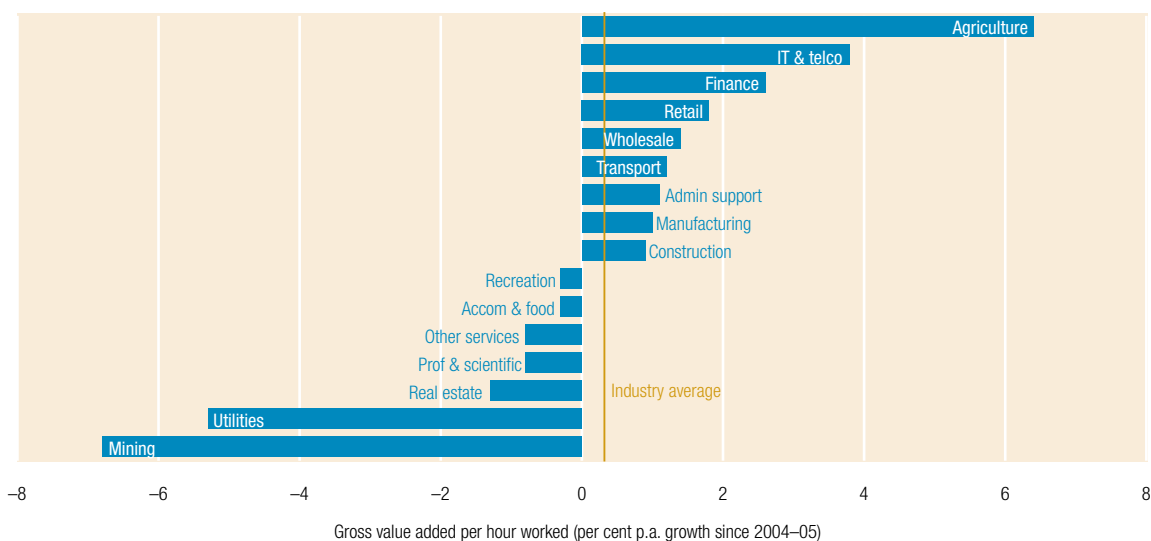
Sources: ABS; NAB

Graph 26
Consumer price inflation (year-ended percentage change)



Sources: ABS; NAB

Graph 27
Productivity growth



Sources: ABS; NAB

falling asset prices, the high AUD and a recent softening in labour market conditions. While the economy had been growing close to trend, with growth largely supported by strength in the resources sector, the risk of higher wages growth outside of mining appears to have lessened. On this basis, and consistent with our inflation models, core inflation is expected to remain subdued in early 2012 and we believe there is scope for the RBA to reduce the official cash rate by a further 25 basis points in February to provide some additional stimulus to interest-rate sensitive sectors of the economy. It is probable that we will also see the RBA lower the cash rate in the middle of this year, although this outcome will be dependent on data (especially the inflation and labour market) and the extent to which banks do not fully pass on the expected rate cut in February in the face of higher funding costs faced by banks. Interestingly, our models of core inflation suggest relatively low CPI outcomes in the first half of 2012 (indeed lower than the RBA's latest forecasts). Consistent with an expectation of the underlying rate of inflation rising to the upper half of the target band in 2013, we have forecast one rate rise in the first half of 2013, partly unwinding the recent and expected further temporary stimulus provided by the RBA.

The implementation of the carbon tax heightens the uncertainty surrounding the expected path for inflation. Commonwealth Treasury modelling of the impacts of the carbon tax indicates an increase in overall consumer prices of 0.7 per cent, with the majority of this increase reflecting higher utilities prices. In terms of its

likely impact on activity, our models suggest that the carbon package will slow medium term GDP growth by around 0.3 to 0.5 percentage points in 2012-13, largely reflecting a reduction in consumption due to falling real wages, as well as the increased cost of capital. While the initial impacts of the carbon tax on inflation will be ignored for monetary policy purposes, there is a real risk that increased price pressures will progressively flow through to core inflation. More specifically, if the cost of living is perceived to have increased, it is likely that wage pressures will mount. In the longer run, there is a risk that the impact of carbon pricing will be more severe than models imply, as wages are not fully flexible.

The productivity slowdown – a few reflections

Australia's measured productivity growth has slowed in recent years, although it is not yet clear that specific government policy intervention is necessary. Reasons for the decline in labour productivity performance in Australia since the middle of the last decade may include the temporary impacts of the drought, high levels of investment in the mining and utilities industries that have not yet come on stream and the impact of slower GDP growth during the GFC. However, a plausible case can also be mounted that much of the slowing is attributable to an apparent stalling in the growth of real wages faced by producers, reflecting the surge in the terms of trade, which has provided

Table 2
Australian economic and financial forecasts

| | Fiscal Year | | Calendar Year | | |
|--------------------------------------|-------------|------------|---------------|------------|------------|
| | 2011–12 F | 2012–13 F | 2011– F | 2012–F | 2013–F |
| Private Consumption | 3.6 | 2.4 | 3.5 | 2.9 | 2.3 |
| Dwelling Investment | 0.1 | 7.6 | –1.5 | 4.0 | 8.8 |
| Underlying Business Fixed Investment | 27.8 | 13.4 | 20.4 | 20.9 | 12.4 |
| Underlying Public Final Demand | –2.8 | –0.8 | –0.7 | –2.2 | –0.3 |
| Domestic Demand | 4.9 | 3.7 | 4.0 | 4.3 | 3.8 |
| Stocks ^(b) | –0.3 | 0.2 | 0.3 | –0.1 | 0.2 |
| GNE | 4.6 | 3.9 | 4.3 | 4.2 | 4.0 |
| Exports | 4.5 | 5.7 | –1.7 | 7.5 | 4.9 |
| Imports | 11.4 | 6.6 | 11.1 | 8.1 | 7.0 |
| GDP | 3.3 | 3.5 | 2.1 | 3.7 | 3.4 |
| – Non-Farm GDP | 3.6 | 3.5 | 2.3 | 3.7 | 3.5 |
| – Farm GDP | –9.4 | –1.0 | –7.6 | 0.7 | –2.4 |
| Federal Budget Deficit: (\$b) | 23 | 12 | 30 | 18 | NA |
| Current Account Deficit (\$b) | 45 | 85 | 33 | 69 | 94 |
| (–%) of GDP | 3.0 | 5.3 | 2.3 | 4.5 | 5.7 |
| Employment | 0.6 | 1.2 | 1.6 | 0.7 | 1.6 |
| Terms of Trade | 2.7 | –9.8 | 14.1 | –8.9 | –4.2 |
| Average Earnings (Nat. Accts. basis) | 5.8 | 4.8 | 5.5 | 5.1 | 4.6 |
| End of Period | | | | | |
| Total CPI | 1.8 | 3.4 | 3.3 | 3.2 | 2.8 |
| Core CPI (exc. carbon) | 2.1 | 2.6 | 2.4 | 2.7 | 2.6 |
| – Core CPI (inc. carbon) | 2.1 | 2.9 | 2.4 | 2.8 | 3.1 |
| Unemployment Rate | 5.2 | 5.2 | 5.2 | 5.2 | 5.0 |
| RBA Cash Rate | 3.75 | 4.00 | 4.25 | 3.75 | 4.00 |
| 10 Year Govt. Bonds | 4.30 | 5.25 | 3.67 | 4.7 | 5.25 |
| \$A/US cents | 0.98 | 0.97 | 1.02 | 1.00 | 0.95 |
| \$A –Trade Weighted Index | 73.7 | 70.6 | 74.8 | 73.3 | 69.7 |

(a) Percentage changes represent average annual growth to June quarter, except for cash and unemployment rates. The latter are end June.
(b) Contribution to GDP growth

other income benefits to wage earners. The current slowing in measured productivity may not reflect any slowing in the growth rate of structural productivity of technical efficiency. That is, the current high profile concern about the slowing in productivity may not be structural (and hence a real concern) but rather a cyclical outcome due to the nature of Australia's current development.

Conclusion

As the mining investment boom progresses and consumer caution abates, signs of divergent economic conditions across regions are likely to become more pronounced. The disparity between industry conditions is also likely to persist for some time, although we may see some improvement in the consumer dependent sectors as incomes rise and consumption strengthens, while a moderating Australian dollar may ease some of the hardship for those non-mining sectors that are competing in global markets (the so-called "Dutch disease"). The multi-speed economy is likely to be a dominant feature of the Australian economy for some time, and will remain a primary concern for policy makers.

While Australia's growth outlook remains positive, the difficulty faced by a multi-speed economy will be challenging. Overall, while we expect the Australian economy to strengthen, that will be very much a resources driven national income effect. Of course, Australia starts from a very strong set of fundamentals, with relatively low levels of unemployment and public sector debt. Both of these fundamentals improve in our central case forecast. That said, developments in Europe will continue to present downside risks to the global economy in 2012 and, consequently, to Australia. Relative strength in the Chinese economy is expected to continue to underpin activity in non-Japan Asia, but the performance of the advanced economies – and to a lesser extent the emerging economies – will be heavily dependent on how European economies deal with their sovereign debt issues as well as market perceptions of their fiscal credibility.

The views in this article are those of the authors and should not be attributed otherwise.



political OVERVIEW



Professor Peter van Onselen hosts three talk shows on Sky News, including its flagship Sunday morning political program, Australian Agenda. He is the Contributing Editor at The Australian newspaper and a Winthrop Professor at The University of Western Australia. Professor van Onselen has written widely on Australian politics, including the best selling: John Winston Howard: The Biography (Melbourne University Press) rated by The Wall Street Journal as the best biography of 2007.

Retrospect 2011

The defining features of the Australian polity in 2011 were the unpopularity of the two major party leaders as well as the “Labor brand” (as determined by its primary vote in the polls), and the polarising view of the government’s achievements (or failures), depending on one’s perspective. On this latter point new media provided a rare insight last year. Whether tracking conversations on Twitter or Facebook, the (tech savvy) public slotted into one of three camps which I believe are reflected in the wider electorate as well:

1. Rusted on Labor supporters who couldn’t see how a government that had passed into law an historic carbon tax, as well as began rolling out the National Broadband Network, could be seen as anything other than doing a good job, given the circumstances. Those circumstances – for this grouping – included not just minority status in the parliament, but a hostile media and a relentlessly negative opposition.
2. Coalition supporters who felt aggrieved by broken promises (think carbon tax) and waste and mismanagement (think BER) and couldn’t understand how the cross benches could see fit to continue to offer the Labor government a lifeline in the parliament. Ongoing budget deficits and scandals including the Craig Thomson saga only served to heighten this groupings negative view of the government.
3. Swinging voters who took a dim view of the government (notwithstanding “achievements”) but also had reservations about the opposition alternative on offer. These voters skewed opinion polls in the Coalition’s favour as they expressed their discontent with the government by registering a protest vote against them. But their switched support for the opposition remains soft, as indicated by low satisfaction ratings for the Opposition Leader despite a decisive two party vote dominance.

The big question for 2012 is: As the next election draws closer, does the final grouping of voters who are unhappy with the government start to also express reservations about the opposition such that the polls tighten? If this were to happen it would likely be a late 2012 phenomenon and only if Labor held its collective nerve until that time, thus using 2012 to stabilise the government after a difficult 2011.

The politicking of 2012

What do the polls tell us for the future?

The final Newspoll of 2011 saw the Labor primary vote register at 31 per cent, up from a nadir in September of just 26 per cent. It was 38 per cent at the 2010 election, not enough to form majority government but seven points higher than the way Labor finished last year. The Coalition vote was 44 per cent in the final Newspoll of 2011, healthy to be sure, but surprisingly only fractionally above the 43.6 per cent it received at the election. Support for the Greens held roughly steady at 13 per cent, up a little more than one point from the election.

The majority of the vote seepage away from Labor has resettled in the “other” column, almost doubling it to 12 per cent from the result recorded at the last election (6.6 per cent). The government believes it can win over those polled who currently fall into the “other” category, giving it a chance to recover despite its very low primary vote. Lending plausibility to this thesis are the internal divisions of the Coalition. Despite outward appearances of strength, courtesy of the polls, there are generational and ideological divides within the Liberal Party, as well as policy tensions between the Nationals and Liberals, for example over coal seam gas. If those divisions become more outwardly apparent in 2012, the weak leadership ratings of the Opposition Leader might become more of an issue internally than they currently are, sparking unrest.

Table 1
Primary votes in 2011 (final, best and worst)

| Party grouping | Final primary vote (December) 2011 | Worst primary vote 2011 | Best primary vote 2011 | Election result 2010** |
|----------------|------------------------------------|-------------------------|------------------------|------------------------|
| ALP | 31 | 26 (September) | 36 (February)* | 38.0 |
| Coalition | 44 | 40 (March) | 50 (September) | 43.6 |
| Greens | 13 | 10 (May) | 15 (March) | 11.8 |
| Other | 12 | 8 (May) | 13 (September) | 6.6 |

*prior to the announcement of the Carbon Tax backflip **Labor forms minority government

What impact will the unpopularity of Gillard and Abbott have on 2011?

According to the personal ratings of the leaders, both major party leaders go into 2012 with a lot of work to do to convince voters they are worth supporting. Gillard and Abbott's net satisfaction ratings (the percentage of voters satisfied with their performances minus those who are dissatisfied) are both in negative territory. Gillard's support improved in the final months of 2011, pushing her rating above Abbott's. However, she remains one of the most unpopular prime ministers since polling began. Abbott is at a personal low according to his numbers.

1. Can either the Prime Minister Julia Gillard or the Opposition Leader Tony Abbott improve their standing in the eyes of voters in 2012?
2. Assuming not, does that put either of them under pressure to retain their positions within their own parties?

In the Prime Minister's case her job security is made more tenuous because of the low Labor primary vote, but whether the party can agree on an alternative to replace her – even if it comes to the conclusion that her position is irrecoverable – is unclear. Former prime minister and now Foreign Affairs Minister, Kevin Rudd, remains deeply unpopular in large sections of Labor's caucus, even though polls show he is clearly more popular than the PM in the eyes of the public.

Speculation about a Rudd return to the Labor leadership will continue in 2012, perhaps resulting in a formal challenge. But without the factional leaders shifting their support away from the Prime Minister, at the time of writing, she remains (tentatively) secure in her position.

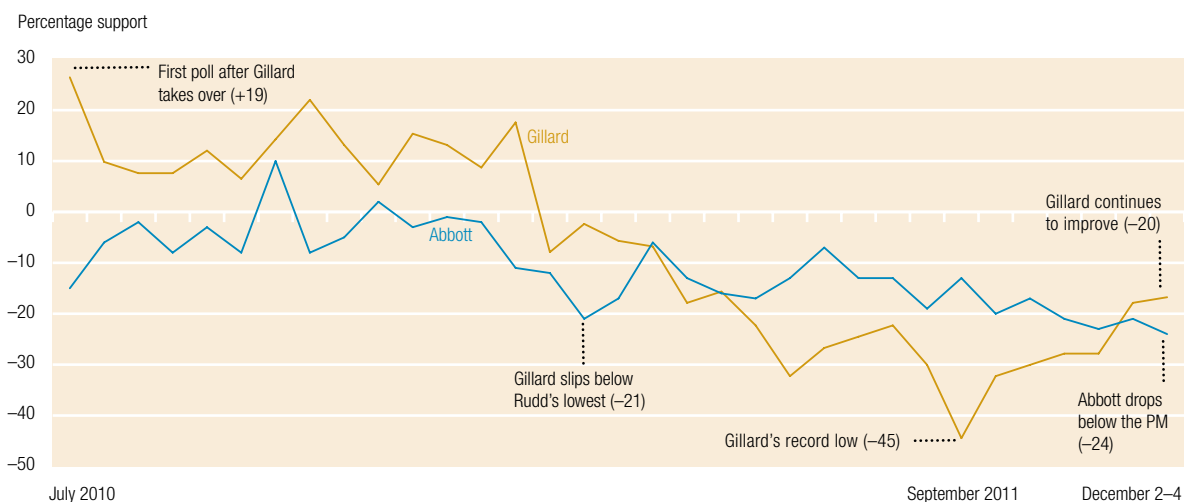
Other candidates for the Labor leadership are less well known and less likely to be supported by the cross-benchers, making an early election one consequence Labor MPs must be aware of if considering changing leaders. This reality probably gives the PM more time in 2012 to recover in the polls, but it does not guarantee a third option won't emerge as a challenger this year. I expect ongoing leadership speculation on the government side to distract from any political or policy recovery this year, leaving the government in a dire position in the polls. This situation will have flow on effects for public policy and business and consumer confidence in 2012.

As already mentioned, in 2011 the public's discontent with the government became increasingly obvious, but that feeling did not translate into support for the Coalition as an alternative. The year ended with voters committed to throwing out the Labor government, but doing so without an active embrace of what they would get in the aftermath.

Abbott is safe from challenges while the Coalition's polling numbers stay strong (not least because there is no clear alternative), but if the polls do tighten his authority will evaporate quickly. Abbott's support within his party as well as the polling dominance of the opposition over the government is what political scientists call soft.

Graph 1

Leaders' net satisfaction rating*



*Net satisfaction: Percentage of voters who approve, minus the percentage of who disapprove
Source: Newspoll

“But the real constraint of the government’s minority position comes from its many and varied alliances.”



Talk of a potential comeback to the Liberal leadership among sections of the business community by Shadow Communications Spokesman, Malcolm Turnbull, misunderstands his isolation inside the parliamentary Liberal party room. Turnbull’s leadership aspirations are, at best, a longer term proposition if the Liberals unsuccessfully were to cycle through alternatives – not a consideration for 2012. The only potential leadership alternatives to Abbott for this year are Shadow Treasurer Joe Hockey or Shadow Immigration Spokesman Scott Morrison. But neither of them is counting numbers of support and both would need to build considerable support before becoming serious contenders. It is more likely that they are the starting pair to challenge for the Liberal leadership in the event of an election defeat.

That’s not to say Abbott has nothing to fear from internal politicking in 2012. The Opposition Leader is running an increasingly autocratic regime in a bid to stay disciplined, avoid political mistakes and ensure that the government’s failures are the issue on people’s minds. It has worked so far, but there are signs of discontent within the Coalition ranks. Even if

the Coalition remains dominant in the polls in 2012, the backbench will increasingly call for policy detail to be spelt out, not to mention adherence to Liberal Party principles. For Abbott, 2012 will be all about timing. When to switch from negative attacks to positive policy development. Get the timing right and he avoids accusations of not looking like an alternative PM. Get it wrong and the Coalition either opens itself up to policy unpicking earlier than it should, or it gives the government the chance to characterise Abbott as only knowing what he opposes not what he stands for.

The constraints of minority government

House of Representatives, Leader of Government Business, Anthony Albanese, has pointed out that the success of the current minority parliamentary arrangements can be judged according to the government’s ability to pass its legislation last year. With the exception of the so called Malaysian Solution, Bills for which were never presented, the government won the day

on the floor of the parliament on nearly all occasions last year. This year such successes are more likely following Peter Slipper's elevation to the speakership.

But the real constraint of the government's minority position comes from its many and varied alliances. Now that the Greens control the balance of power in the Senate, and Andrew Wilkie has withdrawn his support for the government, the list of obstacles to legislation passing through the parliament has only increased. 2012 will be the first full year that the government will have to deal with a Greens balance of power in the Senate, and I expect just as the Labor Party will try and appeal to the political centre this year, the Greens will look to sure up their left flank after a year of compromise to pass legislation. This mix will ensure that legislation goes through more than the usual horse trading to be passed in 2012.

However, last year the Prime Minister was forced to spend much of her time massaging the parliament to win the day. Her skills inside the beltway saw legislative successes, but the time taken to ensure those wins meant that she was unable to focus on her popular and public persona. This year I expect the government to be more focused on bedding down what it has achieved, rather than embarking on more reform. Hence, while the minority parliament may be as volatile in 2012 as it was last year, a smaller legislative agenda may make the instability of minority government less of a factor in 2012.

The policies of 2012

Why the carbon tax will be THE issue of 2012

Few moments in Australian political history have seen partisan divisions as significant as they are right now, despite a lack of obvious ideological or policy divides when examining the causes of such divisions. This is the paradox of modern politics in Australia at the moment, and it will likely continue in 2012. Both major party leaders will use the media to explain to the electorate the importance of removing or preventing the other side access to the Treasury benches, yet the depth of analysis as to why this must happen will be hard to come across. No policy debate is more emblematic of this phenomenon than pricing carbon, a debate which has compromised both sides of politics.

In 2011 both major parties stuck to climate change policies which had as their benchmark a five per cent emissions reduction target by 2020, according to 2000 emissions levels. Labor's plan, legislated by the parliament in 2011 and due to commence later this

year, includes a fixed price on carbon (the said carbon tax) moving to an emissions trading scheme in a few years time. The Coalition's plan (the said direct action alternative) would see the government allocate funds following a competitive process whereby businesses apply for support for schemes to lower emissions.

Despite all of the Coalition's predictions of doom and gloom, it has the same emission reduction target as Labor, and a majority of economists regard pricing carbon as the most efficient means of achieving emissions cuts. Despite panning the carbon tax and ETS which will follow, the Coalition's climate change spokesman, Greg Hunt, wrote a university thesis in the 1990s titled *A tax to make the polluter pay* and just three years ago under Turnbull's leadership advocated support for an ETS with similar design features to the one which has been legislated.

Equally, despite Labor's contempt for Abbott's direct action plan, in order to win the support of the Greens for its carbon tax, Labor's package includes a multi billion dollar direct action handout of its own (a \$10b Clean Energy Fund). Former Labor leader Mark Latham told Sky News' Australian Agenda that he thought the clean energy fund could become "the greatest waste of money in the history of the Commonwealth". And the Prime Minister, now so passionately in favour of the carbon tax played a leading role in talking Rudd out of holding firm on his timeline for introducing an ETS when he was leader, and pledged to hold a citizens assembly to achieve consensus on the issue (ruling out a carbon tax) before the last election.

The undercurrent to any policy debate in 2012 involving pricing carbon will be how serious (or viable) achieving the 2020 target really is. Labor's scheme involves significant purchasing of carbon credits from overseas at a time when international action appears unlikely. The Coalition's scheme can't achieve the 2020 target without purchasing credits from overseas (which they have said they will not do), and many in its ranks consider the whole effort to achieve a five per cent cut a waste of taxpayers' dollars. With the world economy again looking weak in 2012 we will see just how important a post-material issue like climate change is to voters when they are worried about their economic well being.

The best of the rest

While the carbon tax will remain the frontline political issue in 2012, there are also a host of other policy debates that will be significant. The introduction of the new mining tax, debate and decision surrounding poker machine reforms, the rolling out of

“While the carbon tax will remain the frontline political issue in 2012, there are a host of other policy debates that will be significant also.”



the National Broadband Network and the likelihood (not to mention importance) of returning the budget to surplus in 2012/13 are obvious political debates which will follow on from last year. Industrial relations could be another one. Added to this mix will be the government's response to the recommendations of the Gonski Review into education and an expected up-scaling of the debate over health reforms and health spending. Irrespective of whether the major parties can reach an understanding on processing asylum seekers off shore, the issue will continue to capture media attention this year.

Mining tax:

The mining tax has passed through the House of Representatives and will likely do the same in the Senate early in 2012. The Greens have used their muscle both as an alliance partner in government with Labor and as the new third force controlling the balance of power in the upper house to force changes

to the legislation, but only around the edges. 2012 will see an escalation of the campaign against the new tax, especially from the smaller miners represented by the Association of Mining and Exploration Companies (AMEC). But the most interesting aspect to debate over the mining tax in 2012 will be its revenue forecasts. So far what the big miners claim they will pay is vastly lower than what Treasury has projected. I suspect this will be the focal point of debate this year.

Poker machine reforms:

Independent Andrew Wilkie's ability to force the government into legislating mandatory pre-commitment of the order he desired was always going to be difficult in 2012. However, the strength with which he has expressed his displeasure with the Prime Minister for breaking their agreement has made the Government's position more tenuous.

The poker machine reform package the Prime Minister



hopes to pass through the parliament in place of the package contained in the Wilkie agreement is still a major reform to the operation of poker machines in this country. However, there may well be some resistance to the package by the sector as we move closer to the point where the framing of the legislation is debated in the parliament. The Prime Minister’s decision to break her agreement with Wilkie pre-empted a likely backbench revolt over this issue because of lobbying pressure from clubs and pubs in Labor MPs electorates.

National Broadband Network:

The NBN will continue to be rolled out across the country with strong media interest in the cost and the take-up rates by consumers. Because the government has claimed the NBN will make a profit, it is off budget. This year will be a real test of consumer interest in the expensive rollout. It won’t simply be a case

of the government wanting strong take-up rates to justify the expense. For the NBN to be the popularity boost Labor is looking for it needs consumers to try it and be won over by it.

The May budget:

In the current global economic environment the May budget is emerging as a key moment for Labor. It has staked its economic reputation on a surplus forecast for the 2012/13 fiscal year, and this year’s budget delivers that forecast with details not yet seen. While Australia is in a strong economic position compared to our global equivalents, domestically the government hasn’t won the applause for economic management that it would have liked. With revenue streams under pressure but the government politically required to hit its surplus target, expect a tough budget as well as plenty of shifting of spending commitments into the outer years.

Industrial relations:

With the ambitious Bill Shorten promoted to the industrial relations (IR) ministry, and following on from the Qantas dispute in 2011, IR will again be an important policy area in 2012. Whether the opposition is prepared to spell out an alternative policy will dictate whether or not media attention translates into more serious debate over policy design. The government has admitted the Fair Work Act is in need of tweaking, but without an opposition prepared to engage seriously in workplace reform, business will not win important changes to the Act in 2012.

Education:

Labor claimed that it would institute an “education revolution” before it won office in 2007, and the responsible shadow spokesman and then minister was Gillard. Education is a traditional policy strength for Labor in the eyes of voters, however since Latham toyed with adjusting public funding for independent schools in the lead up to the 2004 election, Labor has been loath to get sucked into debate about appropriate levels of funding for public versus private schools lest “the politics of envy” becomes the mantra. The Gonski Review will return this debate to the political frontline, an awkward debate for the government to manage.

Health/disability support:

Prior to the end of last year the Prime Minister reshuffled her frontbench, and the most significant change was in the health portfolio area. Nicola Roxon, who had held the position since opposition, was moved and replaced by Tanya Plibersek. In 2011 the government won agreement for a heavily watered down version of the health reforms it had proposed in its first term. Strategists within the PM's office have expressed concern that Labor's salesmanship of its health agenda has been too bogged down in technocratic details, which suggests a more emotive retail pitch in 2012. Plibersek will facilitate such a switch, the question is whether yet another policy issue can be inserted into the policy frontline and gain attention. Especially if little in the way of new details, are forthcoming. In addition, having won support at last year's ALP National Conference for a disability insurance scheme, I expect that Labor will look to move towards presenting legislation on such a scheme this year. It would form a popular part of a new social agenda, so long as the funding mechanism holds up.

Asylum seekers:

The more dominant the asylum debate is in 2012, the harder it will be for the government to spruik its worth. Australia is in the unusual position where both major parties favour (albeit different) forms of offshore processing, yet their inability to agree on the model sees Australia operating onshore processing more in keeping with the minority policy position of the Greens. The only firm prediction which can be made on this policy front is that whatever direction the adopted policy goes, boats are likely to keep coming and the historical context for the debate means that the more it hits the headlines the better off (politically speaking) the conservative side of politics is.

Conclusion: a hard year ahead for Labor

Politics in Australia will break one of two ways this year: either the decline in Labor's standing will stay fixed, guaranteeing a sizable defeat at the next election for Australia's left of centre major party (in the order of what occurred in 1975 and 1996). Or voters will question their desire for change based on concerns with the conservative alternative, in which case an opposition scramble will fuel Labor's recovery (reminiscent of 1990 or 1993), putting the government right where it needs to be come year's end. Political predictions in volatile times are always difficult. Nevertheless, the former outcome looks far more likely than the latter.

The views in this article are those of the author and should not be attributed otherwise.



Productivity



Saul Eslake has over 25 years' experience as a financial markets economist, including five years as Chief Economist at McIntosh Securities (1986–91), four years as Chief Economist (International) at National Mutual Funds Management (1991–95) and 14 years as Chief Economist at the Australia & New Zealand Banking Group (ANZ) (1995–2009).

After leaving ANZ Saul took up part-time roles as Director of the Productivity Growth program at the Grattan Institute and as an advisor in PricewaterhouseCoopers' Economics and Policy Practice. In December 2011, Saul returned to the financial markets as Chief Economist of Bank of America Merrill Lynch Australia.

Saul has a first class honours degree in Economics from the University of Tasmania, and a Graduate Diploma in Applied Finance and Investment from the Financial and Securities Institute of Australia. He has also completed the Senior Executive Program at Columbia University's Graduate School of Business in New York.

While Australia's economic performance over the past decade has been impressive on many dimensions, productivity is not among them. Australia's productivity performance over the past decade has been, to put it mildly, poor – both by Australia's own historical standards, and by contemporary international standards.

Australia's productivity performance in the 2000s

Australia's productivity performance, however measured, has deteriorated substantially since the late 1990s:

- Since 2005–06, labour productivity (real gross value added per hour worked) across the Australian economy as a whole has grown at an average annual rate of just 0.6 per cent, compared with 1.9 per cent per annum over the first half of the 2000s, 2.5 per cent over the second half of the 1990s, and 1.7 per cent per annum during the first half of the 1990s. Indeed going back to the 1960s, there is no period of five years or more during which labour productivity growth has been slower than since the mid-2000s;¹
- Labour productivity in what the Australian Bureau of Statistics (ABS) calls the market sector (ie excluding public administration and safety, education

and training, and health care and social assistance sectors where productivity is particularly difficult to measure) has grown at an average rate of just 1.1 per cent per annum over the past six years, compared with 2.4 per cent per annum over the first half of the 2000s and 2.9 per cent per annum over the second half of the 1990s;

- Multi-factor productivity (which takes account of the contribution of capital as well as labour) in the market sector actually *declined* over the six years to 2010–11. It declined at an average annual rate of 0.7 per cent, after growing by 0.9 per cent per annum, on average, over the first half of the 2000s and at an average annual rate of 1.7 per cent during the second half of the 1990s.

As Reserve Bank of Australia Governor Glenn Stevens put it last year: "It is now just about impossible to avoid the conclusion that productivity growth performance has been quite poor since at least the mid 2000s."²

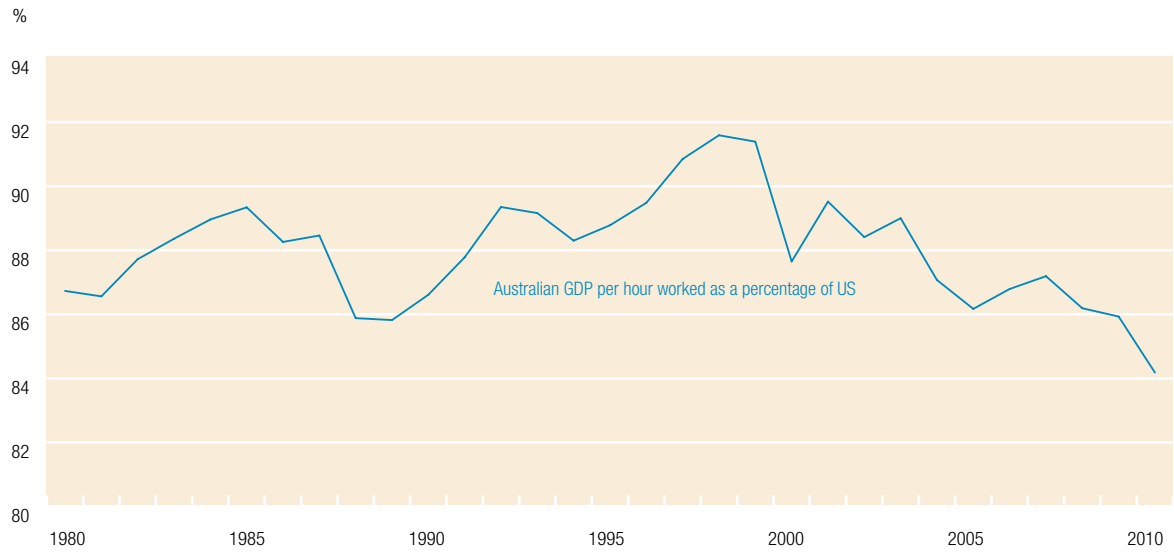
Australia has been by no means unique in experiencing a slow-down in productivity growth since the turn of the century. However, whereas Australian labour productivity growth was in line with the (unweighted) OECD average in the 1990s, during the 2000s it was 0.2 percentage points below the weighted OECD annual average growth rate. Australia ranked 11th out of 25 OECD countries in descending order of labour productivity growth in the 1990s, and 17th out of 34 countries in the 2000s.

Figure 1
Australian labour and multi-factor productivity growth in the 1990s and 2000s



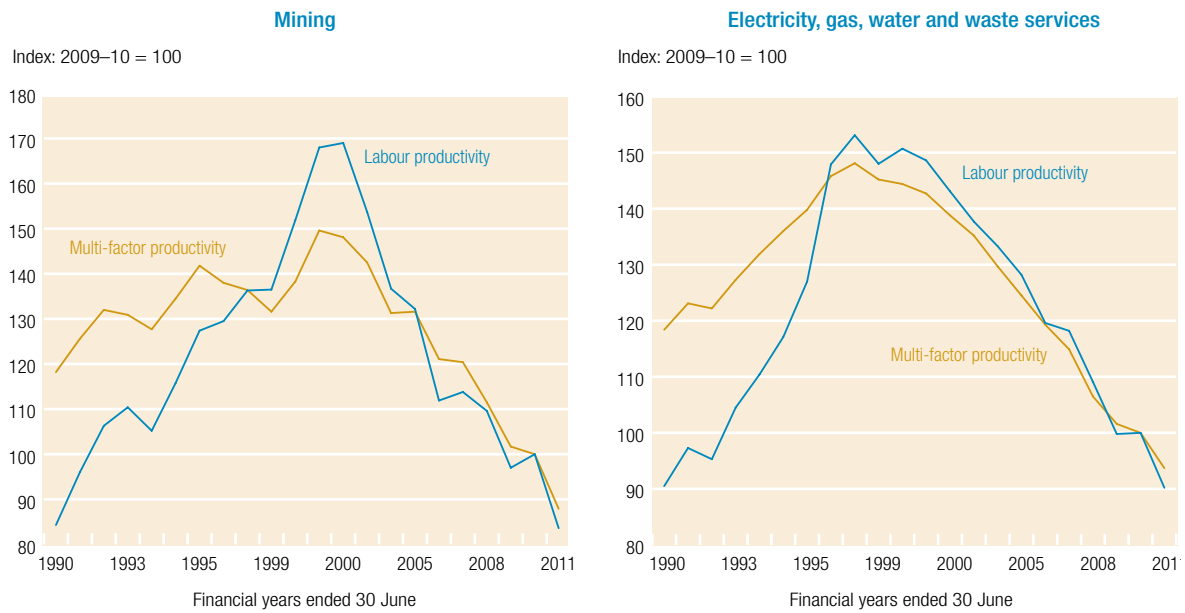
Note: Selected market sectors are agriculture, forestry and fishing; mining; manufacturing; electricity, gas, water and waste services; construction; wholesale trade; retail trade; accommodation and food services; transport, postal and warehousing; information, media and telecommunications; financial and insurance services; and arts and recreation services.
Sources: ABS Australian National Accounts (5204.0) and Experimental Estimates of Industry Multi-factor Productivity (5260.0.55.002).

Figure 2
Australian labour productivity as a percentage of the US level



Note: Labour productivity here is real GDP (in 2010 US dollars) per hour worked.
 Source: The Conference Board Total Economy Database (January 2011).

Figure 3
Productivity in the mining and utilities sectors



Source: ABS Experimental Estimates of Industry Multi-factor Productivity (5260.0.55.002).

Using the United States as a crude proxy for best practice in terms of labour productivity³, the level of Australian labour productivity declined from a peak of 91.6 per cent of the corresponding US level in 1998

to 84.2 per cent of the US level in 2010, more than reversing the five percentage point increase in this ratio which occurred between 1990 and 1998 (see Figure 2).



“The mining sector has been gearing up for a huge expansion in response to the demand for energy and minerals (particularly those associated with steel-making) from China and India.”

Can the productivity growth slowdown be explained by peculiar trends in mining and utilities?

Until recently the accepted wisdom in policy circles and elsewhere had been that the decline in Australia's productivity growth rates since the beginning of the 2000s could be ascribed largely to sharp falls in productivity in the mining and utilities sectors. This was the result of factors peculiar to those industries and which would eventually be reversed, so that there was no particular cause for concern.

There is no denying that both labour and multi-factor productivity have fallen sharply in the mining and utilities sectors over the past decade, as shown in Figure 3.

The mining sector has been gearing up for a huge expansion in response to the demand for energy and minerals (particularly those associated with steel-making) from China and India. Since 2001-02, hours worked in mining have risen by more than 150 per cent and the real value of the mining industry's capital stock has risen by 115 per cent. Yet the volume of

mining output has risen by only 26 per cent over the same period. As a result, labour productivity in the mining sector has fallen by 50 per cent over this period, and multi-factor as a whole moves past the ramping up stage into full production. Although, it has changed to the extent that high prices for various mineral commodities have made it commercially logical for companies to exploit low-grade ores (which require larger amounts of labour and capital to produce a given volume of output, therefore also detracting from measured productivity), the mining industry's apparently poor productivity performance could continue for a prolonged period.

The utilities sector recorded substantial productivity gains in the 1990s, largely as a result of reforms engineered by State Governments. However, during the past decade electricity and gas businesses have had to invest heavily in response to continued growth in demand (especially for peak load, which inevitably entails a large degree of “redundancy” at non-peak times), to replace ageing transmission infrastructure, and to meet government-mandated renewable energy targets. Likewise governments have undertaken significant investments in water infrastructure (including desalination plants in five states), with a view to

Figure 4
Market sector labour productivity including and excluding the mining and utilities sectors



Sources: ABS Australian National Accounts (5204.0), Labour Force, Australia, Detailed, Quarterly (6291.0.55.003) and author's calculations.

guaranteeing security of supply in drought conditions, while simultaneously imposing restrictions on the use of water throughout much of the decade. As a result this has detracted from the output of water businesses without commensurate reductions in factor inputs.

In this sector, hours worked have increased by 80 per cent since 2002–03, and the real value of the productive capital stock by almost 90 per cent, whereas output has risen by only 13 per cent: correspondingly, labour productivity has fallen by 37 per cent and multi-factor productivity by 33 per cent in the utilities sector over this period.

However, given over the last decade both the mining and utilities sectors have employed about 19 per cent of Australia's non-housing capital stock and a little over two per cent of Australia's workforce, to produce about 11 per cent of Australia's overall output, it seems *prima facie* implausible that these two sectors could have accounted for nearly all of the decline in Australia's productivity since the turn of the century.

Indeed if these two sectors are excluded from consideration⁴ (as shown in Figure 4), labour productivity growth in the rest of the market sector has still slowed from 3.1 per cent per annum over the five years to 1999–2000 to 1.3 per cent per annum over the five years to 2010–11, only 0.1 of a percentage point per annum less than the decline in the equivalent measure of labour productivity growth including the mining and utilities sectors.

Other explanations for Australia's productivity slowdown

A considerable volume of research supports the contention that the acceleration in Australia's productivity growth rate during the 1990s owed much to the economic reforms implemented by successive governments of both political persuasions during that decade and the second half of the preceding decade.⁵

To the extent that the reforms of the 1980s and 1990s prompted step changes in the level of productivity – as may well have been the case with, for example, the privatisation of government monopolies or with at least some aspects of competition policy – then the fading of what appeared at the time to have been an increase in the *rate* of productivity growth is unsurprising.

It seems highly plausible that at least part of the slowdown in productivity growth since the turn of the century is attributable to the absence of any significant productivity-enhancing reforms.

The dearth of productivity-enhancing reforms since about 2000 is clearly in part attributable to changes in the political environment. This includes a diminution in the enthusiasm of both major political parties for continuing reforms of the type pursued in the 1980s and early 1990s once the politically easiest reforms



“... the past decade has been one of almost uninterrupted growth in economic activity, employment and household disposable income.”



(what management consultants typically call the low-hanging fruit) had been accomplished, and once what remained was seen as more politically challenging, including to important elements of the core constituencies of both sides of Australian politics.⁶ Changes in voting behaviour – particularly in rural and regional areas, but also in areas such as western Sydney – made both major political parties more sensitive to the views of those who perceived themselves (not always inaccurately) as losers from the reforms of the 1980s and 1990s.

The lack of enthusiasm for productivity-enhancing reforms since about 2000, on the part of both political leaders and the public at large, also seems in part attributable to the more prosperous economic circumstances of the last decade.

The willingness of political leaders to undertake (and the public at large to accept, if only tacitly) the reforms of the 1980s and 1990s were to a significant degree prompted by the economic vulnerabilities exposed by the persistence of high inflation and unemployment since the mid-1970s, the decline in Australia's terms of trade during the 1970s and 1980s, and two severe recessions occurring within less than a decade.

By contrast, the past decade has been one of almost uninterrupted growth in economic activity, employment and household disposable income. There has been lower unemployment than at any time since the mid-1970s, sound public finances (especially by comparison with other advanced economies), relatively low and stable inflation, relatively low and stable interest rates, a generally rising exchange rate (something widely seen among the broader population as a short-hand summary of international investors' views of Australia's economic performance) and (perhaps most importantly in this context) a dramatic reversal of the downward trend in Australia's terms of trade which had prevailed throughout most of the twentieth century.

This diminished focus on productivity over the past decade has not been confined to the public policy arena.

As the profit share of Australia's national income has increased to unprecedented levels during the past decade (apart from the period immediately after the global financial crisis), businesses have attached less importance to the pursuit of productivity gains at the enterprise or workplace level (which is, after all, where the decisions that lead to higher levels of

“... whatever public or private benefits that have been procured through legislation and regulation of this type they have inevitably come at some cost in terms of productivity.”



productivity are formulated and executed, if at all). A survey conducted last year by Telstra found that, among over 300 organisations each with over 200 employees, while 76 per cent regard productivity as an important business priority, only 24 per cent have “achieved significant productivity improvement” over the past year, a proportion which was only five percentage points higher than when this survey was first conducted in 2009.⁷

As with the diminished enthusiasm for productivity-enhancing reforms at the political level, this low emphasis on achieving productivity gains at the enterprise level, is to at least some extent, understandable. Productivity-enhancing change in individual workplaces is often disruptive and unpleasant, both for those on the receiving end of that change and those (typically middle managers) who have to communicate and implement it. When making such changes is no longer a matter of survival – as it was for many businesses in the 1990s – it is not surprising that the appetite for making them has diminished.

It is also inevitable, and consistent with both historical experience and the contemporary experience of other countries, that as the Australian economy moved closer to full capacity in the second half of the 2000s, a situation characterised by (among other things) increasing shortages of skilled labour and the emergence of bottlenecks in key areas of infrastructure provision, measured productivity would deteriorate. This is irrespective of whether political and business leaders had maintained their earlier enthusiasm for productivity-enhancing change in either public policy-making or business decision-making.

Another pertinent development of the past decade has been the increasing volume of legislation and regulation in reaction to various actual or perceived threats to security, instances of misbehaviour in the corporate sector, and other more quotidian aspects of life.

A common belief underpinning this legislation and regulation appears to be that it is both possible and desirable to eliminate various kinds of risk (to life, property, public order and safety, people’s savings, standards of corporate or private behaviour, and so on) through additional legislative or regulatory action, irrespective of the probabilities attaching to those risks or the adequacy of existing legislation or regulation, and irrespective of the costs of seeking to eliminate those risks relative to the benefits.⁸

Much of this legislation and regulation has required the employment of additional staff, the acquisition of additional capital equipment or the costly modification of existing buildings and infrastructure. This is without resulting in the production of any additional (measured) goods or services, and often with the incidental effect of diverting time and attention from activities that would have otherwise resulted in the production of additional goods and services.

In other words, whatever public or private benefits that have been procured through legislation and regulation of this type, they have inevitably come at some cost in terms of productivity.

Australia’s experience in this regard has not been unique, although when you look beyond the realm of aviation security to other aspects of business and personal life, the quantum and reach of risk-averting legislation and regulation may have been more pervasive in Australia than in many other advanced economies.

Consistent with this, Australia has slipped from fifth on the World Bank’s annual ranking of economies by “ease of doing business” in 2005, to 15th last year.⁹

Although difficult to verify in any empirical manner, there is considerable anecdotal evidence suggesting that the increased recourse to legislative and regulatory means of eliminating various types of risks has

“It is also clear that the broader business community has begun to press for a renewed emphasis on policy measures aimed at enhancing productivity growth...”



prompted business owners and managers to devote increasing proportions of their time and attention to compliance and risk management activities. They have become less willing to take on some of the risks associated with decisions to undertake organisational change, enter new markets, develop new products or services, or engage in other forms of productivity-enhancing innovation.

One illustration of this may be the apparent decline in Australia's relative take-up of new technologies.

In the second half of the 1990s, Australia ranked behind only the Nordic countries and the United States in various (objective and subjective) measures of the penetration or diffusion of new information and communications technologies. However, by the end of the past decade, Australia's ranking had slipped to between 15th and 22nd, behind not only the US and Nordic countries but also a large number of Western European countries, a growing number of Asian economies, Canada and Israel.

It would be wrong to suggest that there is any single, or overwhelming, cause of Australia's poor productivity performance over the past decade. But there seems to be little doubt that the broader economic and political environment (one in which there has been little pressure on either policy-makers or individual firms to pursue productivity-enhancing structural

or organisational change) has been of critical importance. As Treasury Secretary Martin Parkinson puts it: “The root causes of Australia's present productivity performance are embedded in the decisions of the last decade.”¹⁰

Reversing the decline in Australia's productivity growth rate

One of the reasons for Australia's poor productivity performance over the past decade has been the lack of any real incentives for firms to pursue productivity gains in the absence of compelling reasons to do so. There are now some indications that the difficulties being encountered by sectors of the economy, which are adversely affected by some of the side-effects of the mining boom, in particular the rising exchange rate (something which did not occur to the same extent, if at all, during previous commodities booms) are prompting businesses in those sectors to place a much higher priority on productivity-enhancing organisational and other changes at the enterprise or workplace levels, as a matter of survival, without any need for public policy changes.

It is also clear that the broader business community has begun to press for a renewed emphasis on policy measures aimed at enhancing productivity growth, although to date, the focus of business attention has been largely confined to industrial relations.

Public policy initiatives can contribute to improving Australia's productivity performance to the extent that they increase the incentives facing the owners or managers of enterprises (including government agencies themselves) to make productivity-enhancing changes (to the goods and services they produce, or the way in which they are produced). They achieve this through increasing the ability of owners or managers of enterprises to implement productivity-enhancing changes once they have decided to make them (or, alternatively, reducing the barriers and obstacles to implementing productivity-enhancing change); or facilitating the movement of factors of production from existing uses to ones in which they can be combined in ways that result in higher levels of productivity overall.

There are several ways in which public policy initiatives could enhance the capacity of Australian businesses to improve their productivity performance and thereby that of the economy as a whole.

Regulatory reform

Many areas of the Australian economy that have remained, largely for political reasons, insulated from competitive pressures of the sort that, in other sectors, have acted as strong incentives for the pursuit of productivity-enhancing structural and organisational change – including international aviation, agricultural marketing (other than grains), pharmacies, newsagents, private service professions (such as law, medicine, and architecture), and services sectors dominated by public sector agencies (such as health care, education, public transport and law enforcement).

Some of these are relatively small as a share of output or employment; others (in particular the service delivery sectors mentioned above) are both large themselves, and important “enablers” for other sectors of the economy. One of the key obstacles to the pursuit of productivity-enhancing reforms in these areas is the near-universal belief that there is a linear correlation between the number of people employed in delivering these services and the quality of them. This is notwithstanding the absence of any empirical evidence in support of that belief (for example, between staff-student ratios in schools and student outcomes, or between police numbers and crime rates).

A rethinking of the increasing trend, identified earlier, of seeking to reduce perceived risks through legislation and regulation without any assessment of probabilities or opportunity costs, would almost certainly be beneficial from the standpoint of improving productivity performance. As the Victorian Competition and Efficiency Commission pointed out last year, this requires “greater public understanding of risk issues, including the omni-present nature of risk in everyday life and the constant trade-offs between risk and return that characterise daily decision-making”.¹¹

Few areas of regulation have broader effects than regulation of the labour market. As Productivity Commission Chairman Gary Banks has observed:

“...whether productivity growth comes from working harder or working smarter, people in workplaces are central to it. The incentives they face and how well their skills are deployed and redeployed in the multitude of enterprises that make up our economy underpins its aggregate performance. It is therefore vital to ensure that regulations intended to promote fairness in Australia's workplaces do not detract unduly from their productivity... if we are to secure Australia's productivity potential into the future, the regulation of labour markets cannot remain a no-go area for evidence-based policy making.”¹²

Given the inadvisability of drawing conclusions about productivity from data over relatively short periods, it is not yet possible to make any reliable statistically-based inferences about the effects of the present government's changes to workplace relations arrangements on economy-wide productivity growth, although there does appear to be a growing body of anecdotal evidence that some businesses are seeking to make productivity-enhancing organisational changes in workplaces, they are finding those changes more difficult to implement than might have been the case hitherto.

The Productivity Commission's recent draft report on retailing noted that closing the productivity gap between Australia and countries such as the US “will require greater workplace flexibility so that employers and employees can work cooperatively and creatively together, to deliver the required productivity improvements”. It also suggested that “some aspects of the *Fair Work* system may be inhibiting the adoption of flexibility enhancing provisions” in retailing workplace arrangements, and observed that the workplace flexibility provisions in the *Fair Work* system appear to have been used to place “greater emphasis on strategies for developing family-friendly workplaces, rather than productivity”.¹³

Of course the scope for regulatory reform extends well beyond the workplace relations framework.



“The Business Council of Australia (BCA) argues that ‘significant reforms...are needed in all jurisdictions to improve their regulatory processes’.”



The Business Council of Australia (BCA) argues that “significant reforms...are needed in all jurisdictions to improve their regulatory processes”¹⁴, while the OECD has drawn attention to the need for further reforms in infrastructure regulation, and that Australia’s barriers to foreign direct investment are the seventh highest in the OECD.¹⁵

There are also still examples where outright deregulation ought to be more actively considered. For example, the removal of restrictions governing entry into the Sydney taxi industry (for which there are few efficiency or social reasons) could produce benefits “in the order of \$250 million per annum”, with even greater productivity and service benefits if accompanied by reform of the “anti-competitive control of the taxi radio networks over all taxi operators”.¹⁶

Taxation reform

Tax reform could play an important role in improving Australia’s productivity performance. Australia’s personal and business income tax systems (and state land and payroll tax systems) are littered with exemptions and concessions which confer favourable treatment on particular groups of taxpayers, particular forms of business organisation, or particular types of economic activity at the expense of others, leading to household and business investment decisions often being excessively influenced by tax considerations rather than their intrinsic merit (which must be to the detriment of productivity, among other things).

The Henry Review of Australia’s tax system urged that: “Australia should configure its tax and transfer architecture to promote stronger economic growth

through participation and productivity.”¹⁷ Unfortunately, many of the Review’s recommendations to that end were promptly ruled out – by both sides of politics – for transparently political reasons.

Skills and infrastructure

To the extent that Australia’s poor productivity performance over the past decade reflects past underinvestment, or poorly targeted investment, in skills formation and in infrastructure, some combination of more and better targeted investment in these areas will contribute to improved productivity performance, albeit with lags that are inevitably protracted. These two areas have been key elements of the current Australian Government’s productivity agenda.

Yet despite the continuing upward trend in the proportion of the Australian working-age population with formal educational qualifications, it is not at all clear that the quality of Australian human capital has increased significantly. The OECD concluded, earlier in the decade, that “skill upgrading has played, at best, a modest role in GDP growth per employed person” in Australia (and also in the US, Canada, the Netherlands and New Zealand).¹⁸ An ABS survey undertaken as part of an OECD study of adult literacy and life skills found that 46 per cent of Australians aged 15–74 lacked the minimum prose and document literacy skills and 50 per cent lacked the minimum numeracy skills “required for individuals to meet the complex demands of everyday life and work in the emerging knowledge-based economy”.¹⁹

It has been recognised for some time that younger Australians from lower socio-economic backgrounds

“The consequences of Australia’s poor productivity performance over the past decade have not, as yet, become widely apparent.”



tend to lag at least one year behind the Australian average, and more than two years behind students in the highest socio-economic quartile (OECD 2010c: 139). The results from the latest OECD Program for International Student Assessment (PISA) suggest that the performance of Australian 15-year old students has declined significantly over the past decade, despite a 33 per cent real increase in public expenditure, and a 54 per cent real increase in private expenditure, on education during this period.²⁰

By comparison with schools and higher education, the vocational education and training (VET) sector attracts little public attention. Yet there is evidence that the effectiveness of the training provided by this sector is variable, and that this sector is characterised by low completion rates in occupations that regularly appear on national skills shortage lists.²¹

It is widely accepted that Australia’s infrastructure, particularly in transport, is inadequate for many of the requirements of Australia’s growing economic, personal and social needs. This is in part due to under-investment in infrastructure in the 1980s and

1990s. However, as the OECD notes, it also reflects “weak co-ordination between public infrastructure and development and fiscal management” and a “lack of co-ordination between the various levels of government, and between jurisdictions at the same level”, so that “infrastructure decisions are frequently taken with no regard for national priorities”.²² The solution to these weaknesses is not simply more spending on infrastructure, especially if that spending lacks coordination and has little regard for national priorities, as in the past. It is of no less importance to the objectives of higher levels of productivity or faster productivity growth that better use is made of existing infrastructure, including through rational pricing regimes, and through avoiding ill-conceived regulation that detracts from the efficiency with which existing infrastructure is used (for example, by arbitrary and knee-jerk reductions in speed limits on roads, or security procedures entailing excessive or unnecessary delays in the movement of goods and passengers through airports).

Innovation

As noted earlier, Australia’s innovation effort falls well short of OECD best practice on many dimensions, suggesting the potential for improvements in Australia’s innovation effort to contribute to higher levels of productivity and faster rates of productivity growth.

In this area, no less than in any others, it is important to emphasise that productivity growth happens as a result of decisions being taken and implemented by the owners and managers of individual enterprises (and government agencies). The role of public policy is to improve the incentives facing those owners and managers to undertake productivity-enhancing innovations, and to remove obstacles to the undertaking of such innovations where they have been inadvertently created by past public policy interventions.

Among the issues that could be usefully considered in this domain are the extent to which Australia’s competition laws inhibit the kind of collaboration among firms in the same industry which overseas experience suggests is an integral part of the innovation process in many industries; the extent to which the treatment of options by the Australian taxation system inhibits the ability of start-up companies to attract and retain talented staff, or to attract institutional investment; and the extent to which what appears to be a highly legalistic approach on the part of many Australian universities to intellectual property rights inhibits the transfer of knowledge between those undertaking pure or basic research in higher education institutions to innovative entrepreneurs.

Conclusion

The consequences of Australia's poor productivity performance over the past decade have not, as yet, become widely apparent. This is largely because they have been masked by a combination of faster population growth (until recently) and the most sustained upswing in Australia's terms of trade in over a century.

The sense of importance of sustaining high rates of productivity growth for Australia as a whole and for individual businesses, has declined substantially. This is a result of a combination of factors including a weakening of an earlier, widely shared consensus around the need for on-going economic reform that is perhaps the inevitable result of what has now been the longest period of more-or-less uninterrupted economic growth in more than a century, falling unemployment, rising real incomes (which have in turn been fairly widely distributed), and rising personal wealth (for most of the past two decades).

It may well be that an end to this period of comparatively easy prosperity – at least for sectors of the Australian economy that are adversely affected by some of the side-effects of the mining boom, or by the more frugal behaviour of Australian households, and possibly for the broader Australian economy if the global economy enters a renewed downturn with limited means on the part of economic policy-makers in the major advanced economies to ameliorate using the tools that have become customary over the past seventy years – will prompt a renewed focus, both among policy-makers and business leaders, on the objective of raising both the level of productivity and the rate of productivity growth.

Indeed developments in the last few months suggest that some businesses – especially in sectors which have been adversely affected by some of the side-effects of the resources boom (such as the stronger Australian dollar), or other emerging structural trends such as more cautious attitudes towards household leverage – are now beginning to make more strenuous efforts to achieve productivity gains at the workplace or enterprise level.

If a renewed focus is not prompted, then it is likely that Australia's economic performance after the present resources boom comes to an end (whenever that might be) will deteriorate significantly – as it did after the end of the last significant commodities boom in the mid-1970s – and that the consequences of that for the living standards of Australia's population will be impossible to disguise.

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Endnotes

- 1 Measured productivity growth is very sensitive to business cycle fluctuations: hence it is unwise to draw inferences about productivity growth from changes over periods shorter than three years (at a minimum).
- 2 Glenn Stevens, 'The Cautious Consumer', Address to the Anika Foundation, 26 July 2011.
- 3 On the grounds that the United States has higher GDP per hour worked than any other OECD country except for Luxembourg and Norway, two small economies an unusually large proportion of each of which is accounted for by a sector with intrinsically high levels of labour productivity, namely financial services and oil extraction, respectively.
- 4 Using the method detailed in Saul Eslake and Marcus Walsh, *Australia's Productivity Challenge*, (Grattan Institute, Melbourne, February 2011).
- 5 For example, Charles Bean, 'The Australian Economic 'Miracle': A View from the North' and Peter Forsyth, 'Microeconomic Policies and Structural Change', both in David Gruen and Shona Sretha, *The Australian Economy in the 1990s* (Reserve Bank of Australia, Sydney, 2000), pp. 74–114 and 235-267; Productivity Commission, *Annual Report 2009–10* (Canberra, 2010), p.62; and OECD, *Towards a Seamless National Economy, OECD Reviews of Regulatory Reform: Australia 2010* (OECD, Paris, 2010), p. 14.
- 6 For example, newsagents, pharmacies, farming interests and the traditional professions (for the Liberal and National Parties), and public sector unions (for the Labor Party).
- 7 *The Telstra Productivity Indicator* (Telstra, Melbourne, April 2011), p. 10.
- 8 For example, John Mueller and Mark Stewart (the latter a Professor of Civil Engineering at the University of Newcastle in NSW), in *Terror, Security and Money* (Oxford University Press, 2011) report that the myriad 'security' measures enacted after the terrorist attacks of the early 2000s have never been subjected to any kind of probability assessment or cost-benefit analysis. Their own cost-benefit analyses find that of these measures, only the decision to harden cockpit doors in aircraft has been 'cost effective'; while programs under which gun-toting officers travel on selected flights, and the implementation of 'full body scanners' at airports, fail such tests 'miserably' and 'comprehensively'.
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- 16 Peter Abelson, 'The High Cost of Taxi Regulation, with Special Reference to Sydney', *Agenda*, Vol. 17, No. 2 (2010), pp. 41–72
- 17 Ken Henry (chair), *Australia's Future Tax System – Report to the Treasurer*, Commonwealth of Australia (December 2009), p. xviii.
- 18 OECD, *The Sources of Economic Growth*, (Paris, 2003), p. 37.
- 19 ABS, *Adult Literacy and Life Skills Survey, Summary Results 2006* (catalogue no. 4228.0) (January 2008), p. 5.
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- 21 Australian Treasury, Statement No. 4: 'Boosting Australia's Productive Capacity: the Role of Infrastructure and Skills', 2008–09 *Australian Government Budget – Budget Paper No. 1* (May 2008), p. 4–20.
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The views in this article are those of the author and should not be attributed otherwise.



Federal/state financial relations



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Introduction

A new order of intergovernmental financial relations is needed to adapt and contribute to a changing demographic and policy environment. The fiscal challenges of the retiring baby boomer generation will have significant implications for Australia's federation and particularly commonwealth/state funding. It may well make the financial positions of Australian governments unsustainable in the longer-term without well thought out policy responses, including in the area of federal/state financial relations.

In comparison with other federations, Australia has a very high level of vertical fiscal imbalance (VFI) – that is, the commonwealth raises a much higher proportion of revenues than it needs to cover its direct expenditures, while the states and territories raise insufficient revenues to cover their direct spending commitments. The resultant shortfall in state revenues is funded by the commonwealth via the states receiving all of the GST revenue together with general and specific purpose grants/payments.

The management of Australia's economic relationship with China is also crucial, particularly the need to maintain the right domestic policy settings in areas such as taxation and competition policy, water and energy pricing, labour and infrastructure.¹ As most of these issues are affected by Australia's system of commonwealth/state relations, potential improvements in this area will also assist us in our relations with China and other key trading partners in this "Asian century".

Federal/state financial relations, particularly VFI, arguably acts as an economic handbrake on the nation's ability to improve productivity growth. Many commentators have now observed that while Australia's GDP has grown over the last decade, productivity growth has actually been in decline.² If Australia is to arrest this flat-lining or downward trend in productivity growth, a number of significant public policy issues must be addressed.

In particular, there is a very urgent need for effective infrastructure. There are significant issues with the current approach and basic infrastructure is a major issue in Australia's current economic and social outlook. CPA Australia's member surveys support this contention. It is clear that current federal/state financial relations have not been a positive influence in this area and it is way over time for the issue to be addressed. While there are some positive signs in NSW and Victoria at present in the infrastructure area, any State Government working in isolation will continue to struggle.

Funding infrastructure investment from the mining boom can be considered an effective means of ensuring Australia's ongoing prosperity. This would require a reallocation of financial resources in the federation.

Higher levels of GST are an obvious source of funding for some of these measures. The states also have available to them the better use of land tax and/or payroll tax (or possibly a cash-flow tax as suggested by the Henry Tax Review) and other more effective ways of taxing generally.

It is clear therefore that for the states to support the transition of our economy, the existing VFI level should be reduced or eliminated if possible. The best solution is through a higher and/or broader GST consistent with the position in most other OECD countries.

Infrastructure issues

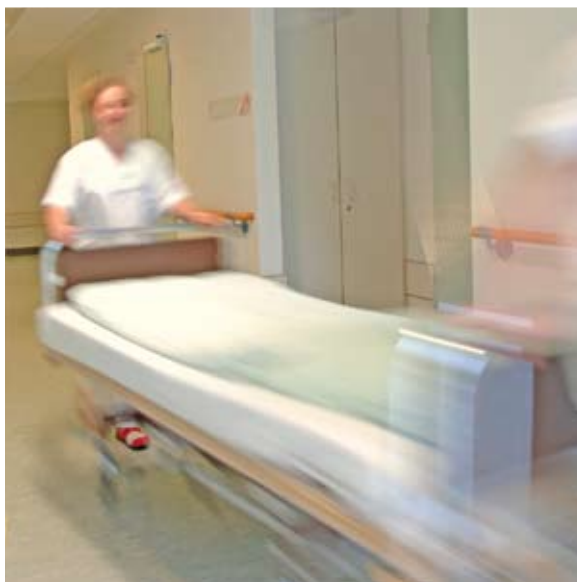
In recent years, the states have clearly faltered in meeting their responsibilities for the provision of adequate infrastructure to support a growing economy. The most significant reason for this appears to have been the concern of most, if not all, of the states in using debt to at least partly fund even major economic infrastructure projects, let alone social infrastructure projects. However, more recently there have been some signs that at least NSW may now be prepared to use some level of debt and/or other more innovative financing arrangements to fund major infrastructure projects.

Given the significant international uncertainty currently in credit markets it may be problematic for State Governments to utilise debt finance at this juncture. However, there are significant issues of intergenerational equity associated with financing long-term investments such as in infrastructure from current cash flows. In other words, it seems appropriate future generations that will also benefit from today's infrastructure investments, should bear some of the costs associated with such investments.

The establishment of Infrastructure Australia as a statutory body to advise governments, investors and infrastructure owners on a wide range of issues has helped to improve the transparency for federal funding of major infrastructure projects. However, some further clarification of the relevant conditions for federal funding could provide greater levels of transparency and may assist in improving infrastructure funding decisions in the future.

Other options for the states include the financing of some infrastructure projects via budget surpluses, sales of existing infrastructure assets, user charges, debt and/or "availability financing" arrangements or

“The states could potentially reduce the cost of infrastructure projects through reform of their tender processes.”



some combination of these options, albeit most states still appear to be averse to using debt. For example, the Premier of Victoria Ted Baillieu recently noted that in relation to state funding of infrastructure:

“You either pay for it out of surpluses or asset exchange or debt, and I think there are significant limitations on debt.”³

While it is clearly important for State Governments to avoid unnecessarily high debt levels, some level of debt would appear to be required to ensure that the states meet their responsibilities in providing and maintaining appropriate levels of investment in essential infrastructure going forward.

The states could potentially reduce the cost of infrastructure projects through reform of their tender processes. It is of interest in this context to note that an Infrastructure Finance Reform Issues Paper⁴ released by Infrastructure Australia in July 2011 noted that bid costs in Canada are generally lower than in Australia but that such costs in the UK are typically higher than for Australia. Infrastructure Australia also noted that bid costs in Australia could possibly be reduced further via the adoption of some of the strategies utilised in foreign jurisdictions, particularly Canada.

It is encouraging, in this regard, to note that some states such as NSW and Victoria (albeit Victoria

appears to be more debt averse) have already used one or more of these options to deliver major infrastructure projects. However, it would be useful, as noted above, for Infrastructure Australia to further clarify the criteria involved in determining the circumstances in which a particular state is eligible for federal funding, as opposed to a state financing a project either partly or wholly from its own resources.

The VFI problem

A major feature of Australia’s federal system of government for many years has been the high degree of VFI characterised by the heavy dependence of the states on commonwealth grants to finance their spending commitments.⁵

While the GST is now delivering more revenue to the states, it has failed to bolster their financial autonomy in relation to the commonwealth, since the states neither individually or collectively determine GST policy. Their ongoing dependence on these GST revenue transfers from the commonwealth, simply preserves the culture of state financial dependency that has characterised the Australian federation for decades. In this context, it is worth bearing in mind that prior to the introduction of the GST in 2000,

the states had previously received (in the 1970s and 1980s) a fixed share of the commonwealth's tax revenues).⁶

Reinforcing that trend is the magnitude and design of tied grants (specific purpose payments) to the states which have simply blurred accountability and given the commonwealth a growing influence on state policies in many areas of service delivery such as education, health and infrastructure more generally.

The states continue to be heavily reliant on a range of inefficient taxes such as stamp duties on property transfers, insurance transactions and motor vehicles. Moreover, state policies have eroded the payroll and land tax bases to such an extent that it is difficult to see them being reconstituted in a broad-based form, particularly in the face of resistance to land tax on owner-occupied housing and payroll tax on small business.

Standing council on federal financial relations

More recently, a new federal financial framework has been introduced which rationalises the number of payments made to the states. At the same time it increases the quantum of payments, centralises payment arrangements and provides greater funding certainty and flexibility for the states.

In agreeing to the new framework for federal financial relations, the commonwealth has committed to the provision of on-going financial support for the states' service delivery through:

- General revenue assistance, including GST payments, to be used by the states for any purpose;
- National specific purpose payments (SPPs) to be spent in the key service delivery sectors; and
- National partnership payments (NPPs) to support the delivery of outputs or projects, to facilitate reforms, or to reward those jurisdictions that deliver on nationally significant reforms.

Consistent with the new framework, the 2011 National Health Reform Agreement embodies the National Health Accord. Under this, the commonwealth has agreed to provide funding for the financing of public hospitals subject to monitoring of the performance of state hospitals and health networks by an independent National Health Performance Authority. While this agreement has been generally welcomed, it appears to be too early at present to make a final judgement as to its effectiveness.

These apparent improvements to the federal financial framework are welcomed as the states continue to be heavily reliant on a range of inefficient taxes,

combined with the erosion of their land and pay-roll tax bases. That said, however, the states agreed at the Federal Government's October Tax Forum to review their options in respect to reforming their inefficient taxes.

Productivity

The Australia's Future Tax System⁷ Review (Henry Tax Review), as well as the more recent Tax Forum discussion paper,⁸ both make it clear that Australians and Australian businesses face what seems like an ever-increasing number of taxes of varying efficiency. Henry counted them as 125 taxes and charges of which 10 collect 90 per cent of the revenue (albeit around 66 of the 125 are agricultural levies). These taxes do not include the carbon tax, the minerals tax and the temporary flood levy.

To address VFI and complexity, compliance and other deadweight economic issues, while also ensuring Australians are provided with the government services they need, requires taxes that are broad based, simple and few in number.

With the revenue from both the carbon tax and the mining tax hypothecated elsewhere, it seems clear that a reconfigured GST should be used to fund the removal of many, if not all of the remaining inefficient state taxes, particularly given that the GST is effectively a quasi state tax.

The main attraction of increasing the GST is to eliminate duplicative and inefficient state taxes, thereby improving productivity. Another attraction of such an approach is that, unlike when the GST was introduced in 2000, the GST mechanism is now well and truly in place. As a result, such a change would simply be an extension of the current system without the accompanying compliance upheaval and uncertainty that businesses faced when the GST was first introduced.

To quantify potential benefits, CPA Australia commissioned a report from KMPG Econtech – *Economic Analysis of the Impacts of Using GST to Reform Taxes*⁹. The research examined the overall economic impact of four scenarios as follows – the first three scenarios involved increasing the GST rate to 12.5 per cent, 15 per cent and 20 per cent respectively, and using the revenue to replace certain inefficient state taxes, and in the fourth scenario the GST rate was kept at 10 per cent but the base was broadened to include those goods and services that are currently treated as GST-free (such as fresh food, health, education, child care and exports).

The inefficient taxes to be either abolished or

reduced included insurance taxes, motor vehicle taxes, commercial conveyancing duty and payroll tax. Under each of the scenarios the number of taxes either abolished or reduced would increase along with the rate of the GST.

Interestingly, the results show that increases in the GST rate to 15 and 20 per cent respectively would deliver the greatest productivity growth with standard of living increases, broadly speaking, as a result. Introducing a uniform GST (maintaining the current rate of 10 per cent but including goods and services currently GST-free) would also deliver significant, but lesser, gains.

Other key findings

These include:

- Australia has a globally low level of GST (the world average is over 15 per cent); and
- The effect of GST rate increases would vary between industries with education/health, finance/insurance, fresh food, motor vehicle and construction/property industries being among those which would benefit the most, while the net impact in the case of other industries would be broadly neutral due to the positive impacts from the removal of payroll tax offsetting the negative impacts of a higher GST.

Scenario one

Increasing the GST rate to 12.5 per cent would pay for the abolition of the following taxes:

- Insurance duties
- Fire insurance levy
- Motor vehicle duty
- Motor vehicle registration fees, and
- Ten per cent of commercial property transfer duty.

Such a reform is estimated to increase annual household living standards by \$1.6 billion per annum.

Scenario two

An increase in the GST rate to 15 per cent would fund the abolition of the following additional taxes:

- All of commercial transfer duty, and
- Forty per cent of payroll tax.

This wider reform package is estimated to provide an increase in household living standards of \$4.7 billion per annum.

Scenario three

A 20 per cent GST would fund the removal of all of the abovementioned state taxes including payroll tax, as well as one per cent reductions in the top personal marginal tax rate and the company tax rate, and result in an estimated increase in living standards of \$4.6 billion per annum. There would also be an estimated \$6.6 billion for additional government spending and/or for use in addressing equity concerns via transfers back to households. As these benefits are not taken into account in the modelling, the estimated \$4.6 billion welfare gain is conservative.

Scenario four

The final scenario, where the GST rate remains at 10 per cent but is broadened to include currently exempt products and services would fund the removal of the following taxes:

- Insurance duty
- Fire insurance levy
- Motor vehicle registration fees, and
- Fifty per cent of commercial property transfer duty.

This reform package is estimated to provide an annual increase in household living standards of \$4 billion.

Summary of potential outcomes

To summarise, the impact of these reform packages would be as follows:

- 12.5 per cent GST – gain in living standards of \$1.6 billion (GDP increase)
- 15 per cent GST – gain in living standards of \$4.7 billion
- Twenty per cent GST – gain in living standards of \$4.6 billion, and
- Uniform GST – gain in living standards of \$4 billion.

From the modelling conducted, a 15 per cent GST appears to be the better option.



“Unfortunately, increasing the GST in the manner described in the various scenarios modelled is not the silver bullet sought by tax policy makers at every level of government.”



Is this the silver bullet for tax reform?

Unfortunately, increasing the GST in the manner described in the various scenarios modelled is not the silver bullet sought by tax policy makers at every level of government. The purpose of CPA Australia’s work through KPMG Econtech was to explore the impact of the removal of inefficient taxes by increasing the GST along the lines suggested by recognised authorities such as the International Monetary Fund (IMF), who stated:

“Going forward, we recommend continued tax reform. A priority should be to remove inefficient taxes such as state stamp duties (that discourage regional mobility) and insurance taxes. Moreover, there is scope to improve work incentives by further reducing effective marginal tax rates and to encourage investment by reforms to business tax, together with simplification of the tax system. While we recognise the difficult political choices, options to replace the lost revenue from these reforms include more reliance on a consumption-based tax, reforming land taxes and broadening the coverage of the minerals resource rent tax.”¹⁰

What the modelling did not do

CPA Australia’s research did not consider various compensation packages for different family/household types. However, given the regressive nature of consumption taxes, any changes to the GST would require compensation as part of the final package. This is consistent with the approach that was taken when the GST was introduced in Australia.

Compensation then introduces the problem of “churn”, as identified by the Federal Treasurer Wayne Swan at the 2011 Tax Forum. He stated:

“I did want to make this very sensible point, that some people believe that the GST is some sort of money tree, but the fact is that when it was introduced originally, in addition to the revenue raised, 18 billion dollars was spent additionally on compensation and I don’t know whether the gentleman from the CPA actually factored that into his modelling. This is not necessarily a great deal in terms of fairness nor in terms of efficiency. So that’s why the government is opposed to increasing the rate or widening the base.”¹¹



“The minister has indicated that the current financial framework is underpinned by legislation that was largely developed in the early 1990s.”



It is acknowledged that churn is inefficient. However, if designed appropriately, the inefficiencies could still be less than what is currently in place. Moreover, there could still be an appropriate compensation package and productivity gains could also be delivered from a reformed GST.

Reform of commonwealth/state financial relations to strengthen federalism, arguably requires a shift from state dependence on commonwealth grants (including the GST) towards wider access to a broad-based tax(es) that the constitution would allow the individual states to control. State control of a broad-based consumption tax (such as the GST, or possibly a cash-flow tax¹² in lieu of the GST) would best meet the criteria for a good state tax, but appears unattainable given constitutional and administrative constraints.

Other options

There are other options that could be discussed here such as possible income tax sharing, access to the commonwealth income tax base or moving service delivery from the states to the commonwealth. However, the major economic benefits would accrue from eliminating inefficient state taxes funded via an increase in the GST rate.

Commonwealth Financial Accountability Review (CFAR)

On 8 December, 2010, the Minister for Finance and Deregulation, Senator the Hon Penny Wong, announced that the Department of Finance and Deregulation would undertake the Commonwealth Financial Accountability Review (CFAR). The objective of the CFAR is to explore options for modernising and improving the commonwealth's financial framework.

The minister has indicated that the current financial framework is underpinned by legislation that was largely developed in the early 1990s. Since that time there have been significant developments in public and private sector financial governance practices and CFAR will examine key aspects of modern financial management (including financial governance, performance, risk management and compliance). CFAR will be a multi-year project and will involve consultation with stakeholders both internal and external to the public sector.

This review should be widened to include the critical infrastructure and VFI issues canvassed above.

The OECD has noted that:

- A high level of VFI may reduce the tax raising efforts of the claimant government, inflate that government's spending and increase deficits and debt at both government levels; and

- Inter-governmental grants also weaken accountability, for example the link between those who benefit from the public services and those who pay for them.

Notwithstanding the issues associated with the VFI problem, it seems doubtful whether a practicable solution to the problem will be found any time soon for the reasons outlined above.

However, it should continue to be an objective of all Australia governments (federal and state) to work co-operatively within the existing system to ensure that Australia's economic and social infrastructure is of a high standard vis-a-vis other comparable countries.

While Infrastructure Australia, and associated reforms, represent an important step forward in providing necessary infrastructure, a proper assessment of these new arrangements may not be available for some time yet.

The list of major infrastructure projects recently submitted (November 2011) by the Victorian Government to Infrastructure Australia for federal funding would, if fully implemented, cost billions and seems to be based on plans dating back to 2008. Victoria is also seeking an initial \$640 million from the Federal Government for the early stage planning and development work associated with the proposed projects. Press reports have noted, not surprisingly, that Victoria's rush for federal assistance is certain to create a heated battle among the other states for infrastructure funds.

It would be unfortunate if the new Infrastructure Australia arrangements simply resulted in the states seeing them as just another avenue for them to obtain further financial assistance from the commonwealth, as may appear to be the case if the recent approach pursued by Victoria is simply replicated by the other states. Developments in this area going forward will clearly be worth watching in coming months in what may be a further stage in the evolution of federal/state financial relations in Australia.

Conclusion

Australia's ageing population presents a range of economic and social policy challenges for policy makers and core to meeting these challenges is productivity growth. Lifting the GST rate to 15 per cent to fund the removal of the most inefficient state taxes is a key way identified by CPA Australia, through its state taxes reform review, to address this issue.

However, in addition to this, the states also need to reassess their funding of infrastructure requirements and to be open to more innovative financing approaches to having them built.

Endnotes

- 1 For example, 2011, Address by the Treasury Secretary, Dr. M. Parkinson, to AmCham, November
- 2 For example, 2011, CPA Australia, Enhancing Australia's prosperity, September, <http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/enhancing-australias-prosperity.pdf>
- 3 'The Australian' (page 5) 17 Nov. 2011
- 4 http://www.infrastructureaustralia.gov.au/files/Infrastructure_Finance_Reform_July_2011.pdf
- 5 <http://www.aph.gov.au/library/pubs/rm/2002-03/03rn13.htm>
- 6 Revenue Sharing or Tax Base Sharing? – Discussion Paper – WA Treasury (June 1998)
- 7 http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm
- 8 http://www.futuretax.gov.au/content/Content.aspx?doc=TaxForum/Discussion_Paper.htm
- 9 <http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/kpmg-econotech-final.pdf>
- 10 See <http://www.imf.org/external/np/ms/2011/080111.htm>
- 11 http://www.futuretax.gov.au/content/Content.aspx?doc=TaxForum/transcripts/session_2.htm
- 12 Note: The HTR devotes about five pages of discussion to CFTs, see http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_d1-1.htm. Further, the recently released UK Mirrlees Review report (Institute for Fiscal Studies) also discusses CFT options, see 8.1 at p.197; <http://www.ifs.org.uk/mirrleesreview/design/taxbydesign.pdf>.
However, before a CFT could be considered as a real alternative to the GST, further development of its main features, operation and application would need to be undertaken.

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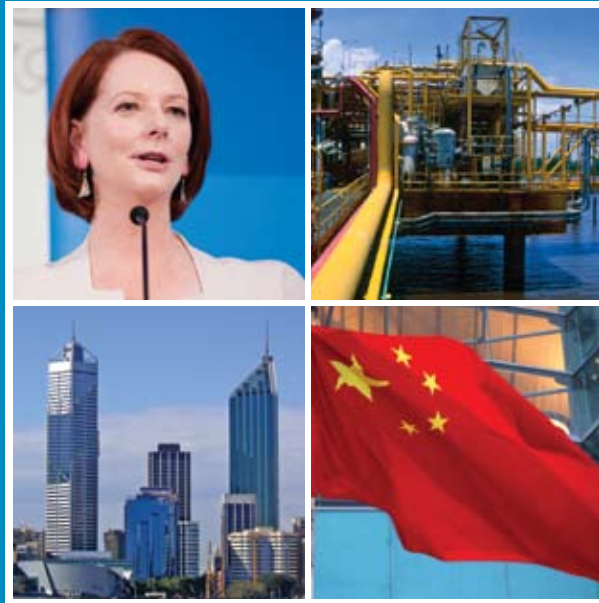
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