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The structural challenges facing Australia

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Key points

> Australia faces three key structural challenges: the end of the commodity price boom is leading to slower growth in national income; this is putting pressure on the budget; & it's all occurring when productivity growth has slowed.

> To get growth in economic activity and in material living standards back onto a strong sustainable path will require more serious economic reform, including getting the budget under control, tax reform, more privatisation, more infrastructure spending and reduced regulation.

> This will likely be necessary to ensure strong sustained performances from Australian asset classes.

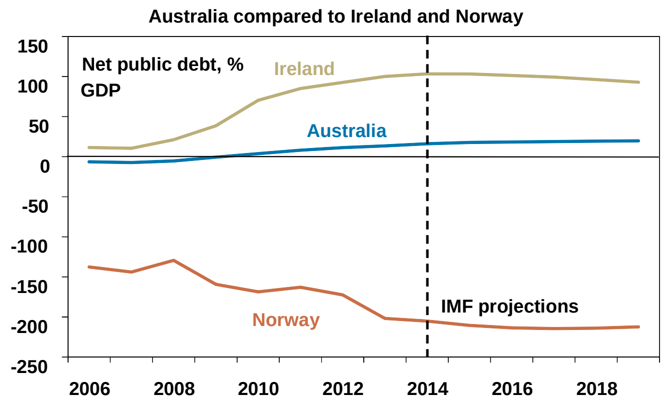
Introduction

During the past few years Australia has had a tough time in achieving economic reform. The first attempt in a decade at serious tax reform got bogged down with debate around the poorly designed Resource Super Profit Tax in 2010 leading to the less than optimal mining tax, the attempt to put a price on carbon pollution looks like it will soon be terminated and getting the budget back under control is proving very difficult.

The saga over the budget in particular has been depressing with the 2013 Budget showing a run of deficits worse than those associated with the 1990s recession despite having the biggest boom in our history. And the community reaction to the latest Budget seems to have had the effect of refocusing the debate from the broad based need to reform the economy and get the budget back into surplus to a focus on equality. In other words rather than focusing on growing the national pie, the focus is back to how to divide it up.

The problems Australia faces are trivial compared to those seen in many other countries with more rapidly aging populations and far bigger public debt burdens. Talk of a budget emergency is over the top. But we do need to take our fiscal challenges seriously or else we could end up in the sort of mess several other countries have run into, where when luck ran out and things turned sour the IMF got called in and the choice became cut back or no bailout from the IMF. We are a long way from that but so too was Ireland in 2006 when its net debt to GDP ratio was the same as Australia's today but its boom turned to bust, house prices tumbled, banks had to be bailed out, public debt ballooned and lenders dried up necessitating IMF support.

After the biggest resources boom in our history, Australia's public finances should be in far better shape. Norway is a good example. Realising that its North Sea oil reserves would not last forever it has been running big budget surpluses and putting the money into a sovereign wealth fund for use when the boom is over. As a result Norway's net public debt is negative, i.e. it is owed way more than it owes.



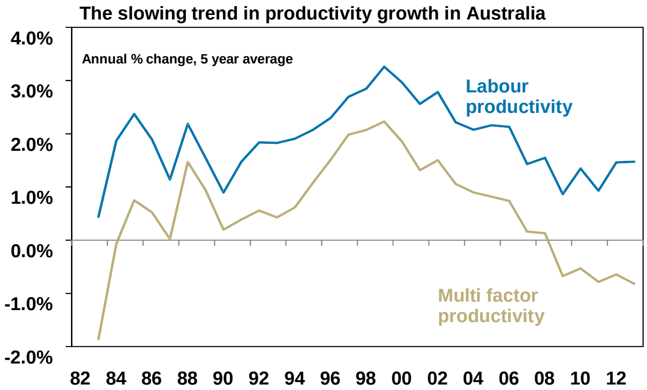
Source: IMF, AMP Capital

I am optimistic we will get Australia and its fiscal finances back into shape, but we need to see much better from all in Canberra than we have seen lately for this to occur.

The Challenges

The structural challenges facing Australia are simple:

- The biggest boom in our history is now fading as lower commodity prices drive lower growth in national income.
- This has seen the boost to the budget from the resources boom go into reverse at a time when we have spent and continue to spend the proceeds whilst the demands on health and pension spending are set to accelerate from the ageing population. At the same time we are embarking on several major expenditure items at once – the National Disability Insurance Scheme, the Gonski education reforms and the new Paid Parental Leave scheme. All of these are desirable, but they are not really all affordable. The NDIS in particular could turn out to be very expensive over time.
- This is all occurring at a time when the boost to productivity growth from the economic reforms of the 1980s and 1990s that lasted into early last decade has faded. This is particularly evident in multifactor productivity (that looks at growth in output per unit of labour and capital), which has gone backwards over the last decade. This didn't matter when national income was growing strongly through the commodity boom, but with it now slowing it matters a lot if we want to keep growing our living standards.



Source: ABS; AMP Capital

What to do – restart the reform agenda

To get back on track, Australia needs to do several things.

Put the Budget on to a sustainable path towards surplus. To not do so will leave us with little fiscal flexibility come the next downturn and leave us vulnerable should our luck turn against us resulting in extraordinary demands being placed on the Federal Government as occurred in Ireland. The Government's Budget puts us in the right direction. To minimise the negative impact on confidence and to gain Senate passage some of the harsher aspects of the Budget are likely to require softening.

Reform the tax system. This is a big one. Put simply the current tax system suffers from a number of problems.

- It's too complex – with over 120 taxes but just 10 of them raising 90% of the revenue.
- There is a heavy reliance on income tax (raising around 50% of revenue) as opposed to sales tax (raising nearly 30% of revenue) and this did not change with the GST. As a result, following the Budget Australia's effective top marginal tax rate at 49% will be 15th highest globally and the highest in our region, viz NZ 33%, Singapore 20% and Hong Kong 15%. Sydney can forget about becoming a world financial centre – as why would individuals locate here and lose half their extra income? The end result is a disincentive for extra effort, increased demand for tax minimisation strategies and less incentive to save.
- The numerous taxes along with the GST exemptions for fresh food, health and education result in various distortions in the economic system.

Ideally, from an economic perspective the GST needs to be broadened and its rate increased and the proceeds used to fund the removal of numerous nuisance taxes and reduced income tax.[1] Tax reform should occur with the aim of not increasing the overall tax burden on the economy. Once allowance is made for compulsory superannuation contributions in Australia and social security levies in other countries, the tax burden in Australia is already around the OECD country average. Taking it higher would only reduce incentive and Australia's long term growth potential, as various high tax European countries have found.

Embark on another round of privatisation. Private operators can invariably run businesses better than governments and the proceeds from asset sales can be used to pay down debt and/or recycle into new infrastructure spending. Privatisation of infrastructure assets also provides investment opportunities for Australian superannuation funds. The Federal and Victorian Governments went down this path significantly in the 1990s and there are still significant utility assets in other states that can be privatised.

Boost infrastructure spending. This is essential if we are to boost productivity and income levels. The Federal/state agreement to privatise assets and use the proceeds to invest in infrastructure is a move in the right direction. Queensland has announced a move down this path, but it won't start till after next year's election.

Reduce regulation. Excessive regulation is slowing business and investment. The Federal Government looks to be taking this on.

Reduce remaining protection. Industry protection has been substantially reduced but remains significant with various protection measures remaining such as bans on book imports, restrictions on pharmacies and the licensing arrangements of doctors and lawyers. The Government has at least made a start on this front by not chasing various failing businesses lately with blank cheques.

Get our education system producing better outcomes. As various studies have shown our education system is lagging other OECD countries in some areas. But as the debate around the Gonski reforms highlights, fixing it probably requires more funding, a solution to which likely involves greater deregulation, greater private sector involvement and higher fees.

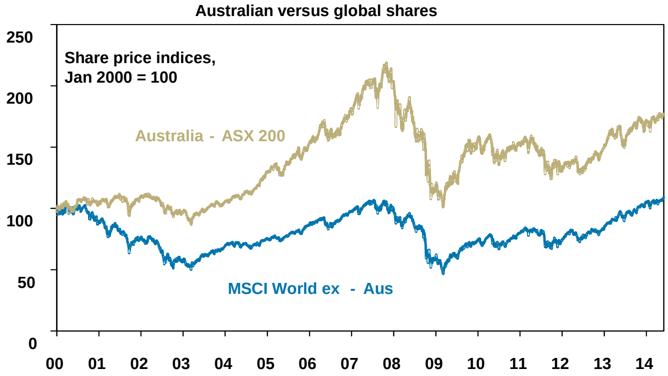
Of course there is much more, but these are the main areas needed to be looked at to boost productivity growth.

What does it mean for investors?

Economic policies can have a significant long term impact on growth and hence asset market returns. Australian shares outperformed global shares significantly last decade. A lot of this owed to the resources boom and our absence of tech stocks which meant the Australian market largely missed the tech wreck. But the boost to productivity and profitability from the economic reforms of the 1980s and 1990s also helped.

Since 2009 though, the relative performance of Australian shares has slipped. While several key global share markets have made new highs including the US share market and just recently global shares generally, the Australian share market remains 20% below its November 2007 high.

Australian versus global shares



Source: Bloomberg, AMP Capital

Why the recent underperformance? A combination of factors have played a role including tighter monetary policy, the strong $A, weakness in China, and the fact Australian shares reached a much higher high in 2007. It's also worth noting that if the reinvestment of dividends is allowed for then Australian shares are above their 2007 high. But the lack of recent growth enhancing reforms and the productivity growth slowdown have likely also played a role in the relative underperformance of Australian shares in recent years.

Concluding comments

Don't get me wrong. I am not bearish on Australia. The economy can rebalance as the mining investment boom continues to fade – as it has been doing over the last year. But if we want strong sustainable economic growth that underpins a relatively strong performance from Australian asset classes we do need to seriously reinvigorate the economic reform process in Australia. Getting lost in endless debate about how to divide up the national cake or denial about the need to get the budget under control will only take us back to the poor economic performance of the 1970s.

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[1] As with the introduction of the GST, pensioners and low income earners can & should be compensated for any broadening and increase in the GST.