economic and political overview

2015

ceda

committee for economic development of australia

About this publication
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Cover images (top to bottom, left to right): President of China Xi Jinping and Prime Minster of Australia Tony Abbott speak at a press conference following the signing of several memorandums of understanding to strengthen trade, Canberra; Man walking past a Centrelink branch, Melbourne, AAP Image/Julian Smith; Road under construction, iStock; Opposition Leader Bill Shorten (right) and deputy leader of the Opposition Tanya Plibersek, Canberra, AAP Image/Lukas Coch.

Page 22: (top left) Prime Minster of Australia Tony Abbott, CEDA event, State of the Nation, Canberra, June 2014; (bottom right) Opposition Leader Bill Shorten, CEDA event, State of the Nation, June 2014.

Page 25: Palmer United Party Leader Clive Palmer, CEDA event, State of the Nation, Canberra, June 2014.

Page 28: (right) Minister for Communications Malcolm Turnbull, CEDA event, State of the Nation, Canberra, June 2014; (left) Foreign Minister Julie Bishop speaks to the media in Perth, AAP Image/Sarah Motherwell.

Page 44: (bottom right) Man walking in to the Reserve Bank of Australia, Sydney, AAP Image/Tracey Nearmy.

Page 46: (top left) Medicare cards, AAP Image/Stephanie Flack; (bottom left) Man walking past a Centrelink branch, Melbourne, AAP Image/Julian Smith.

All other images used in this publication are from iStock.

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 membership includes 700 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 and sponsorship.

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Contents and contributors

The content in the *2015 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 33rd edition of the Economic and Political Overview publication once again delivers a comprehensive analysis of the major economic and political issues confronting Australia, and how they may play out.

This will be an interesting year both for our economy and politically. The mining boom is over and the falling terms of the trade, falling Australian dollar and rising unemployment will be issues that continue to dominate national discussions.

ANZ Chief Economist Warren Hogan and Senior Economist Justin Fabo, along with the ANZ Research Team, have once again put together an excellent assessment of the year ahead.

The chapter examines the likely movements in the international environment including China and the United States, falling commodity prices, consumer spending and growth, the labour market and the falling Australian dollar.

As highlighted in this chapter, Australia needs a persistent lift in productivity growth to ensure gains made in our standard of living are not eroded as we manage the continuing fall in the terms of trade and an ageing population.

On the political front, while I'm sure many expected the change of government in 2013 to signal the end of the political unrest and the leadership speculation that surrounded the previous Labor governments, we enter 2015 with renewed leadership speculation around Prime Minister Tony Abbott.

This comes as the Government continues to struggle to make headway with its policy agenda in areas such as health and education.

The political chapter this year has been completed by Roy Morgan Chief Executive Officer Michele Levine, and it offers insight into the issues on the agenda for Australians and difficulties likely to be faced by the increasingly unpopular Federal Government.

Key issues identified include unemployment, especially youth unemployment, underemployment and industrial relations, and growing domestic concern about terrorism and war.

This chapter also identifies ‘sleeper’ issues with the potential to re-emerge in 2015 as major issues including policy around asylum seekers, the environment and the Royal Commission into Institutional Responses to Child Sexual Abuse.

In addition to the economic and political chapters, this year’s publication includes chapters around *Funding and finance* and *Funding social equity.*

These chapters were selected because financing in Australia is likely to change significantly in coming decades and social equity is an issue that is increasingly gaining traction on the national agenda as debates continue about access to healthcare and education.

Monash University Adjunct Professor and Victoria University Vice Chancellor’s Fellow Professor Rodney Maddock’s chapter, *Finance and funding*, looks at changes occurring in financing such as the growing pool of funds managed through superannuation and likely increasing foreign capital flows, in particular from China.

This chapter examines what these changes mean for financing of Australian businesses and major projects, such as infrastructure.

Australian Council of Social Service Chief Executive Officer, Dr Cassandra Goldie’s chapter, *Funding social equity*, examines the reforms necessary to repair the gaps in our social safety net, in particular looking at unemployment benefits, health, education and retirement income policies.

I would like to thank each of the authors for their contributions to this publication, which provide critical thinking and insight to the year ahead.

Finally, I look forward to seeing many of CEDA’s members at the EPO events being held in every Australian state and territory capital city in February to coincide with the launch of this publication.

Professor the Hon. Stephen Martin
Chief Executive, CEDA

economic OVERVIEW

Warren Hogan is ANZ's Chief Economist and is responsible for the bank's Economics, Commodities and Financial Markets Research. Warren has been at ANZ for nearly 10 years, having run the Global Markets Research team and the Australian Economics team before being appointed Chief Economist in 2010. Warren's research focus is global macroeconomics, monetary economics and financial markets. Prior to joining ANZ, Warren was Chief Economist and Head of Interest Rate Product Research at Credit Suisse First Boston and he held senior economic positions with Westpac Banking Corporation and NSW Treasury Corporation.

Justin Fabo is a Senior Economist at ANZ with a focus on the Australian economy and industry research. Prior to joining ANZ around three years ago, Justin worked as an economist in various positions at the Reserve Bank of Australia for more than a decade and also worked at the Federal Treasury.

The **ANZ Research Team** consists of product-specific strategy teams that are organised on a global basis. The strategists utilise the core views of the economics team and apply these to the relevant markets. In doing this they assess market valuations of financial instruments and commodities as well as providing market risk assessments.

ANZ Research provides a cohesive view of the economic and financial forces affecting the global economy with particular reference to the Asia-Pacific region.

Introduction

The Australian economy faces several challenges despite some progress in the transition away from mining-investment-led growth towards other sources of activity. This rebalancing, supported by historically low interest rates, a lower currency and a slowly improving global growth backdrop, will take some time yet. While there have been somewhat better signs in the non-mining economy, overall growth is expected to remain below average again this year.

The economic outlook remains uncertain due to the interplay between several factors. On the one hand, global growth is expected to continue to gradually improve, supported by notable improvement in the United States (US) economy. Since the Global Financial Crisis (GFC) hit in 2008, however, world growth has been below its long-run average of 3.5 per cent in all but two years and well below the pre-GFC decade average of more than 4 per cent. This has resulted in rising spare economic capacity, discouraging business investment and putting downward pressure on inflation.

For these reasons, global policy support is expected to remain significant. Official interest rates are likely to remain close to their lower bounds in most major economies, notwithstanding that official rates in the US are likely to start rising slowly this year. Central banks in Japan, the euro area, Canada and China among others are easing monetary conditions to help generate some traction in growth and amid falling inflation. The GFC continues to cast a long shadow and these are certainly still far from normal times. A degree of caution about the overall growth outlook is warranted.

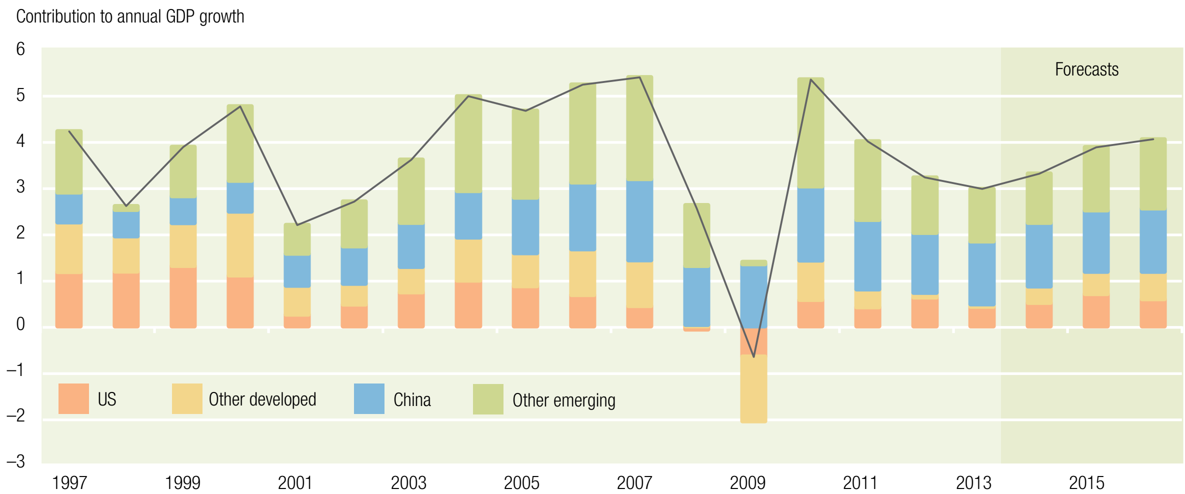
Domestically, there are clear signs that non-mining growth has improved after several years of weakness. But more is needed. Growth outside the resources sector will need to be above average for at least a couple of years to compensate for the significant drag on growth from falling mining investment and weaker incomes as the prices for Australia's key commodity exports have declined. One large part of the non-mining economy – the public sector – is likely to continue contributing only modestly to overall growth.

Against this backdrop, interest rates are expected to remain low by historical standards to support overall growth, with scope for rates to fall further. A lower Australian dollar would help rebalance the economy. This would provide opportunities for some Australian businesses but challenges for others. A lower currency is unlikely to be a panacea for overall activity, however, and risks remain of disappointment with the degree of depreciation relative to what the currency's medium-term 'anchor' – the terms of trade – might suggest.

The global backdrop has improved

Global growth remained below average in 2014, despite some improvement as the year progressed. Growth is expected to improve a little further this year and return towards its average in 2016 (refer to Figure 1). Several forecasters, including the International Monetary Fund (IMF), have recently revised down forecasts for global growth, which has

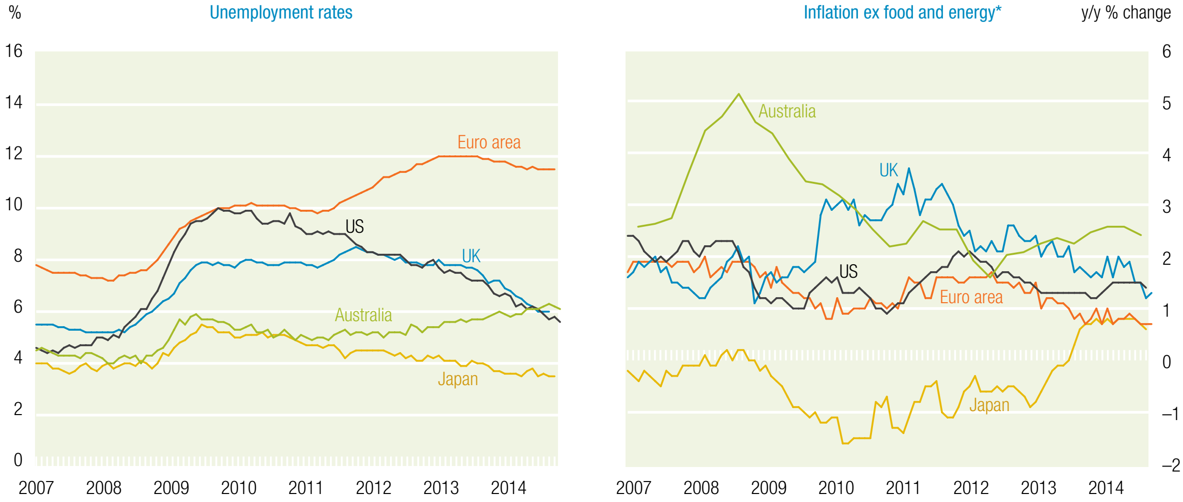
Figure 1
Global growth forecasts



Sources: Consensus Economics, IMF, ANZ Research

Figure 2

Unemployment and inflation in major advanced economies

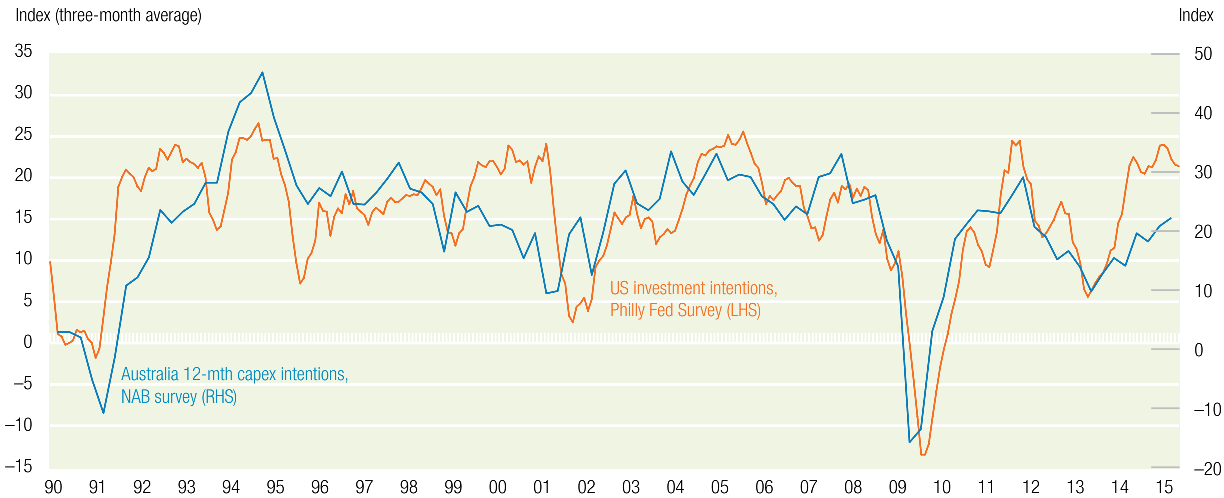


*Australia is the average of the Reserve Bank of Australia's underlying measures. UK and euro area also exclude alcohol and tobacco. US is the core private consumption expenditure deflator. Japan excludes the estimated effect of the value-added tax increase from April 2014.

Sources: Bloomberg, ANZ Research

Figure 3

Private capital expenditure intentions



Sources: Bloomberg, NAB, ANZ Research

been commonplace since the GFC as growth has typically disappointed.

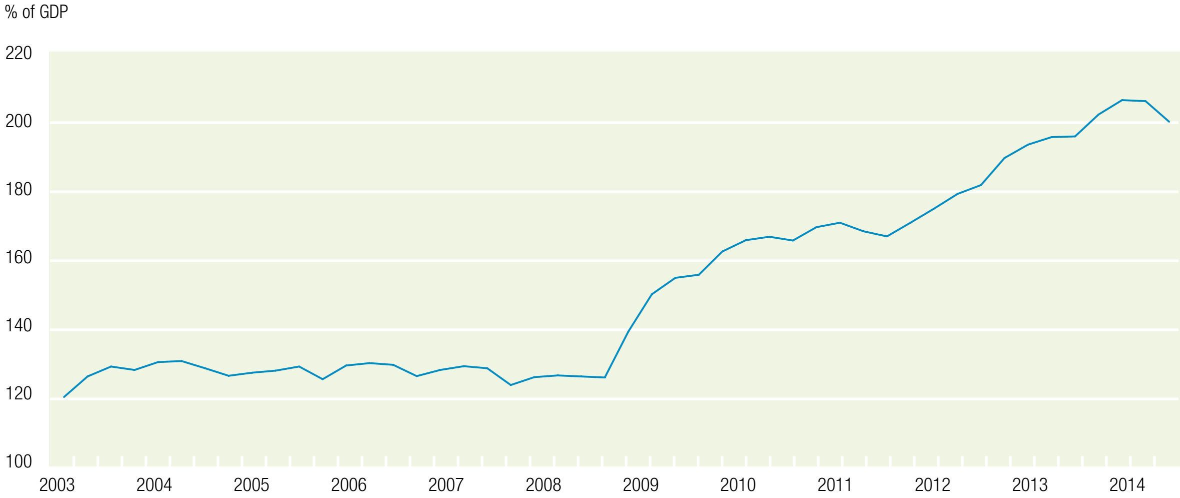
The US economy has strengthened but only modest improvement in growth is expected in Europe and Japan from subdued rates. China's growth is expected to slow further to around 7 per cent this year but its contribution to global growth continues to increase. Resource-intensive parts of China's growth, however, are slowing faster than overall activity. Positively, the sharp decline in oil prices since mid-2014, to the extent it is supply driven and persists, should provide some support to global growth.

Monetary accommodation and global liquidity will remain abundant and continue to provide support to asset prices. Market interest rates are expected to increase a little from current levels as the US Federal Reserve starts to gradually normalise policy but overall they are likely to remain very low.

Concerns about inflation being too low are likely to persist in some regions, particularly Europe and Japan where economic spare capacity remains significant. Output in these economies remains below pre-GFC levels.

Figure 4

Outstanding borrowing of China's households and businesses



Sources: Bloomberg, ANZ Research

Too low inflation is not only symptomatic of weak demand, it is also a concern if it results in businesses and households deferring spending decisions, further weakening activity. While this needs to be watched closely, it is important to recognise that inflation lags underlying economic activity, which we expect to improve. Inflation in the US is expected to pick up as the significant improvement in the unemployment rate eventually feeds through to higher wages growth (refer to Figure 2). Jobless rates in the United Kingdom and Japan have also improved noticeably.

An investment-led recovery is required

The key to growth will be investment over the next few years. Capital investment needs to lift outside China where the construction boom since the GFC has played a critical role in supporting global economic activity and commodity prices. (As an aside, China's high investment share and still-fast growth in capital spending means that its *contribution* to global investment growth is still rising.)

Business confidence and investment intentions have improved in some countries, notably in the US, which has historically been positive for investment plans in Australia (refer to Figure 3). Infrastructure investment should continue to be a focus of governments worldwide, with announcements in late 2014 from the G20 countries and European Commission encouraging in this regard.

Growth in household spending globally is likely to remain relatively soft for some time amid soft wages growth and consumer caution. The drag on consumer spending from ageing populations is also gathering speed. Business finances are typically in better shape than household finances across the globe so the preconditions appear reasonably supportive for a strengthening in private capital spending.

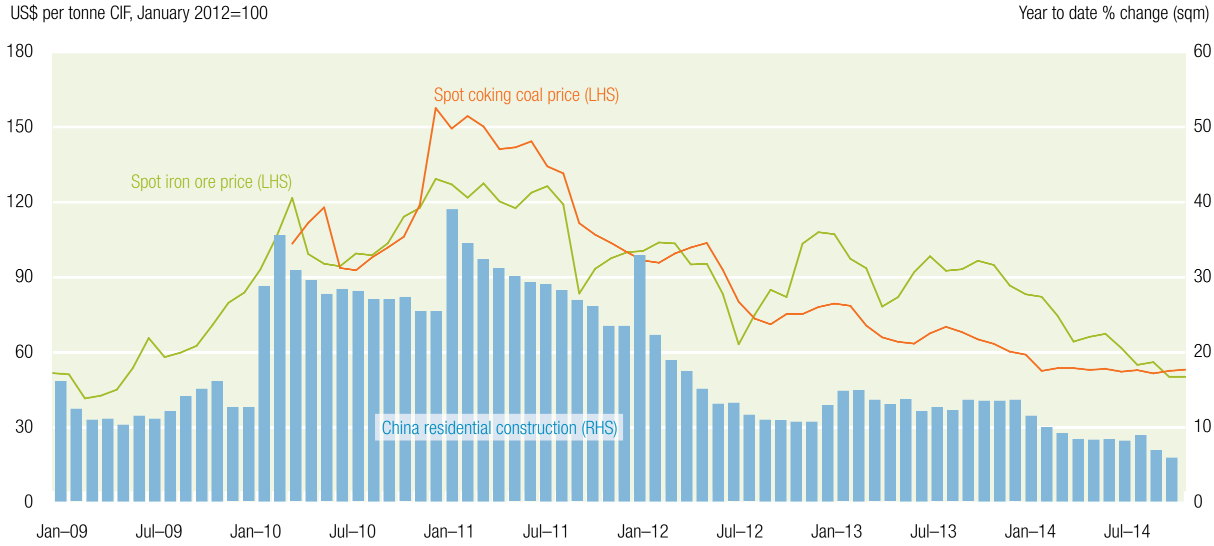
There is evidence that stronger growth in the US economy is spilling over into non-Japan Asia through mildly stronger trade flows and domestic production along the global manufacturing supply chain. Our expectation for relatively broad-based US dollar strength as the US Federal Reserve raises rates should also provide some support to economic activity in Asia and other regions. This is an important element of our constructive view on the global economic expansion. Rather than a weak Japan and Europe and slower growth in China holding the US economy back, we expect the US to help the rest of the world slowly regain some economic momentum.

China's tricky path ahead

China continues to face a delicate juggling act. Growth has slowed in recent years and will slow further. Growth in housing construction – which is roughly one-tenth of China's gross domestic product (GDP) – and house prices are under downward pressure, and fallout from the country's massive credit expansion remains a real possibility (refer to Figure 4). At the same time, China's authorities are trying to

Figure 5

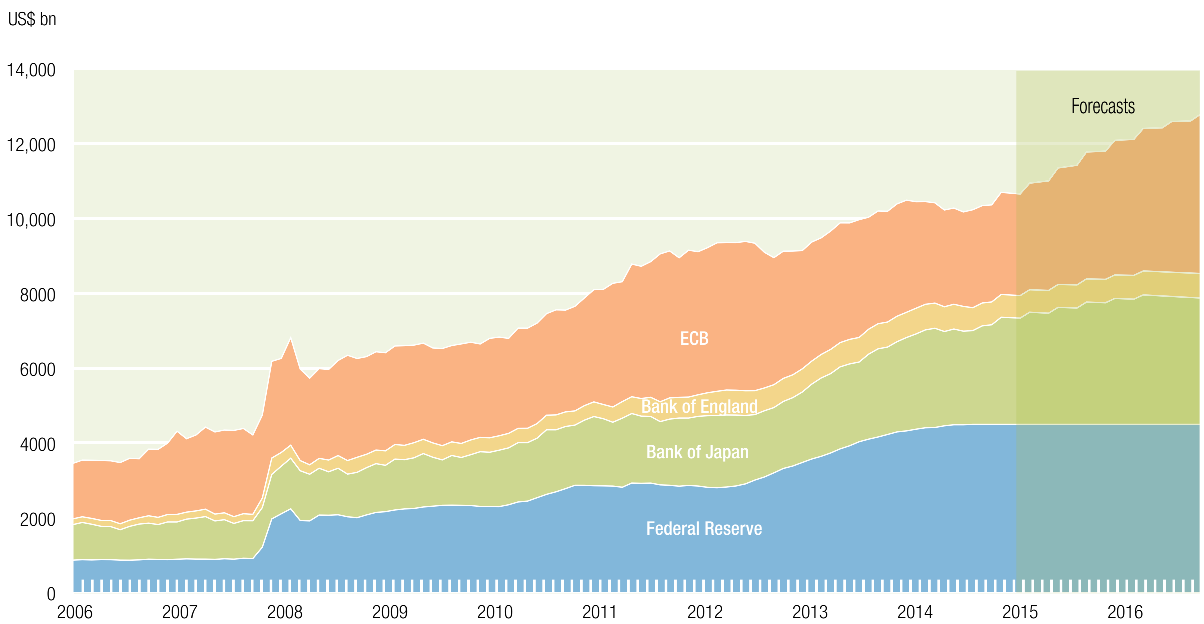
China residential construction and selected bulk commodity prices



Sources: Bloomberg, ANZ Research

Figure 6

Major central bank balance sheets



Sources: Bloomberg, IMF, ANZ Research

reform various aspects of the economy, which is itself very challenging if past experience in other countries, including Australia, is anything to go by.

We are relatively confident that China's authorities would be able to manage any fallout of a significant adverse financial event. But this does not mean that there wouldn't be implications, possibly severe, for global demand and commodity prices. The effect of slower growth in China's residential construction has already been plain to see on the prices of Australia's key steel-making commodity exports, iron ore and coking coal (refer to Figure 5).

> "Global financial liquidity will remain abundant even with the end of US quantitative easing and a few US Federal Reserve rate hikes. We expect the European Central Bank's balance sheet to grow this year … and the Bank of Japan is committed to further balance sheet expansion."

Can markets cope with US rate hikes?

Global financial system liquidity will remain abundant even with the end of US quantitative easing (QE) and a few US Federal Reserve rate hikes. We expect the European Central Bank's balance sheet to grow this year as they undertake QE, and the Bank of Japan is committed to further balance sheet expansion (refer to Figure 6). China has been easing monetary policy and we expect further easing.

The main implication of this global liquidity story is that we do not expect major disruptions in financial markets due to higher US rates but volatility is expected to remain higher than the low levels experienced last year. While some increase in short-term market rates may occur, long-term rates are not expected to greatly increase. This should continue to support asset prices and global wealth.

Australia faces a challenging period ahead

Traits commonplace in Australia's society for many years will need to come back to the fore given the challenges we face. A penchant for hard work, innovation and risk taking, challenging the status quo and giving everyone a fair go are certainly still there.

Some of these traits, however, appear to have drifted to the background amid more than two decades of very good economic times. This included a massive 'free kick' to Australia's national income as foreigners paid more each year for our key commodity exports, which also triggered huge investment in resources infrastructure.

Most Australians haven't had to make too many really tough economic decisions for some time. Governments enjoyed windfall revenue gains, including from ever-higher commodity prices. Businesses

"Housing activity has picked up strongly, and elevated building approvals indicate a solid pipeline of activity over the next year or so."

saw strong profits growth year in, year out. All this resulted in households enjoying a long period of significant real income and wealth gains – a 30-year old working now has little idea what a recession is.

Things are changing. The shadow cast by the financial crisis lingers over global growth. Commodity prices have weakened substantially amid slower growth in China and higher supply, and risks to Australia's terms of trade remain tilted to the downside. Australia's youth are getting a taste of conditions that for some might feel arguably recession-like – the rate of employment for youths is the lowest since the mid-1990s. Luckily, most of their parents have (so far) remained in work.

Tough decisions *will* need to be made by all levels of government, and by businesses and households. This is already happening. Firms across the economy have been cutting costs and deleveraging, governments limiting expenditure and households curtailing spending to pay down debt. These trends are likely to continue to varying degrees.

Looking ahead, it's (almost) all about lifting productivity growth. There are already positive signs here as firms have been reorganising their operations. It is clear that this needs to go up a notch. We need to innovate more and invest in people and technology-enhancing capital to become even more productive. Without a persistent lift in our productivity growth above the subdued rates of the past decade, the gains in our standard of living will be eroded, possibly significantly as the terms of trade decline and the population ages.

Growth to remain relatively subdued

Many forecasters, including ourselves, see GDP growth remaining below average in 2015 before returning to around average in 2016 (refer to Figure 7). Overall, growth in non-mining demand has improved but remains a little below average (refer to Figure 8). Concurrently, resources investment has now been declining for around 18 months but the rate of decline is expected to hasten this year.

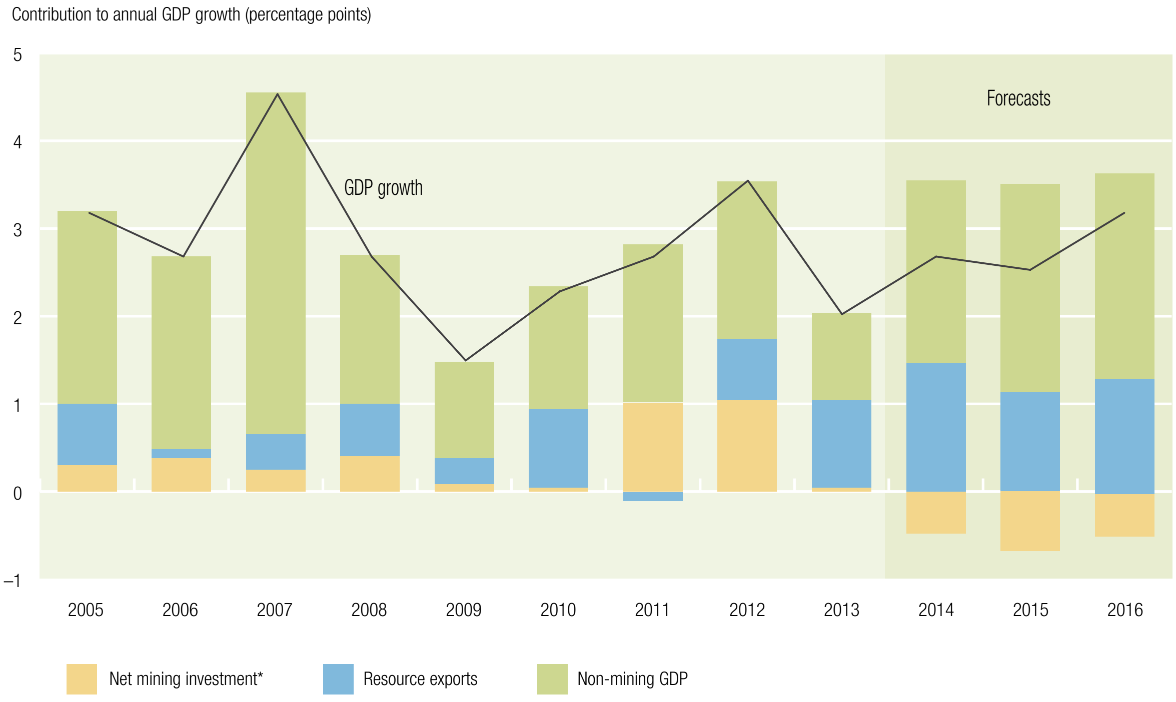
Housing activity has picked up strongly, and elevated building approvals indicate a solid pipeline of activity over the next year or so. But while activity is likely to be sustained at a high level, housing construction's contribution to growth will fade in 2015 without further rises in building approvals.

For several reasons, conditions will continue to feel weaker than the headline GDP numbers suggest:

1. Growth would still be noticeably slower than the 3.5 per cent rate experienced, on average, over the decade to 2007;
2. Ongoing strong population growth is flattering the headline growth numbers – GDP growth per person is expected to remain soft at best by historical standards;
3. Job generation now from average rates of GDP growth is likely to be slower than in the past due to the significant contribution coming from resources exports, which tend to be very capital intensive (and increasingly so, as LNG exports account for a higher share);

Figure 7

Australian GDP growth forecasts by key components

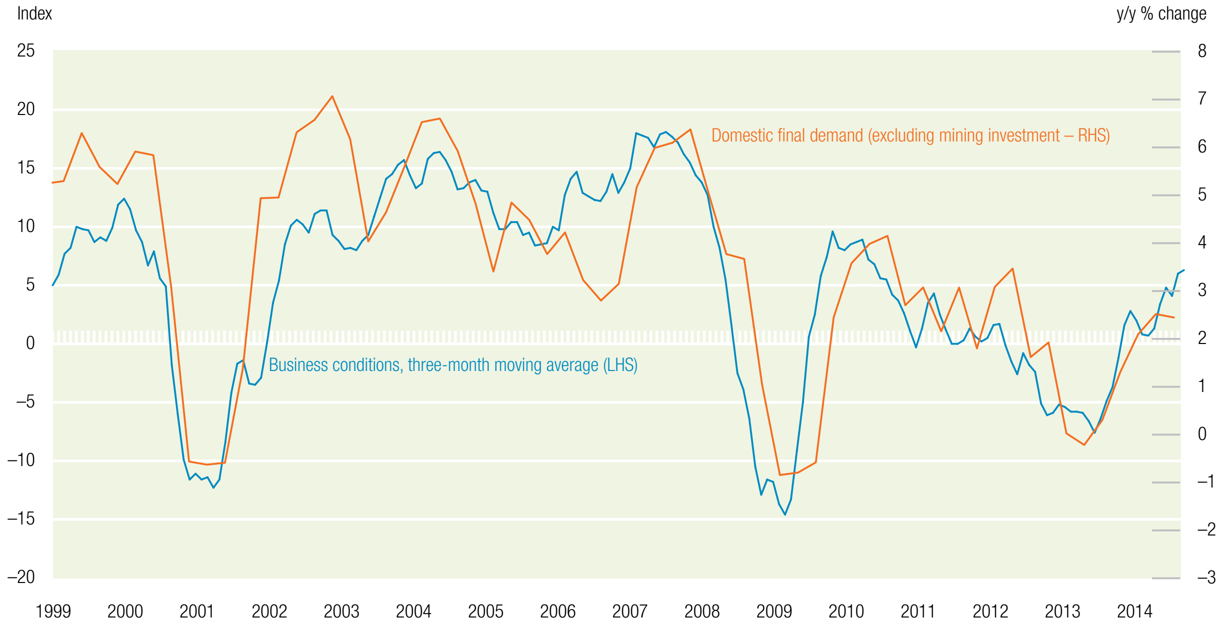


* Assumes a 50 per cent import share for mining investment

Sources: Australian Bureau of Statistics (ABS), ANZ Research

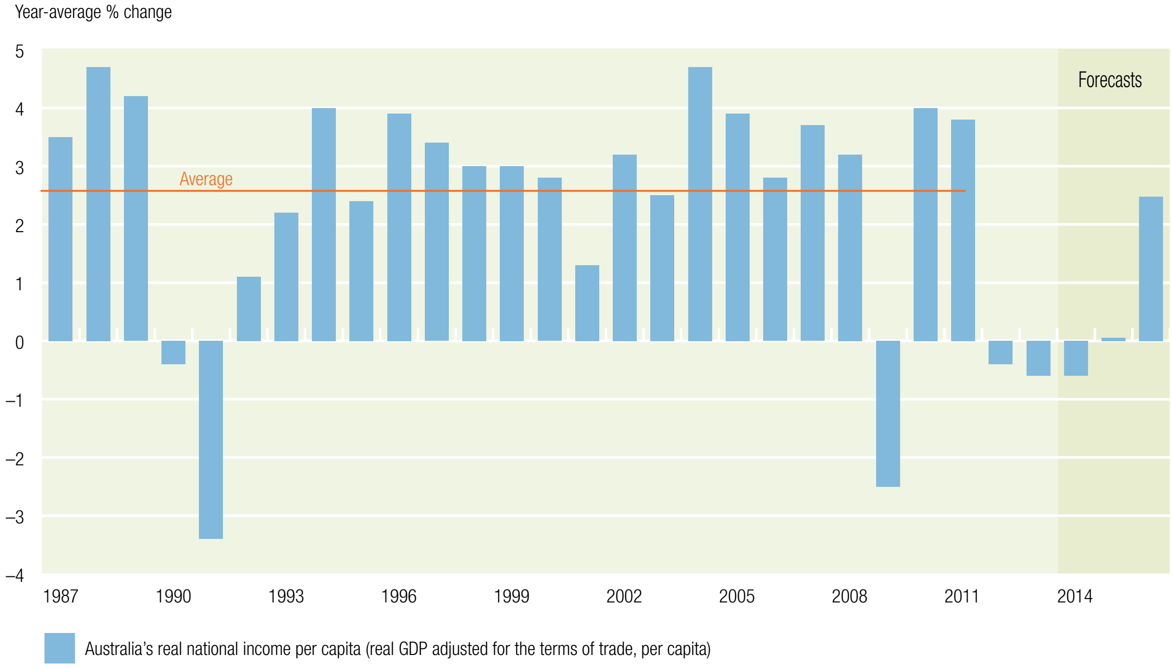
Figure 8

Business conditions and domestic demand growth



Sources: ABS, NAB, ANZ Research

Figure 9
Growth in Australia's real national income per capita



Sources: ABS, ANZ Research

"The effects of lower commodity prices are felt throughout the economy, just as the terms of trade boom had significant positive spill-over effects."

4. Most importantly, growth in Australia's national income is expected to remain under downward pressure from weaker commodity prices (refer to Figure 9). It is (real) *income* that ultimately matters for our standard of living.

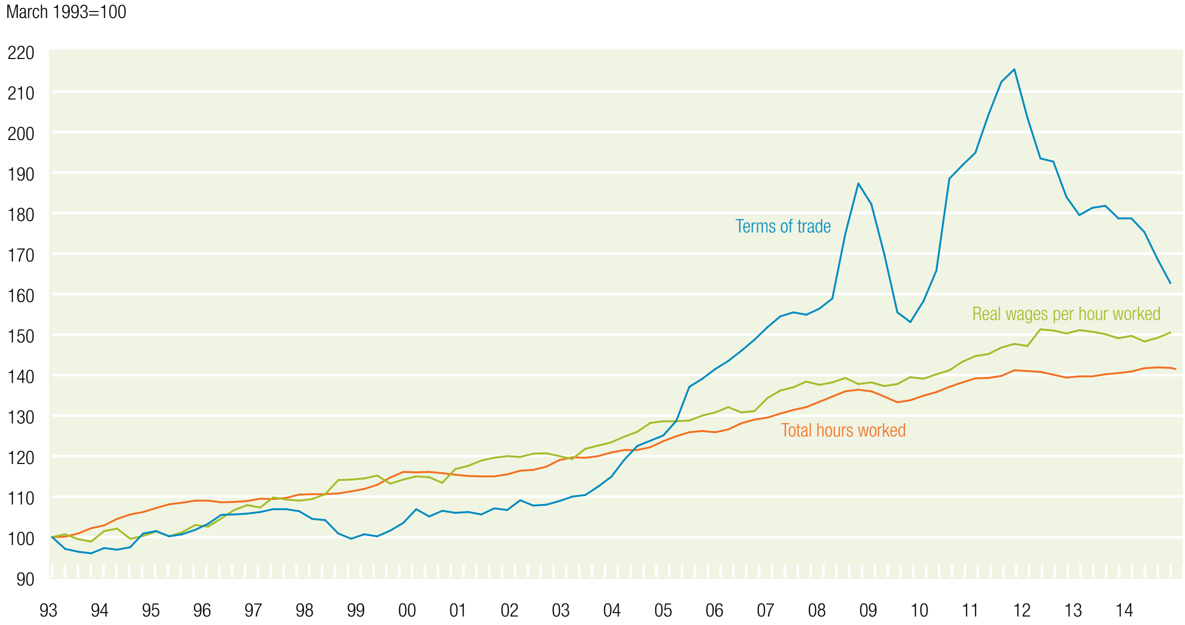
The key risk is even lower commodity prices

The outlook for the economy continues to be clouded by the outlook for commodity prices. Australia's terms of trade – the nation's purchasing power – have fallen by more than one-quarter since peaking in late 2011. This has weighed on incomes and activity, and has contributed to the Reserve Bank of Australia (RBA) cutting the cash rate to an historic low.

The effects of lower commodity prices are felt throughout the economy, just as the terms of trade boom had significant positive spill-over effects. Since the terms of trade peaked, real wages per hour worked have flat-lined and total hours worked in the economy have barely risen (refer to Figure 10). Business profits and government revenues have also come under downward pressure. In essence, the 'free kick' from higher commodity prices is now well and truly in reverse.

Figure 10

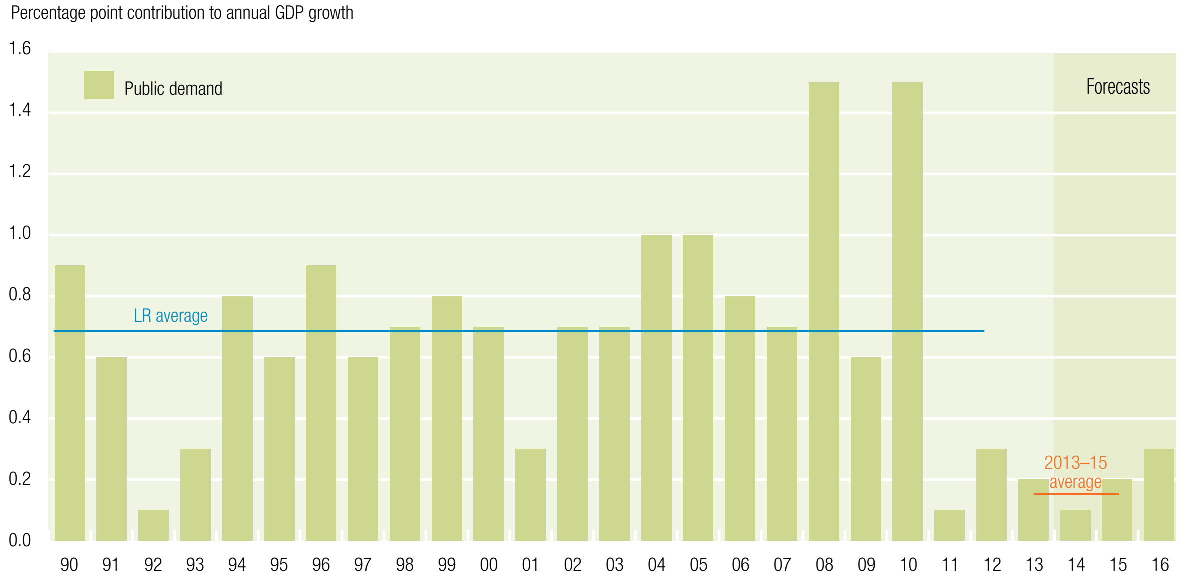
Terms of trade, real wages and hours worked



Sources: ABS, ANZ Research

Figure 11

Contribution of government spending to GDP growth



Sources: ABS, ANZ Research

If Australia's terms of trade continue to weaken more than expected – and that appears to be where the risks are tilted – this will constrain consumer spending and business investment, and prolong the weakness in public demand. Government spending, which represents one-fifth of GDP, has already been contributing only modestly to economic growth (refer to Figure 11). A lower Australian dollar would likely help cushion the economic effects of unexpectedly lower commodity prices but it is unlikely to provide a complete offset.

> "A sustained pick-up in household spending growth would appear necessary to ensure that the positive signs in non-mining business investment intentions are sustained. This is vital to the outlook."

Consumer spending is unlikely to be a key driver of growth

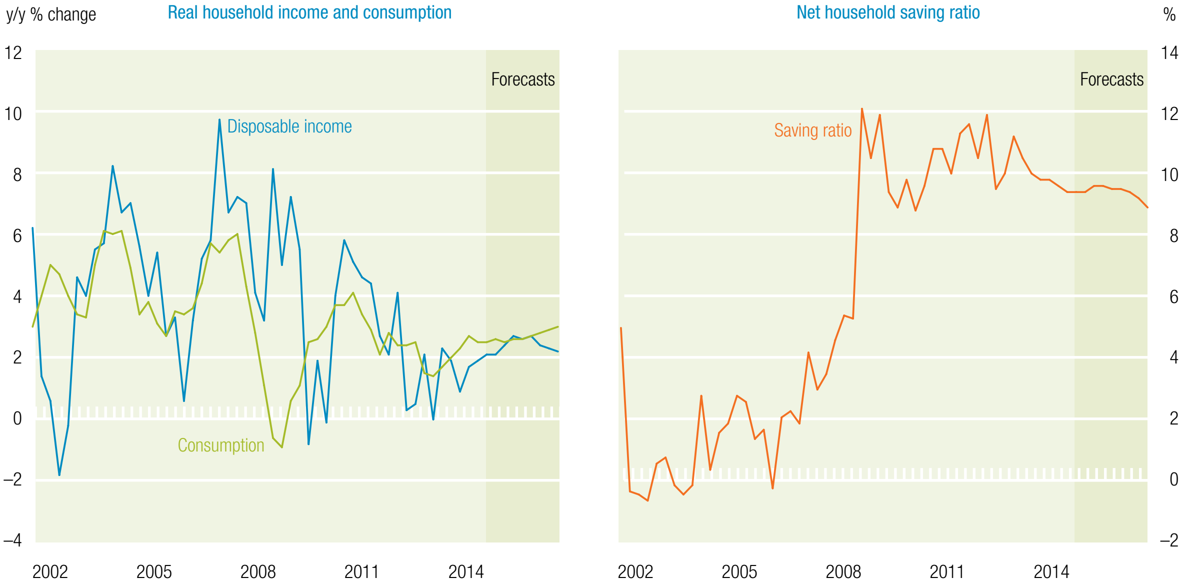
Like the situation globally, household consumption growth in Australia is likely to remain below average for some time yet. Growth in household incomes is expected to remain soft due to subdued wages and employment growth. Even allowing for some further 'wealth effect' from rising asset prices resulting in a lower household saving ratio, we expect consumption growth to remain moderate until 2016 (refer to Figure 12).

With household spending accounting for around 55 per cent of GDP, the desired rebalancing of growth will be made even harder without a noticeable recovery in household spending. Any wealth effect from rising asset prices is expected to wane as house price growth slows, including in Sydney and Melbourne. At the same time, measures of consumer confidence remain at or below average and susceptible to adverse news.

A sustained pick-up in household spending growth would appear necessary to ensure that the positive signs in non-mining business investment intentions are sustained. This is vital to the outlook given that mining investment has a long way to fall yet; net of imports it is expected to subtract something like 1¼ percentage points from GDP growth in the next couple of years.

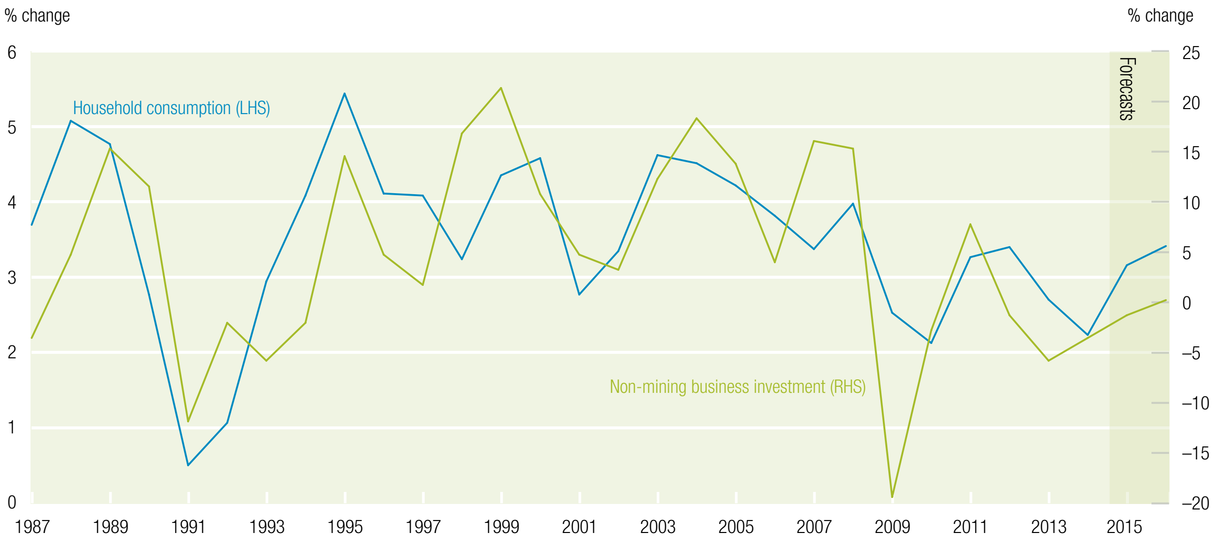
The fundamentals are in place for a solid upswing in non-mining business investment at some stage but firms continue to express some reluctance to

Figure 12
Household income, consumption and saving



Sources: ABS, ANZ Research

Figure 13
Household consumption and non-mining business investment

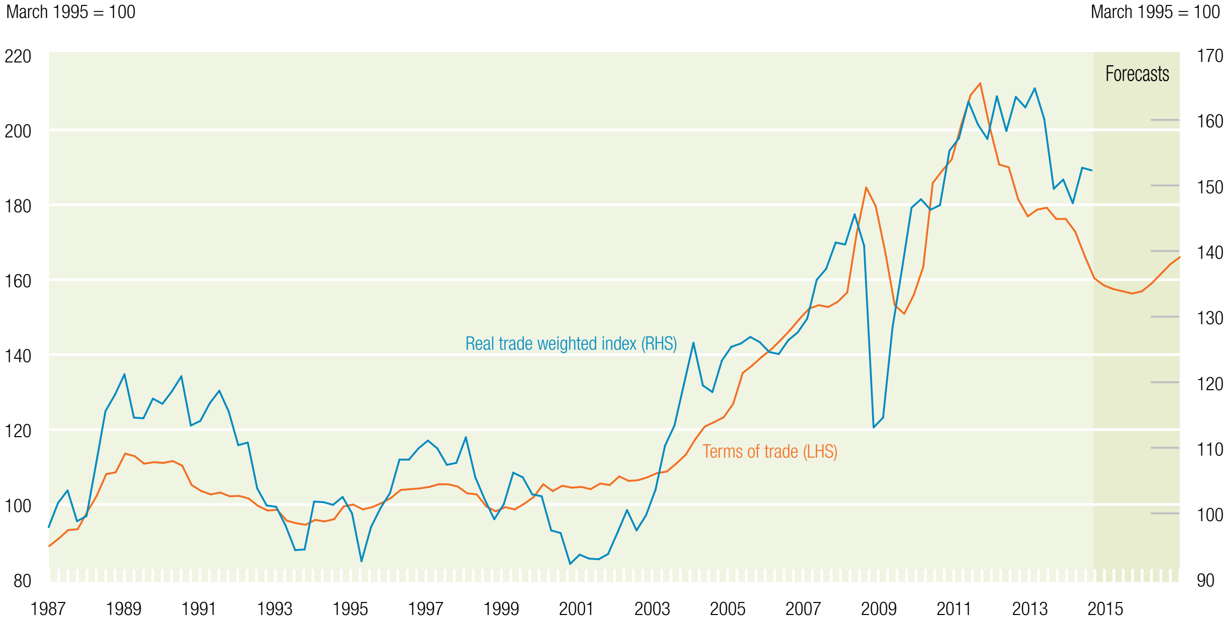


Sources: ABS, ANZ Research

spend until the pick-up in demand looks sustainable. Indeed, strong growth in non-mining business investment has only come about historically amid a strong pick-up in household consumption growth (refer to Figure 13).

Encouragingly, a pipeline of infrastructure investment appears to be forming, in part to take advantage of Federal Government incentives if state governments sell assets and use the funds to build new infrastructure. Outside of New South Wales, however, where a few large projects are underway or will start soon, considerable lags until ground is actually broken limit the near-term opportunities for businesses and the economy.

Figure 14
Real trade weighted index and terms of trade



Sources: ABS, RBA, ANZ Research

A lower currency will help but it is no panacea

A key point is that unless the currency overshoots levels consistent with its weakening fundamentals, it will only help dampen the adverse effects on the overall economy from lower commodity prices.

Since floating more than 30 years ago, the Australian dollar has played an important 'shock-absorbing' role for the economy. When overall growth has needed support, the currency has typically depreciated and when activity has been a little too strong, it has tended to appreciate to take the edge off. For example, the currency appreciated significantly during the terms of trade boom Australia experienced up to 2011. It dampened the huge positive income effect on the economy but it did not completely offset it.

Since 2011, the currency has depreciated as the average prices of Australia's commodity exports have fallen by nearly half from the peak in US dollar terms. Against the US dollar, the currency has fallen by around one-quarter from its peak of US$1.10 and we expect it to end 2015 at around US$0.74 before moving a little lower in 2016.

In our view, the medium-term 'anchor' for the Australian dollar – the terms of trade – points to further *real* currency depreciation (refer to Figure 14). In aggregate, unless the currency noticeably overshoots its fundamentals, which is possible, it would just continue to play a shock-absorbing role. That is important to help rebalance growth in the economy – firms that export and compete with imports, including in tourism, stand to benefit. But in aggregate, a modestly lower currency will only *dampen* the adverse effects on national income from lower commodity prices.

A lower currency is unlikely to be the panacea that some seem to think. But it would help.

Ample spare labour market capacity will persist…

Labour market conditions have been soft at best for a number of years. Below trend growth has resulted in a gradual increase in the unemployment rate to a little more than 6 per cent currently. Other measures point to a greater increase in labour market slack. But with economic growth expected to remain below trend for some time, the unemployment rate is expected to rise to around 6.5 per cent this year before declining gradually.

Resources employment will continue to decline amid falling mining investment and weaker commodity prices. Employment in related industries, including a range of business services, is also likely to remain under pressure. In contrast, strong residential construction and the lower Australian dollar should support hiring in a range of other industries, some of which are relatively labour intensive, including tourism.

Ongoing soft labour market conditions have resulted in a pronounced and broadly based slowing in wages growth. For many businesses, this will be welcome and help limit upward pressure on the jobless rate. However, those firms seeing their selling prices under downward pressure – including directly or indirectly from lower commodity prices – are still likely facing uncomfortable real wage outcomes.

Overall, nominal wages growth is likely to remain much slower than the average rates of the past couple of decades. With the terms of trade falling, an extended period of limited real wages growth is both likely and necessary to improve Australia's international competitiveness. Only persistently stronger productivity growth will make this transition easier.

…which means inflation is off the radar…

Expectations that wages growth will remain relatively subdued suggest that inflation will not be a focus for some time. Disinflationary pressure globally amid substantial spare capacity and lower commodity prices will also continue to dampen inflation in Australia. Our expectation, and that of the RBA, is that inflation will remain comfortably in the 2 to 3 per cent target range over the next couple of years. Moderating inflation for non-tradable goods and services and disinflationary effects of lower oil and other commodity prices are expected to outweigh the inflationary effects of the lower currency. In the near term, we expect inflation to be around the bottom of the RBA's target band.

Policymakers, both in Australia and globally, will remain firmly intent on generating sufficient growth over time to absorb the excess capacity that has built up since the GFC. Inflation is off the radar.

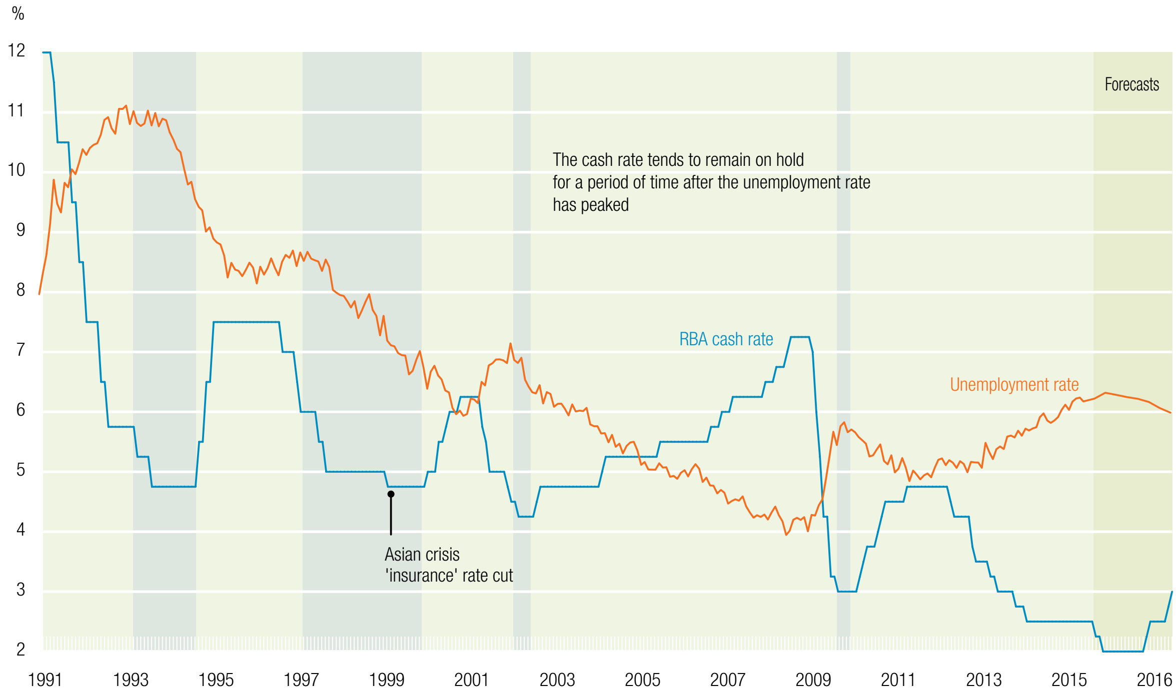
…and points to further scope for the RBA to lower the cash rate further

The benign inflation outlook points to the official cash rate remaining low for some time yet. Risks remain that the currency does not completely play its shock-absorbing role amid the weaker terms of trade. An important reason is that Australian interest rates remain attractive to foreign investors as interest rates abroad have kept falling. Fiscal policy will remain highly constrained in the support it can provide to the economy if a medium-term path to sustainable

"Ongoing soft labour market conditions have resulted in a pronounced and broadly based slowing in wages growth. For many businesses, this will be welcome."

Figure 15

RBA cash rate and unemployment rate



Note: Shaded areas are from the unemployment rate peaks to just before the following cash rate increase.
Source: ABS, Bloomberg, RBA, ANZ Research

government finances is maintained – falling commodity prices are proving a significant stumbling block on this path.

Below trend growth will provide the RBA scope to ease monetary policy further. Our view, and that implied by financial market pricing, is that the cash rate will fall a further 50 basis points to 2 per cent by the middle of this year. Thereafter, the RBA is unlikely to raise the cash rate until it is certain that the unemployment rate is on a firm downward path, which is likely to take some time (refer to Figure 15). As long as the global economy continues to improve heading into 2016, and interest rates globally begin to normalise, the RBA should be well placed to start raising the cash rate next year.

What are the risks to our base case? With Australian interest rates already at historic lows, one line of thought is that monetary policy is already doing all it can to support demand and that even lower rates are unlikely to spur confidence but could risk a boom-bust cycle in housing market activity and prices. Importantly, however, the RBA has signalled that it believes that lower rates from here would provide additional support to activity. Further, housing market activity appears to be cooling and moves by the Australian Prudential Regulation Authority to limit potential risk taking in aspects of the housing market, particularly among investors, diminishes one potential hurdle for the RBA to cut rates further.

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

Forecast tables

	2008–2012 average	2013a	2014f*	2015f*	2016f*
GDP					
United States	0.9	2.2	2.3	3.2	2.7
Euro area	–0.3	–0.4	0.8	1.3	2.0
United Kingdom	–0.6	1.7	3.0	2.7	2.5
Japan	0.0	1.5	0.5	1.6	1.8
China	9.1	7.7	7.5	6.8	6.7
India	7.5	4.7	5.0	6.2	6.6
New Zealand	1.3	2.8	3.1	3.0	2.7
World	**3.1**	**3.3**	**3.3**	**3.8**	**4.0**

*Forecast

Australia – annual % growth

Key indicators	2013	2014	2015	2016
Real GDP				
Consumption	1.7	**2.5**	**2.6**	**2.9**
Dwelling investment	0.2	**7.9**	**5.5**	**4.0**
Business investment*	–3.9	**–4.6**	**-6.9**	**0.1**
Public demand*	0.7	**0.4**	**0.9**	**1.2**
Inventories (contribution)	-0.4	**0.1**	**0.1**	**0.0**
Gross national expenditure	0.0	**1.3**	**0.8**	**2.2**
Exports	6.2	**6.1**	**4.9**	**6.8**
Imports	–1.9	**–1.3**	**–4.0**	**2.3**
Net exports (contribution)	1.6	**1.5**	**1.8**	**1.0**
GDP	2.1	**2.7**	**2.5**	**3.2**
Labour market				
Unemployment rate (%)	5.7	6.1	**6.5**	**6.3**
Employment growth	1.0	1.0	**0.9**	**1.7**
Wages (WPI)	2.8	**2.6**	**2.6**	**2.9**
Inflation				
Headline	2.4	**2.5**	**1.8**	**3.0**
Core (Avg. RBA measures)	2.5	**2.5**	**2.1**	**2.5**
External sector				
Terms of trade	–3.9	**–7.3**	**–4.6**	**3.6**
Current account balance**	–3.3	**–3.2**	**–3.1**	**–1.7**
Markets* **	–4.2	–3.1	**–2.4**	**–0.6**
RBA cash rate (%)	2.50	2.50	**2.00**	**3.00**
10-year bond (%)	4.24	2.74	**2.10**	**3.25**
AU$/US$	0.89	0.82	**0.74**	**0.72**

Notes: Forecasts in bold; annual data and forecasts are year-averages.
* Net of second-hand asset transfers ** % of GDP *** Market forecasts are for year-end

political
OVERVIEW

Michele Levine has more than 30 years' experience as a researcher and has been responsible for thousands of surveys, including many of the largest research projects ever undertaken in Australia, many of which continue to play a critical part in shaping our society today.

With a fundamental belief in the empowering value of information, Michele was instrumental in the development and refinement of Roy Morgan Single Source, the world's leading consumer study (based on over 50,000 interviews a year) and, in 2010, the introduction of the Roy Morgan Business Survey.

Since her appointment as CEO in 1992, Michele has been responsible for the launch of Roy Morgan Single Source in other markets, including New Zealand and Indonesia and is driving the impressive global growth of the company in major markets like the United States and the United Kingdom.

Overview: A decade in review

Over the last decade, we have seen dramatic changes in Australians' priorities and worries, reflecting the changing issues facing both Australia and the world.

In 2005[1], immediately after the 2005 Bali bombings, a majority of Australians (52 per cent) saw terrorism and war as the most important issues facing the world – well ahead of economic issues (16 per cent) and the environment (12 per cent).

By early 2008[2], the big issue was the environment: climate change, greenhouse gas emissions, water, and so on. At its peak, in May 2008, the environment was seen by 35 per cent of Australians as the biggest problem facing the world. This was well ahead of economic concerns at 24 per cent. Remember of course, in the decade to 2007, the Australian economy was booming. This underpinned the rise of household wealth and expenditure, and as a nation, Australia turned its attention to social issues.

When the Global Financial Crisis gained force later that year[3], economic concerns took over and remained a priority until the later part of last year[4], when terrorism and war re-emerged. Now, 43 per cent consider war and terrorism the most important issue facing the world – ahead of the economy at 19 per cent and environmental issues at 14 per cent.

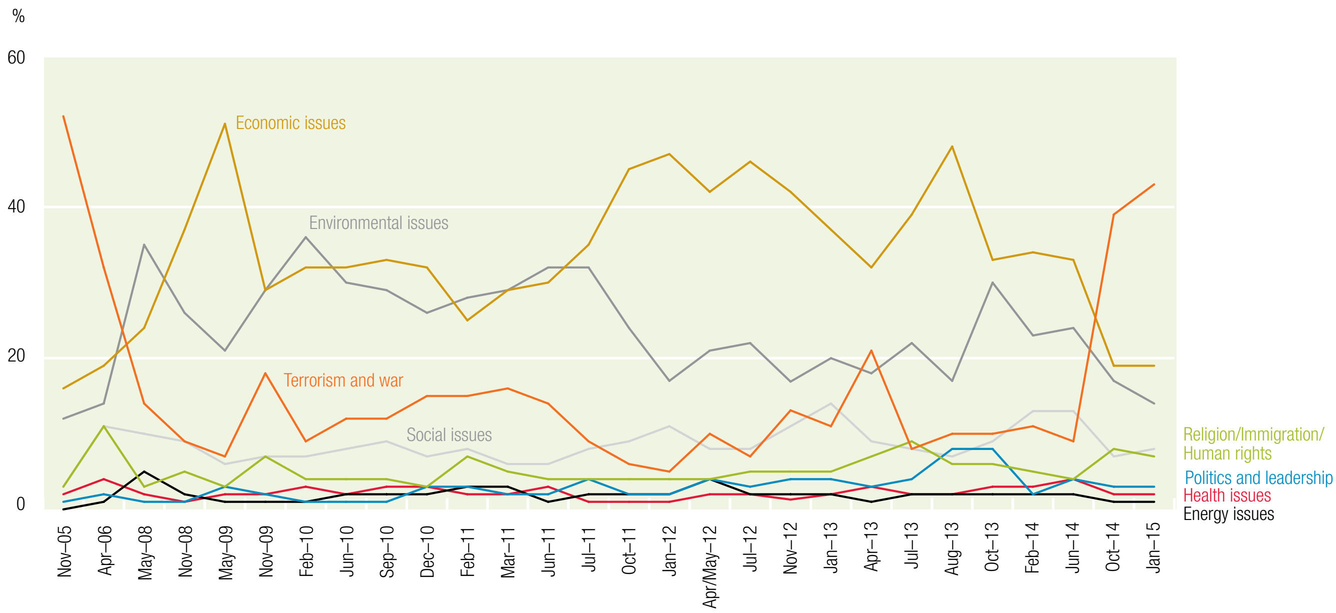
On the local or national scene, economic issues still dominate Australians' concerns, as they have done for most of the period since 2009.

It is worth noting that over the last decade, our national concerns have followed a similar pattern to global concerns. In 2005[6], concerns about terrorism and war were seen as the biggest issue facing Australia at 21 per cent (ahead of the environment at 15 per cent and economic issues at 14 per cent). The environment as an issue peaked in May 2008[7] when 30 per cent of Australians considered the environment the most important issue facing Australia. The environment has since declined as an issue as economic concerns take priority for Australia and Australians.

Since late last year[8], terrorism and war have re-emerged as national concerns for Australia. Eleven per cent of Australians now consider terrorism and war to be the most important problem facing Australians.

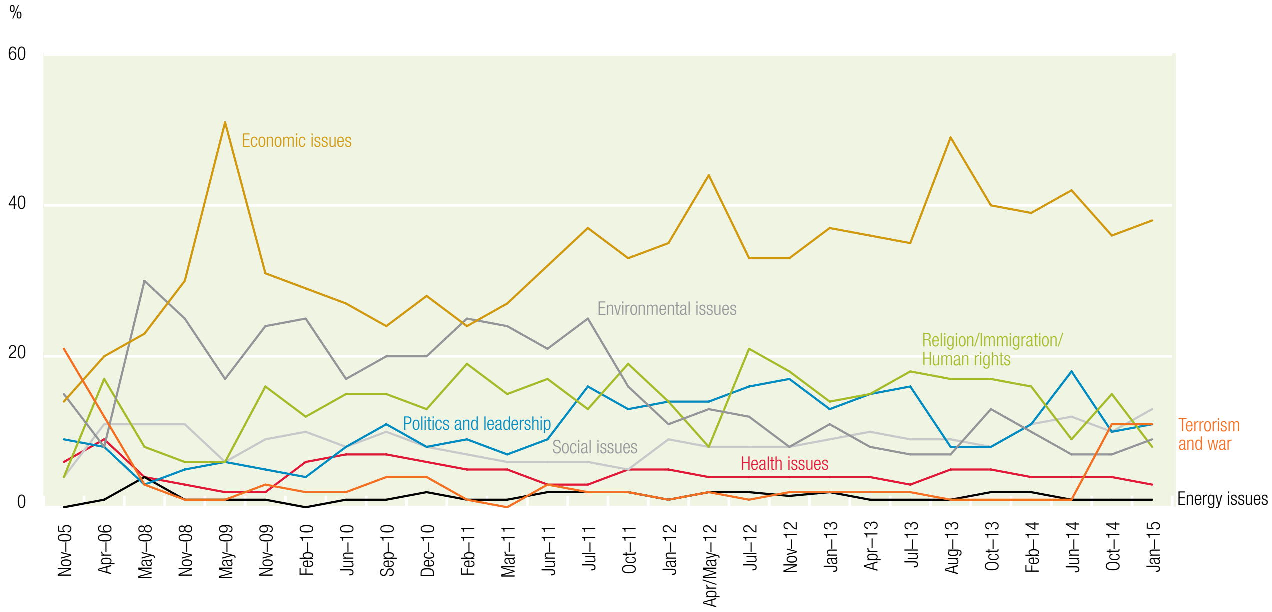
The last decade has also seen slow but dramatic changes in Australia's demography and psyche.[9] Australia's population is growing and with 7.8 million Australians aged 50 and over, and 3.3 million aged 65 and over, the population is also ageing. Within the ageing population, the 65 and over age group is projected to grow at a faster rate as the Baby Boomers move into the age group. Only two years of Baby Boomers are in the 65 and over age group so far.

Figure 1
Most important issues facing the world



Base: Australian population 14+
Source: Roy Morgan Nationwide qualitative research conducted by telephone (n=604) 12–13 January 2015

Figure 2
Most important issues facing Australia



Base: Australian population 14+
Source: Roy Morgan Nationwide qualitative research conducted by telephone (n=604) 12–13 January 2015

As a nation, we continue to be increasingly open-minded and socially progressive. The trend is solid and manifest in such attitudes as 58 per cent support for homosexual couples adopting children. Marriage is now officially the minority: only 48 per cent of Australians aged 14 and over are now married and about two in three Australians live in a household with no children. This is the context within which the 2015 political agenda will be played out.

Australia enters 2015 in a precarious position: serious economic issues, an increasingly complex international environment; and politically, an unpopular Tony Abbott-led LNP Government, which does not appear ready, willing or able to deal with the issues and which is hampered by a dysfunctional Senate. Conservative governments, especially those that need changes, are inherently 'at odds' with the operational arm of government – the public service – with the powerful inertia of its own culture. The dysfunctional Senate makes it just that much harder.

Serious economic issues include:

- High unemployment,[10] especially youth unemployment, and with falling 'hours worked', the emergence of underemployment as a major issue as part-time jobs increase at the expense of full-time jobs;
- The dramatic fall in the iron ore, coal and oil prices that has seen the end of the mining boom;
- The falling value of the Australian dollar leading to concerns about cost of living;
- An unpopular budget including changes to health and education that divided the country and has not yet been passed and now appears to have at least a $40 billion hole; and
- A dysfunctional Senate controlled by minor parties.

Inextricably intertwined with these economic problems is the political context. The Tony Abbott LNP Government has lost the support of the Australian electorate and some of his backbenchers, and moreover, has made promises about industrial relations that have paralysed the Government in terms of much needed action to free up the labour force.

If an election were held today, the LNP Government would not be returned. However, the sheer size of the vote for other parties at the last election is an indication that the Australian electorate does not see a credible alternative in the current opposition Labor Party.

These issues are examined in detail under three major themes that will undoubtedly be underpinning the political scene this year:

- Party politics;
- Political and economic pressures; and
- The international context.

"Confronting the Abbott Government is the makeup of the Senate. The Senate is controlled by minor parties including Palmer United Party (PUP)."

Party Politics

Snapshot:

- Support for the LNP Government is 45.5 per cent versus ALP at 54.5 per cent[11];
- Government confidence is in negative territory at 93 points[12];
- Australian electors prefer Malcolm Turnbull as Liberal Leader ahead of Julie Bishop who in turn is ahead of Tony Abbott for the first time[13];
- The majority (52 per cent) of electors disapprove of Tony Abbott's handling of his job as Prime Minister, and while Opposition Leader Bill Shorten doesn't fare much better (40 per cent disapprove, 37 per cent approve and 23 per cent can't say), more Australian electors believe Bill Shorten would make a better Prime Minister (43 per cent) than Tony Abbott (41 per cent)[14].

The Government in review

In September 2013, after fewer than six years in Opposition, Tony Abbott led the LNP to a comfortable Federal Election victory – LNP at 53.5 per cent versus ALP at 46.5 per cent[15] – and 90 seats in the House of Representatives. Although Tony Abbott has been Prime Minister for just over a year, his Government has already faced several difficult challenges, such as the departure of the Australian car industry – Holden and Toyota announcing the closure of their Australian operations within the next three years following on from Ford's early 2013 announcement that it was pulling out – and significant job losses at Qantas, Forge Group, Alcoa, Telstra and IBM, and several franchises 'going under' with associated job losses. Given these job losses, the Abbott Government's clear priority is to find a way to improve job prospects for the 2.65 million (20.6 per cent of the Australian workforce) who are unemployed (1.40 million – 10.9 per cent) or underemployed (1.25 million – 9.7 per cent)[16]. However, promises made about industrial relations laws have paralysed the Abbott Government in terms of much needed action.

The drop in iron ore, coal and oil prices has seen the end of the mining boom. While the previous Government faced the issue of whether or how to redistribute the wealth from the mining boom (Mining Tax or Mining Super Profits Tax), and how to moderate environmental concerns (Carbon Tax), the LNP Abbott Government is having to deal with socioeconomic and political issues associated with the end of the mining boom.

Also confronting the Abbott Government is the makeup of the Senate. The Senate is controlled by minor parties including Palmer United Party (PUP). Billionaire Queensland miner Clive Palmer started his party midway through 2013, won his own seat of Fairfax on the Queensland Sunshine Coast, as well as the decisive balance of power in the Senate, which gave Palmer a big say on important issues such as the repeal of the Carbon Tax and the Mining Tax, and also the Abbott Government's more controversial measures from their first Federal Budget delivered by Treasurer Joe Hockey.

While it is often hard to determine what exactly Clive Palmer's policy convictions are and while the defection of Tasmanian PUP Senator Jacqui Lambie late last year has reduced Palmer's power somewhat, PUP's position holding two crucial votes in the Senate (Senators Glenn Lazarus and Dio Wang) presents many headaches for the Prime Minister over the next two years at least.

The Federal Budget itself represents yet another huge challenge for the Abbott LNP Government. It was an unpopular Budget that divided the country with many key measures not passed by the Senate nearly a year after the Federal Budget was announced, and more recently, the $40 billion 'hole' in that Budget.

There was a rocky start to the new LNP Government's Indonesian–Australian relationship following allegations of Australians spying on several Asian nations on behalf of the United States as well as continued controversy about asylum seekers. Skilful diplomacy by Foreign Minister Julie Bishop, as well as solid negotiations by Trade Minister Andrew Robb, saw our relationship with Indonesia improve. However, the recent executions of drug traffickers in Indonesia and the fact two Australians remain on death row are likely to present the Abbott Government with further headaches over the following year. Abbott has already made an appeal for clemency for the two convicted Australian drug traffickers Myuran Sukumaran and Andrew Chan to new Indonesian President Joko Widodo.

Several important international trade agreements are being implemented, including those with South Korea, China and Japan. Discussions have begun with India, and Indonesia might follow. The most recent Japanese Trade Agreement saw the price of imported Japanese cars fall dramatically. The implications of our increasing trade relations include cheaper imports, potentially higher export prices for food, but continued downward pressure on labour costs, particularly affecting manufacturing in Australia and therefore unemployment.

State elections

In March 2014, two State elections held in Tasmania and South Australia were split between the two sides of politics. The Liberals won a convincing victory in Tasmania to form Government for the first time since 1998, while in South Australia, the 12-year old Labor Government held on for a fourth term with the support of an independent. The South Australian result was followed by another Labor victory in Victoria in November 2014. The Queensland Election in January 2015 and the New South Wales Election in March will be crucial in determining whether the momentum that brought the Abbott Government to power has comprehensively reversed and Australians are swinging once more to the Labor side of politics. The latest Morgan Poll results show the Coalition well ahead in New South Wales, but Queensland too close to call.[17]

Cabinet reshuffle

Prime Minister Tony Abbott announced a Cabinet reshuffle just before Christmas. This involved Immigration Minister Scott Morrison – widely seen as the Government's most effective performer during the Coalition's first year in office – being appointed Minister for Social Services, which includes welfare, child care and the Abbott Government's contentious paid parental leave scheme. An important part of Morrison's remit during the remainder of the Parliamentary term is to reform the pensions system and the changes to unemployment benefits that are designed to get unemployed Australians back in work.

Politics in 2015 so far

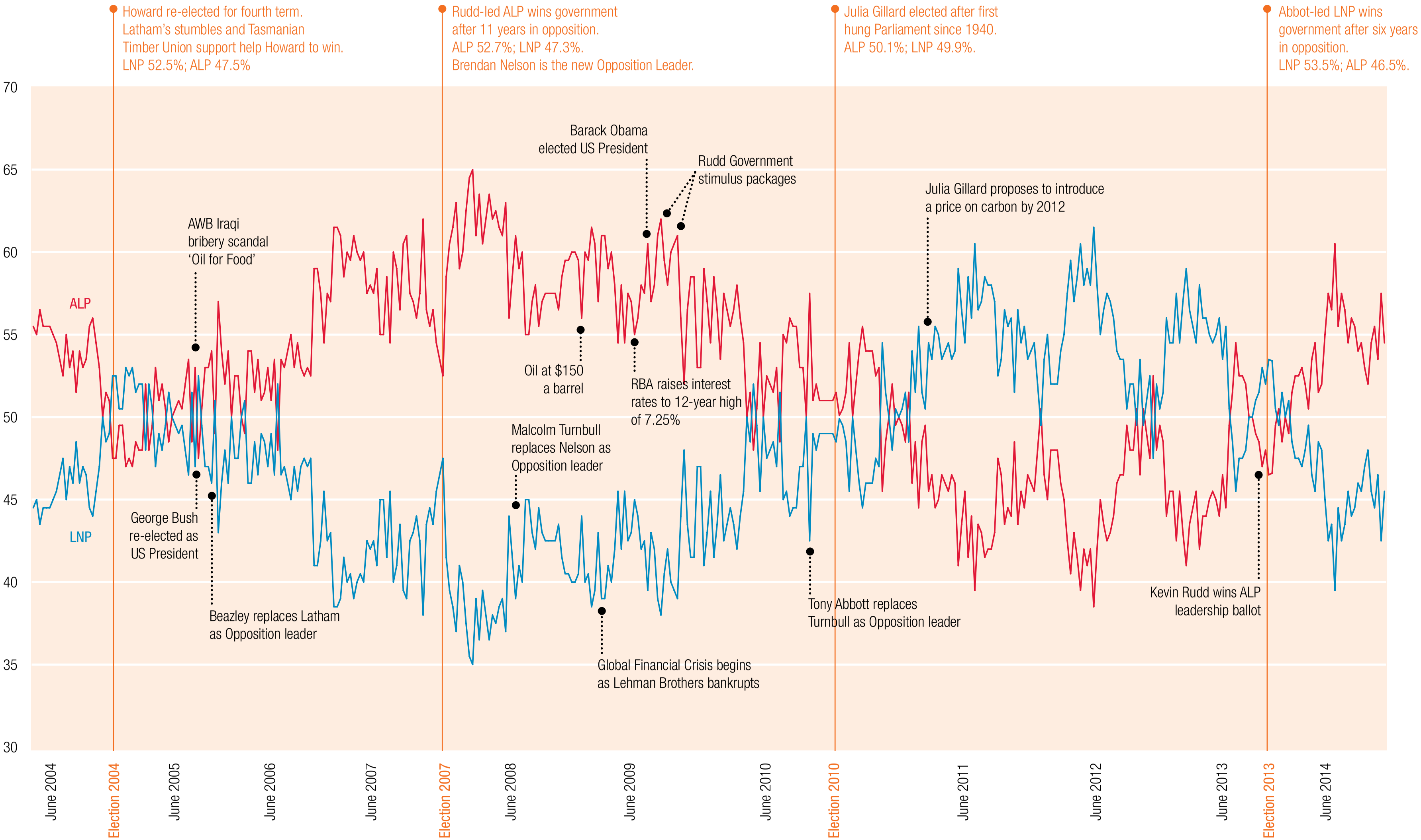
In the first Morgan Poll taken this year, and the first since the LNP Cabinet reshuffle, support for the LNP was 45.5 per cent. This is an increase of three per cent since before Christmas, but still puts the LNP well behind the ALP at 54.5 per cent on a two party preferred basis. If a Federal Election were held in January, the LNP would not be returned, the ALP would still win easily according to this Morgan Poll on voting intention conducted with an Australia-wide cross section of 2622 Australian electors aged 18 and over in the first two weekends in January.

Primary support for the LNP increased to 38.5 per cent (up 3.5 per cent), level with the ALP (down 2.5 per cent). Support for the other parties totalled 23 per cent including:

- The Greens at 9.5 per cent;
- PUP at two per cent; and
- Independents/others at 11.5 per cent.[18]

The Coalition's improvement reverses the large surge to the Opposition seen in December when Treasurer Joe Hockey was forced to reveal an unexpected increase to the size of Australia's Federal Budget deficit. However, it should be noted that the party in office usually gains support early in the new year.

Figure 3
Federal: two party preferred



Base: Australian voters aged 18+
Source: Roy Morgan Nationwide Research (MP)

"Australian electors prefer Malcolm Turnbull as Liberal Leader ahead of Julie Bishop who in turn is ahead of Tony Abbott for the first time."

Roy Morgan Government Confidence Rating

The Roy Morgan Government Confidence Rating is 93 points, unchanged since before Christmas and the Cabinet reshuffle. More Australians say Australia is 'heading in the wrong direction' (44 per cent) than say Australia is 'heading in the right direction' (37 per cent).[19]

Leader approvals

Australia enters 2015 with little support for either Prime Minister Tony Abbott or Opposition Leader Bill Shorten, with more Australians believing Bill Shorten would make a better Prime Minister than Tony Abbott,[20] and Australian electors preferring[21] Malcolm Turnbull or Julie Bishop as Liberal Leader ahead of Tony Abbott according to a special telephone Morgan Poll, conducted 12–13 January with an Australia-wide cross section of 523 electors.

Prime Minister Tony Abbott[22] has lost popularity, with a majority of electors (52 per cent) now disapproving of his handling of his job as Prime Minister, only 37 per cent approving and 11 per cent can't say.

For Opposition Leader Bill Shorten's handling of his job,[23] electors' disapproval (40 per cent) also outweighs approval (37 per cent) and a high 23 per cent still can't say how they view the Opposition Leader after more than a year in the job.

Despite neither leader having positive job approval,[24] Opposition Leader Bill Shorten (43 per cent, up six per cent since October 2014) now narrowly leads Prime Minister Tony Abbott (41 per cent, down three per cent) as the 'better Prime Minister' according to a special telephone Morgan Poll conducted 12–13 January.

Former Liberal Party Leader Malcolm Turnbull is preferred[25] as Liberal Leader by 36 per cent of electors – well ahead of Tony Abbott at 14 per cent (down five per cent). This is not new: Malcolm Turnbull has been preferred over Tony Abbott for some time and indeed his support at 36 per cent is some two per cent lower than recorded in 30 September — 2 October 2014. Deputy Leader Julie Bishop has improved her standing substantially in the last few months. At 26 per cent (up 10 per cent), Bishop is now ahead of Abbott for the first time as preferred Liberal Leader. Bishop's support has surged over the past year following her strong performance as Foreign Minister dealing with the crash of MH17 in Eastern Ukraine and also the increasing tension surrounding the Islamic State (ISIS) in the Middle East.

Although only 14 per cent of electors [26] (down five per cent) prefer Tony Abbott as Liberal Leader, LNP supporters still narrowly favour Abbott (30 per cent, down 11 per cent) over both Bishop (28 per cent, up 11 per cent) and Turnbull (26 per cent, up two per cent). It appears that Bishop has gained support from LNP voters who previously supported Abbott whereas Turnbull is virtually unchanged from three months ago. Treasurer Joe Hockey has lost significant support and is now at only four per cent (down four per cent).

Electors are more confused about who they want leading the ALP,[27] with no candidate attracting more than a quarter of the electorate's support – although current Labor Leader Bill Shorten (preferred by 25 per cent, up four per cent) has slightly consolidated his lead over Deputy Labor Leader Tanya Plibersek (18 per cent, unchanged) and is now significantly in front of both Shadow Infrastructure Minister Anthony Albanese (10 per cent, down five per cent) and former Deputy Prime Minister Wayne Swan (10 per cent, unchanged).

Although leadership and popularity issues are interesting, it is crucial to remember what matters to the electorate. When asked about the most important problems facing Australia, party politics and popularity contests are low down on the agenda – it's all about the economy.[28] Some 38 per cent mention something to do with the economy, economic problems, interest rates, unemployment, the Federal Budget, cost of living, and so on, as the most important problems facing Australia. Economic issues are, and continue to be, well ahead of social issues, human rights, and even politics and leadership.

The real way to solve the 'leadership vacuum' is not to seek popularity, what is needed is bravery: clear, honest articulation of the problems facing Australia and Australians, and solutions that are explained clearly and with the honesty of the leader's convictions.

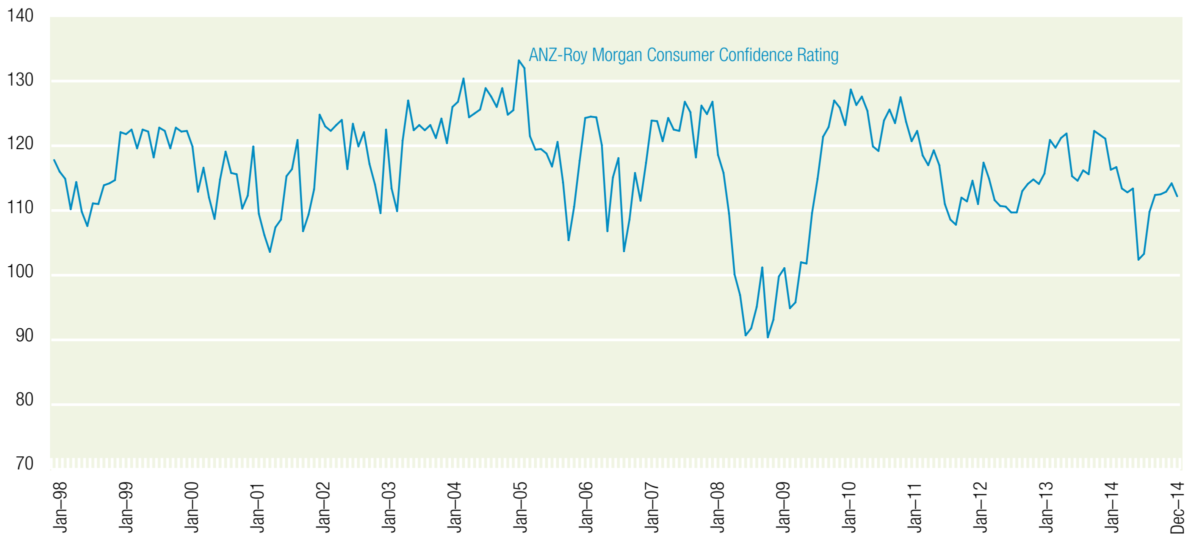
The Abbott Government appears to be making the same mistake as the Baillieu/Napthine Victorian Coalition Government – following the advice of political advisers or 'spin doctors' who are more worried about how any action will be seen rather than tackling the real issues. That's not leadership.

Political and economic pressures

Snapshot:

- Consumer confidence is 113.6[29] *(changes weekly)*;
- Business confidence is 105.3 *(changes monthly)*;
- Both are above 100 but Australia is nowhere near as confident as many of our Asian neighbours – ANZ Roy Morgan Consumer Confidence Rating shows Australia behind China at 155.5, Indonesia 152.0, Vietnam 135.6, Hong Kong 130.1, New Zealand 126.5, Singapore 121.8, India 120.3, and Thailand 117.4, but well ahead of Taiwan at 96.3 and South Korea at 80.6.[30] *(changes monthly)*

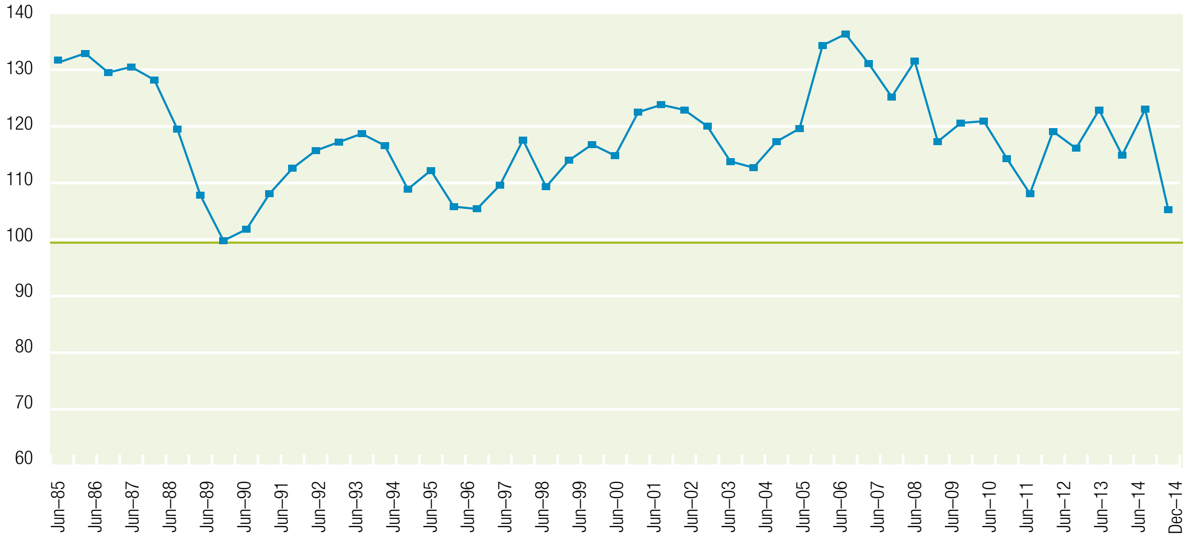
Figure 4
ANZ-Roy Morgan consumer confidence (monthly trend)



Base: Australian population aged 14+
Source: Roy Morgan Research; Monthly data, January 1998 – December 2014

Figure 5

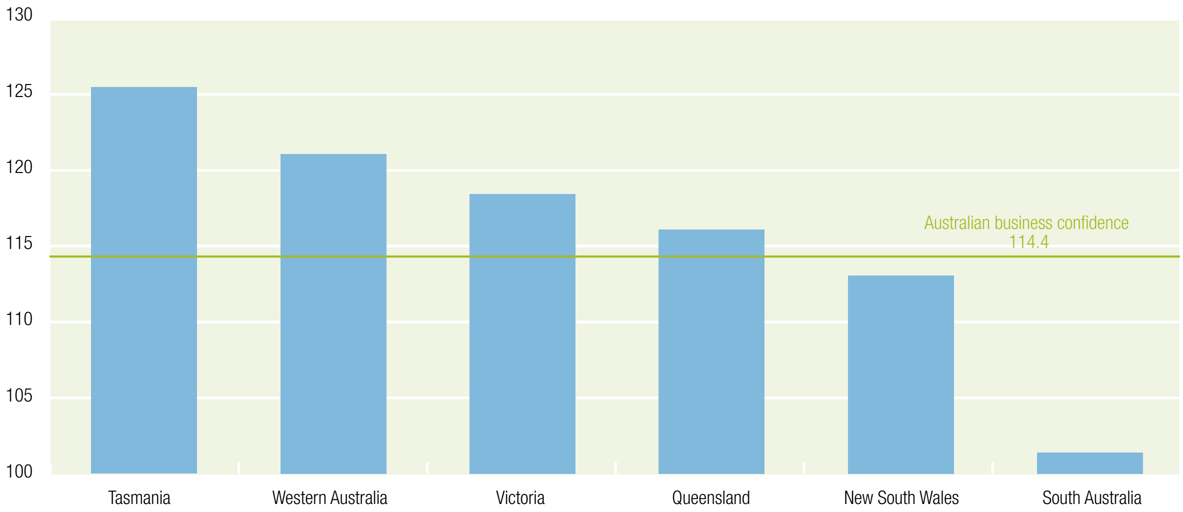
Roy Morgan business confidence (monthly trend)



Base: Australian population aged 14+
Source: Roy Morgan Research; Monthly data, January 1998 – December 2014

Figure 6

Roy Morgan business confidence



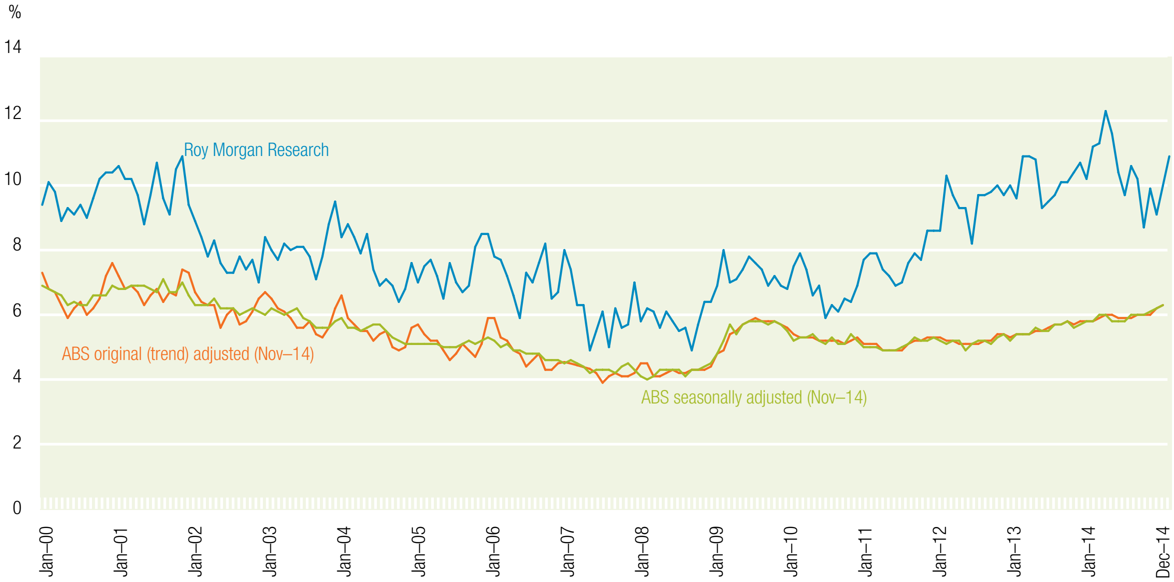
Base: Australian population aged 14+
Source: Roy Morgan Research; Monthly data, January 1998 – December 2014

Unemployment is Australia's major issue, particularly among young people and those made redundant due to Australia's deteriorating manufacturing and mining industries. Unemployment increased and total hours worked decreased substantially over the last year.

The latest Roy Morgan December employment estimates[31] show a rise in part-time workers with the full-time workforce stagnant. Australia's unemployment is now at 10.9 per cent (1.40 million) with a further 9.7 per cent (1.25 million) under-employed. That is almost 2.65 million Australians looking for work or looking for more work.

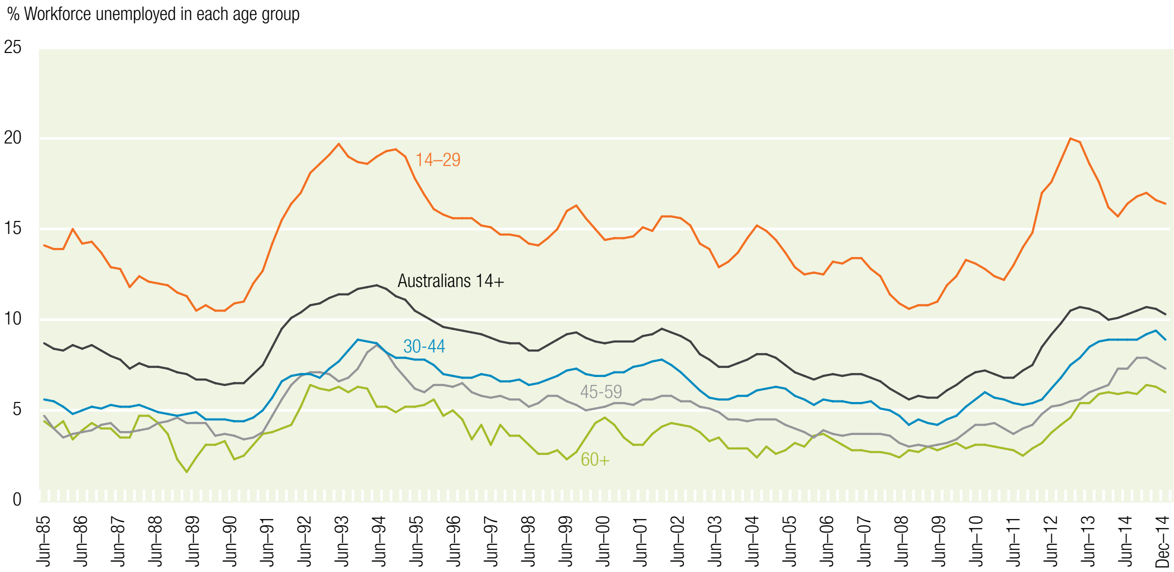
Real unemployment as measured by Roy Morgan is way ahead of the Australian Bureau of Statistics (ABS) estimate[32] of 6.2 per cent (or 6.1 per cent seasonally adjusted) based on a much stricter definition of unemployment. It has been of concern that using

Figure 7
Level of workforce unemployed



Base: Australian population aged 14+ in workforce
Source: Roy Morgan Research; monthly data, January 2000 – December 2014, ABS; monthly data, January 2000 – December 2014

Figure 8
Unemployment by age group



Base: Australian population aged 14+ in workforce
Source: Roy Morgan Research; 12 month moving averages, March 1985 – December 2014

an estimate of unemployment with such a low base gives governments and policymakers a false sense of security.

However, even the lower ABS unemployment estimates are showing the seriousness of the growing unemployment and underemployment in this country. The ABS unemployment figure[33] of 6.1 per cent is substantially higher than its own estimate of 5.2 per cent in December 2011, 5.4 per cent in December 2012 and 5.8 per cent in December 2013.

Crucially the ABS estimate of 'total hours worked' in the month of December dropped substantially in the last 12 months – from 1634 million in December 2013 to 1597.8 million in December 2014:

"Prime Minister Tony Abbott's team has so far struggled to make real progress on any major economic reforms, so little has been done to implement pro-growth policies."

"The overall picture of the Australian labour market shows an economy with a large amount of under-utilised labour – now 2.648 million Australians (20.6 per cent) are either unemployed or under-employed. It is now more than three years that more than two million Australians have been looking for work or looking for more work (37 months) and the 31st straight month more than one million Australians have been unemployed – both these figures demonstrate that the Abbott Government must look seriously at industrial relations reform – including the abolition of weekend and public holiday penalty rates as recently called for by the Restaurant and Catering Association."
– Gary Morgan, January 2014[34]

Despite his promises regarding industrial relations, Tony Abbott will come under increasing pressure to free up the labour market to solve unemployment. Prime Minister Tony Abbott's team has so far struggled to make real progress on any major economic reforms, so little has been done to implement pro-growth policies. Employers will only employ more people if the Abbott Government cuts 'red tape', and reverses many of the 'pro-union' industrial relations laws. Today the over-regulated employment market means the large Australian cash economy is the only area of Australian 'business' that is 'booming'.

Now that the true state of Australia's employment market is able to be considered by policymakers (including the Reserve Bank), 'real action' to deal with Australia's deteriorating economy can be taken.

The Reserve Bank of Australia (RBA) now has good reason and evidence to reduce interest rates by one per cent. As at mid-January, it is more than 18 months (August 2013) since the RBA cut interest rates and leaves Australian interest rates (2.50 per cent) among the highest in the developed world. *(RBA meeting in early February could well see an interest rate cut.)*

International context

The international context is one that includes unrest and terrorism throughout much of the world, particularly in the Middle East and Eastern Europe, which directly affects Australia and Australia's increasing engagement with, and dependence on, Asia.

Asian engagement

Australia is increasingly engaging with, and part of, Asia. Today only 71.2 per cent of Australians[35] were born in Australia and some 10 per cent were born in Asia or the Middle East. That number would increase substantially if it were to include children who were born here with Asian parents. Australians increasingly travel to Asian destinations on holidays, for business, or to visit family and friends.

Trade with Asia is increasing. Several important international trade agreements are being implemented, including those with three of Australia's biggest trading partners: China, Japan and South Korea. It is reasonable to anticipate more trade agreements and thus more exchange of products, services and simply more engagement. The implications of our increasing trade relations include cheaper imports, potentially higher export prices for food, but continued downward pressure on labour costs, particularly affecting manufacturing in Australia and therefore unemployment.

Politically in an environment where unemployment is, and is increasingly seen as, one of, if not the single most important issue, there are bound to be tensions as these trade agreements and the business done as a result change the nature of our economy – and there are winners and losers.

International unrest

At the same time, Australians are experiencing and reporting increased concern about international unrest, religious extremists, terrorism and war. In particular, now 43 per cent consider war and terrorism the most important issue facing the world[36] – ahead of the economy at 19 per cent and environmental issues at 14 per cent. And since late last year, terrorism and war have re-emerged as national concerns for Australia. Eleven per cent of Australians now consider terrorism and war the most important problem facing Australians, and Muslims are increasingly seen to blame for the terrorism in the world. A majority (52 per cent) now believe Muslims are one of the groups responsible for terrorism (up from 47 per cent in 2007).

> "Australians are experiencing and reporting increased concern about international unrest, religious extremists, terrorism and war."

A special Morgan Poll conducted after the terrorist attacks in France in January asked Australians to name which one group they consider most responsible for terrorism in the world today. Forty-two per cent (up 17 per cent) mentioned Muslims well ahead of any other group. A further seven per cent (down one per cent) mentioned Arabs while only eight per cent (down 10 per cent) mentioned Americans and just four per cent (unchanged) mentioned Israelis. Clearly over the past eight years, Australians have become far more likely to put the blame for terrorism at the feet of Muslims rather than any other group.

The complex set of issues surrounding asylum seekers and their treatment has divided the nation – and not on political lines. Indeed, the human rights aspect of Australia's treatment of asylum seekers has drawn outrage and despair from across the political spectrum. It is in part why the non-major parties have gained momentum. The fear surrounding asylum seekers, whether expressed as a fear that they may be criminals, that there may simply be too many of them, that they are too different from us to assimilate, and many other fears – rational and irrational – also cut across political lines. With increased global unrest, increasing terrorist attacks and heightened fears among the Australian population, the issue of asylum seekers is unlikely to disappear. It will remain a 'sleeper' ready to ignite at any moment.

How these issues may play out

Unless decisive action is taken by the Abbott Government on unemployment and getting a Federal Budget passed, 2015 can expect to see leadership battles, industrial unrest as unions and business are left to 'battle it out' in a political power vacuum, and an increasingly divided nation.

If decisive action is taken by the Government, without explaining clearly to the electorate why decisive action is needed and how the actions will take the country forwards, the Government will be unable to govern.

The only hope is if the Government is able to understand the fears and hopes of the electorate, and more particularly, the different electorates, cohorts, communities and people, to be able to explain and regain the critical level of trust needed to have Australians support the changes needed to take the country in the right direction.

> "With increased global unrest, increasing terrorist attacks and heightened fears among the Australian population, the issue of asylum seekers is unlikely to disappear. It will remain a 'sleeper' ready to ignite at any moment."

The sleepers

At any point in time there are always 'sleepers' – those issues that are not 'top of mind' for the electorate, but about which they feel strongly once they are reminded.

The obvious issues this year are:

- The Royal Commission into Institutional Responses to Child Sexual Abuse: Although the enquiry is not set to hand down its findings this year, publicity about a single child is enough to inflame this emotive issue;
- The environment: An environmental disaster in Australia or anywhere could inflame Australians' latent emotions about the environment;
- Asylum seekers: Any asylum seeker boat approaching Australian shores is guaranteed to draw extensive media coverage and alongside that will be considerable discussion about the effectiveness of the Government's approach to asylum seekers and whether their policy is working;
- Health is always a priority for Australians: The politics and economics of health have been played out recently, and we've seen the Government fail to gain acceptance for its proposals. A serious health scare of the order of a pandemic or any spectacular failure involving even a single human would throw this issue into the spotlight.

Clearly the media has a pivotal role in determining how any of the 'sleepers' are brought to the attention of the electorate. So the relationship between the Tony Abbott LNP Government and the media is itself a sleeper.

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

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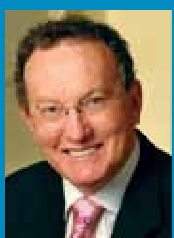
Finance and funding



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Professor Maddock had earlier been Chief Economist at the Business Council of Australia, head of economic policy in the Victorian Cabinet Office and a Professor of Economics at La Trobe University. He is a regular speaker at conferences, writes for the *Australian Financial Review* and *The Conversation*, and has a large number of academic publications including books on Australian economic development and on infrastructure reform in Australia. He is President of the Economic Society of Australia's Victorian branch and a non-executive director of the Committee for Economic Development of Australia.

Introduction

Australia is a high-investing and high-savings country by the Organisation for Economic Co-operation and Development (OECD) standards. The investment is important: used well, it powers our growth, facilitates productivity improvements and enhances our well-being. We finance most of that investment from our own savings, corporate and individual. The residual – somewhere between one-fifth and one-tenth of the total – is financed by foreigners.

Looking forward, three trends seem clear:

1. More of our savings will be channelled through superannuation;
2. We are likely to be more closely linked into international savings and investment flows; and
3. Investment in the resources sector is likely to slow. Most particularly it seems that investment will progressively rotate away from resources and towards sections of the economy, with particular emphasis on infrastructure and smaller business investment.

The first half of this chapter focuses on where savings will come from. The second half on where these savings are likely to be used.

Where will the savings come from?

1. Superannuation

Most spending in the economy, whether for investment or consumption, is financed directly out of income. Households, companies and governments all use their current income to pay for most of their current expenditure, and borrow or lend only a small proportion of their incomes. Figure 1 shows the extent to which the different sectors actually borrow or lend (as a proportion of gross domestic product [GDP]).

We normally expect householders to be net savers, companies to be net borrowers and government to be quite neutral. By making productive investments with borrowed funds, companies are both able to repay their loans and to generate profits for their shareholders.

On average over the business cycle, government will balance its budget; although with surpluses in good times generating funds that allow them to suddenly increase spending during recessions to support a sagging economy. It is clear from Figure 1 that these norms do not always apply. We saw some unusual behaviour by households in the early 2000s when they were net borrowers, funded by a jump in savings borrowed from offshore. But the normal pattern of households funding business appears to be re-establishing itself.

Essentially, businesses are likely to be the main borrowers into the future, with households and foreigners providing most of the savings they need to invest. The way in which money flows from households to businesses is however destined to change.

One of the consequences of Australia's system of compulsory savings is that the superannuation sector will become an increasingly important channel of household funds into the economy. With people required to put about 10 per cent of their income into superannuation, and then having the money locked up until they retire, the pool of investible funds managed by the sector will continue to grow for a very long time. It may stabilise eventually, as withdrawals match injections, but that is unlikely to happen before 2040.

This will change the structure of the Australian financial system. While superannuation funds currently manage about half the volume of assets that banks manage, by the 2030s, the two pools are likely to be about the same size. It may happen earlier if the bank regulators impose tighter constraints on bank growth than they so far have. Modelling by Deloittes suggests that the superannuation pool of funds will grow to some $8 trillion by the mid-2030s, double the size of GDP (and up from approximate equivalence with GDP at present).

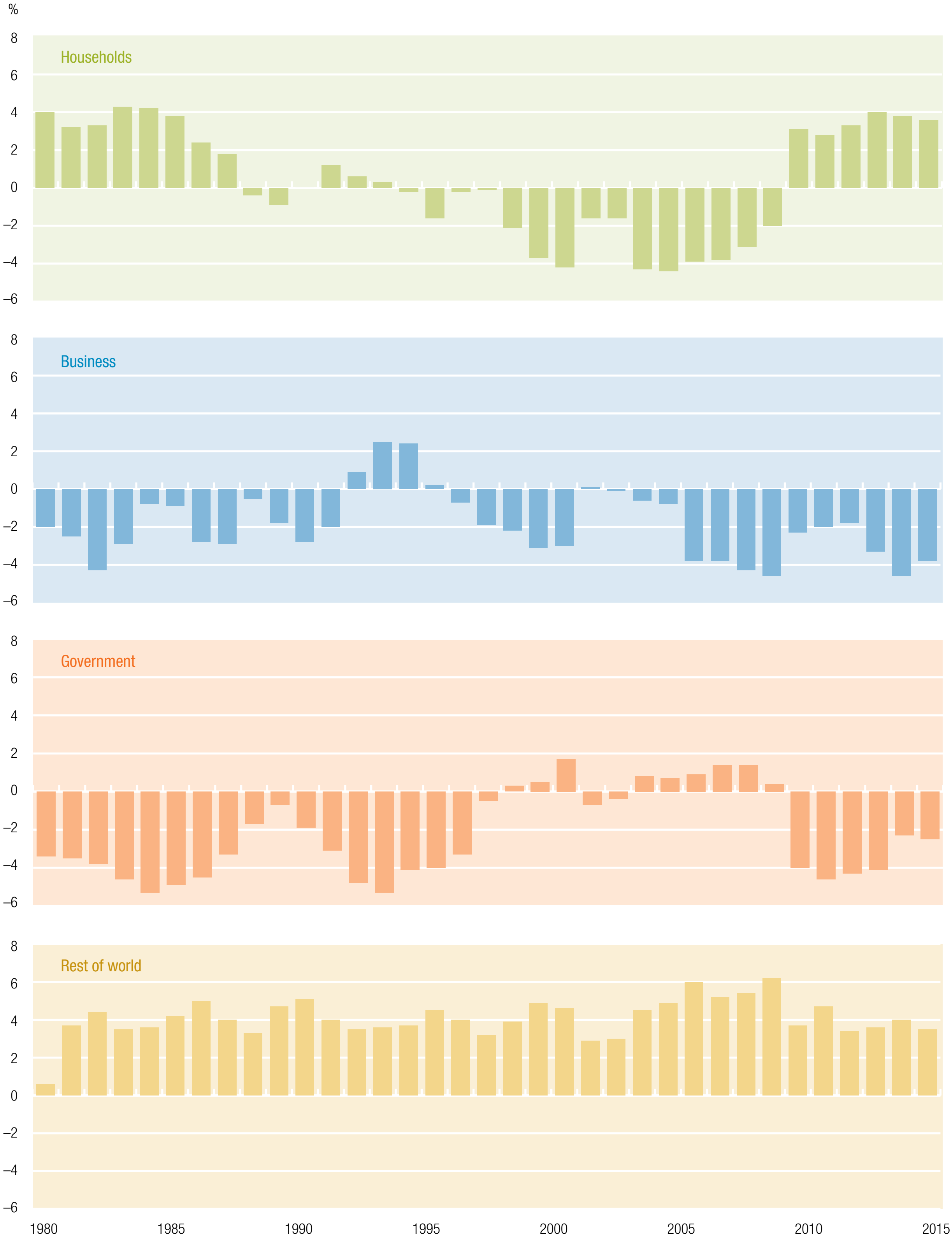
This is an important change because superannuation funds are managed on quite a different basis to bank funds. They are different in two important ways:

1. While banks basically make loans against security and hence mainly fund established enterprises, superannuation funds are much freer to take equity and to invest in new projects. The distinction is not complete because some businesses secure bank loans against property (for example, the family home) but use the funds to start or develop new businesses, so banks do effectively fund a lot of small and new businesses.
2. Superannuation funds are much more likely to invest offshore than are banks.

There are also important differences within the superannuation sector. The fastest growing segment is the self-managed category – growing at about double the rate of the managed funds (industry or retail) – which now constitutes about one-third of the total funds in the sector. Given the increasing regulatory pressures on the managed funds, it is possible that the self-managed funds will continue to outgrow the others but the immaturity of the whole superannuation sector makes it hard to form any strong view. The distinction is important however, because

Figure 1

Australia: Net lending by sector (% of GDP)



Source: Michael Blythe, Chief Economist, Commonwealth Bank of Australia

"Self-managed funds are much less diversified than managed funds. They hold a lot of cash and Australian equities, but little else."

the self-managed funds are much less diversified than the managed funds. They hold a lot of cash and Australian equities, but little else. If this persists as they grow, with other things equal, we will see less investment in new projects than we might if the managed funds retain their dominance.

Since superannuation funds have obligations that mature over decades, it makes sense for them to match these with assets that are also long dated. Infrastructure seems a natural fit. As an example, to facilitate this, industry funds have created some specialist vehicles to develop such assets. There are limits however. The funds are always restricted in what they can do by the mandates specified by their clients, and by the need to retain a strong liquidity buffer to address the possible outflow of funds (due to the client choice rules). It is important to remember that they are managing the funds in trust for their clients.

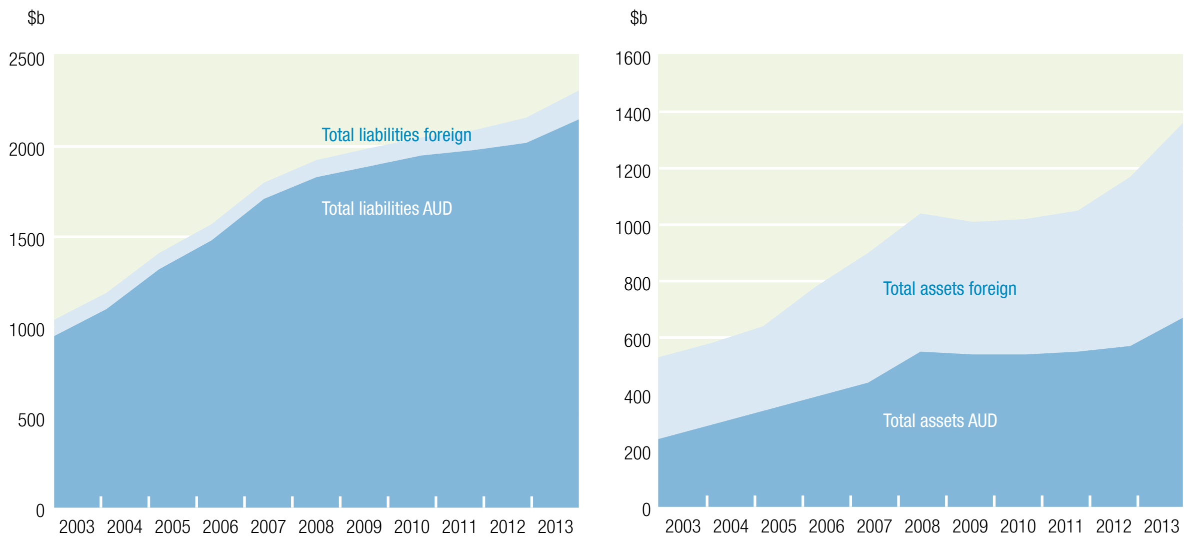
2. Households, China and the world

As is clear from Figure 1, the rest of the world has been a consistent contributor of savings to Australian governments, businesses and households. The funds come into Australia by a wide variety of channels. Governments borrow directly as do an increasing number of Australian businesses. Businesses also receive injections of funds from direct foreign investment, through the stock market

Figure 2

External position (composition after hedging, quarterly*)

Australia's assets and liabilities by currency in which they are denominated



* Hedge ratios inferred from ABS Foreign Currency Exposure surveys
Sources: Australian Bureau of Statistics, Reserve Bank of Australia

and via the banks. To the extent that households rely on foreign funding, it is normally channelled through the banks, which borrow offshore and on-lend to Australian households.

For most of our history, capital has flowed freely into Australia. This is because foreigners have been able to earn an adequate return on their investment when adjusted for risk. Features like a good legal system and strong rule of law, as well as an educated population and a good resource base, have been fundamental to this. While these attributes are likely to persist, the advantage Australia has had relative to other resource-rich countries will decline as they strengthen their institutions.

One consequence of foreign lending to Australians is that our gross foreign liabilities have been on a steady upwards trend. This is clear from the left-hand panel in Figure 2, while the right-hand panel shows that Australians also have an increasing volume of assets in other countries to offset some of the liabilities. While once Australians worried that foreigners owned 'too much' of Australia's assets, our net foreign liability has stabilised at about 55 per cent of GDP with no clear upwards trend. Even more notably, Australians now have as much equity in offshore entities as foreigners own here, so that we own as much of 'them' as 'they' own of us. Australia's net liabilities are now all comprised of debt, not equity.

The rise of superannuation has been important in this transformation. Virtually all managed superannuation funds invest a significant share of their portfolios offshore as part of their risk-management strategies. As a result, where in 1990 some 90 per cent of Australians' equities were held in domestic companies, the percentage has now fallen to about 70.

The big unknown is what will happen as China opens up its capital market over the next five or six years. It is currently quite hard for Chinese to invest here and quite hard for Australians to invest there. As the market opens, two-way flows are likely to increase significantly.

The International Monetary Fund (IMF) forecasts that Chinese outwards investment will increase by a factor of five, while inwards investment will treble.[1] This suggests we should see a very significant and sustained demand by Chinese firms and individuals for Australian assets over the next decade. Just as the opening of world goods markets to Chinese manufacturers has altered production, so is the outflow of Chinese investment likely to disrupt world financial flows. For us, the likely consequence is that the price of Australian assets will be bid up.

"The big unknown is what will happen as China opens up its capital market over the next five or six years. As the market opens, two-way flows are likely to increase significantly."

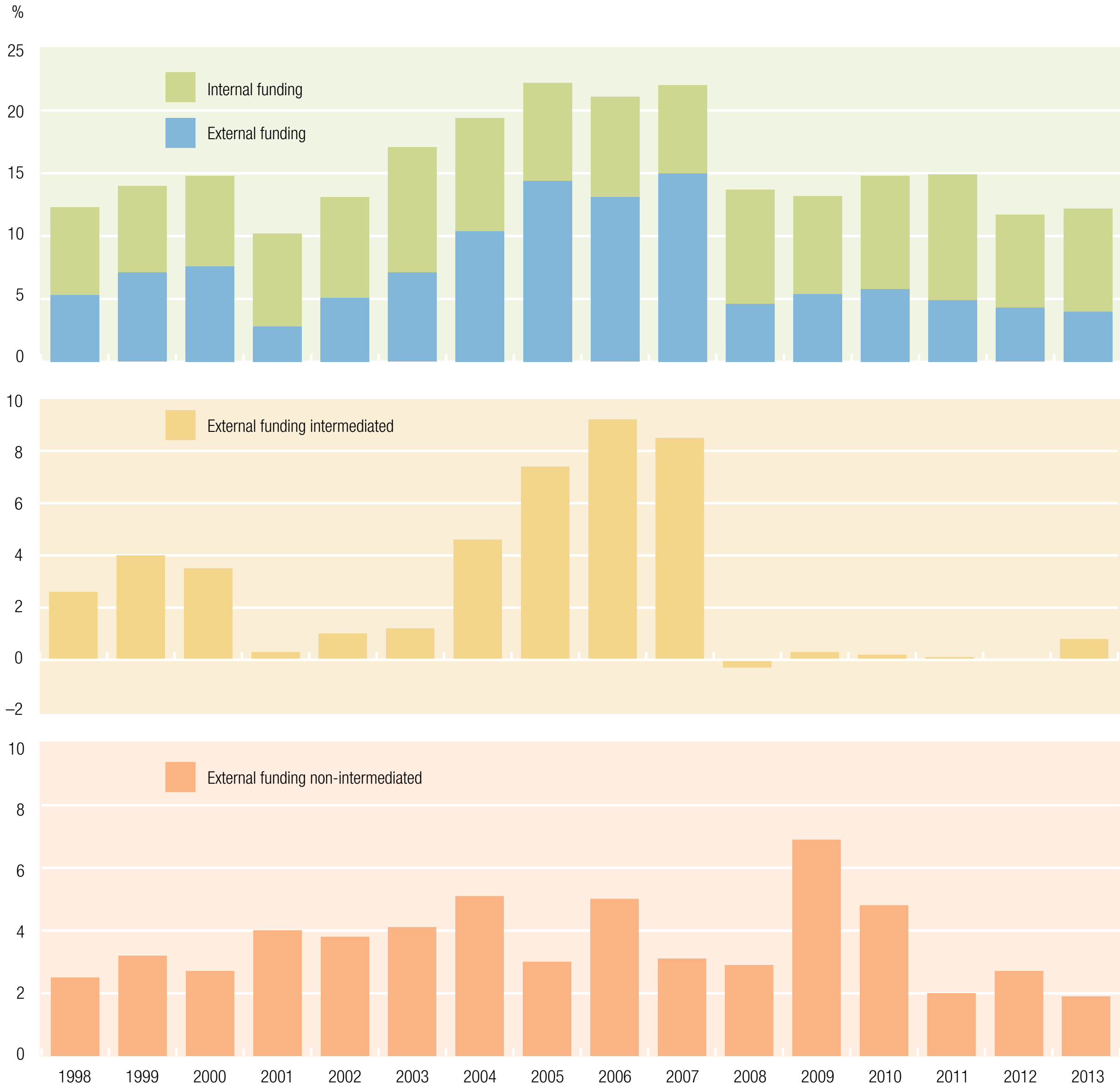
How to fund business

Once they are established, businesses fund most of their spending from their own sources, and most of their investment from retained earnings. There are circumstances in which they seek additional capital from shareholders or borrow to finance expansion or to address temporary difficulties, but they mainly fund themselves. This is clear in the top panel of Figure 3.

The middle panel reveals the extent to which businesses rely on banks for funds, while the bottom panel shows the importance of stock market raising and the issuance of bonds for businesses to raise funds. The overall picture is that businesses borrowed heavily from banks and by issuing shares during the mid-2000s but they have since been reluctant to do so. This makes sense if we realise that businesses borrow when they can see good investment opportunities that they are not able to fund from current income. They borrowed in the mid-decade period of optimism but have not done so in the more recent period of slower growth.

Smaller and newer businesses face a different problem in accessing funds.[2] Many are like households, borrowing inside the family, on credit cards or from banks but secured against residential property. More than half of small businesses have no debt at

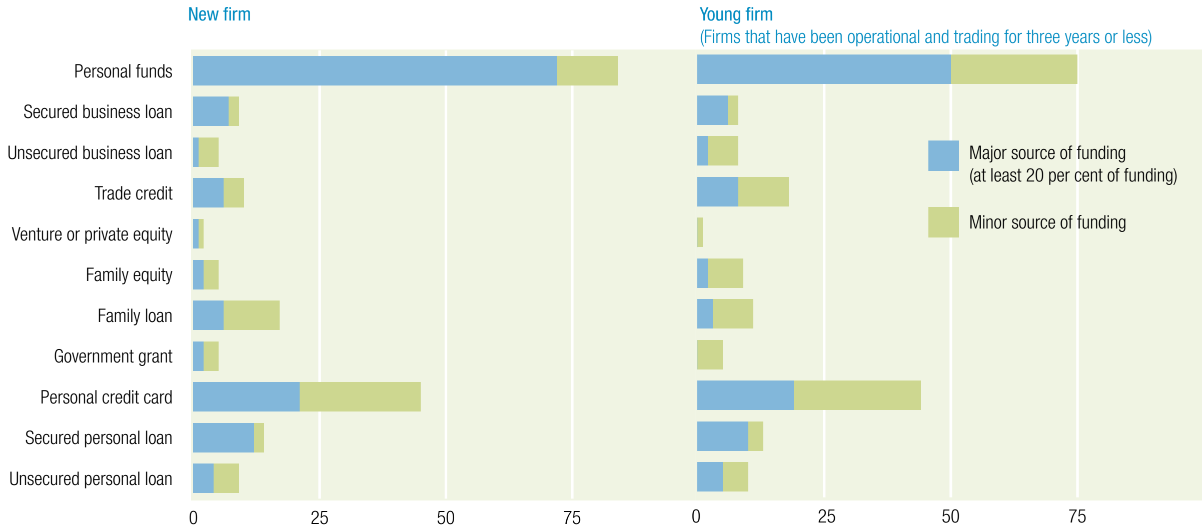
Figure 3
Business funding (net change as a % of GDP)



Sources: Australian Bureau of Statistics, Australian Prudential Regulation Authority, Australian Securities Exchange, Reserve Bank of Australia

Figure 4

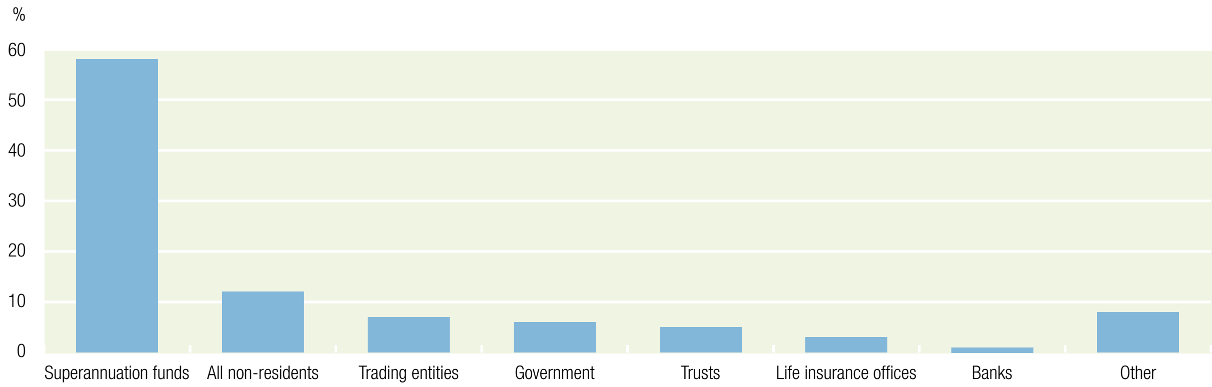
Small business funding sources (2007–11)



Sources: Reserve Bank of Australia submission to the Financial System Inquiry, ACE, Department of Industry

Figure 5

Major sources of venture capital in Australia (% of total)



Source: Australian Bureau of Statistics 5678.0

all, although it is also clear that small businesses constitute a heterogeneous group, with agriculture and mining appearing to be much more capital intensive than most of the rest.

This pattern is consistent with a standard view of how firms evolve. Businesses are initially funded from personal savings (or borrowings). It also seems likely that it is cheaper for immature businesses to seek funds from family or an immediate group of investors rather than go to the expense of justifying their investment case to external parties and paying the premium that lenders would have to charge given the risks involved. As they grow, small businesses' need for funds gradually exceeds the capacity of the initial shareholders to finance them and so they seek external funding.

As the Australian market evolves, we may well see a larger pool of venture funds becoming available. Venture funds are comprised of individuals and institutions willing to take on the additional risk of lending to new enterprises in the expectation of higher returns. There are a number of different reasons for this:

- First, technology is emerging that has made direct lending between individuals more practical, the so-called peer-to-peer lending. It is unclear how quickly it will evolve or how extensive it will become but the process of matching lenders to borrowers has become simpler, which should encourage growth in such direct lending.
- Second, superannuation funds have evolved some ability to make loans to the small business venture sector and the rapid growth in the funds they manage will see the pool of funds they are willing to put into new ventures grow equally rapidly.

How to fund infrastructure

Infrastructure investment is much like any other investment. As such, it will normally be provided by private companies and funded by them through a mixture of equity and debt. For firms to undertake such investment, they must of course be able to capture the benefits of the investment when they sell the output. Thus we have a lot of private infrastructure, for example, private shopping malls, private railway lines and private airports.

However, for much infrastructure it is hard for private owners to capture the benefits. Lighthouses provide the usual example. There are also cases in which the private owner can charge too much if the piece of infrastructure has some monopoly power. In both these type of cases it has been normal for government to become involved in the provision of the particular infrastructure.

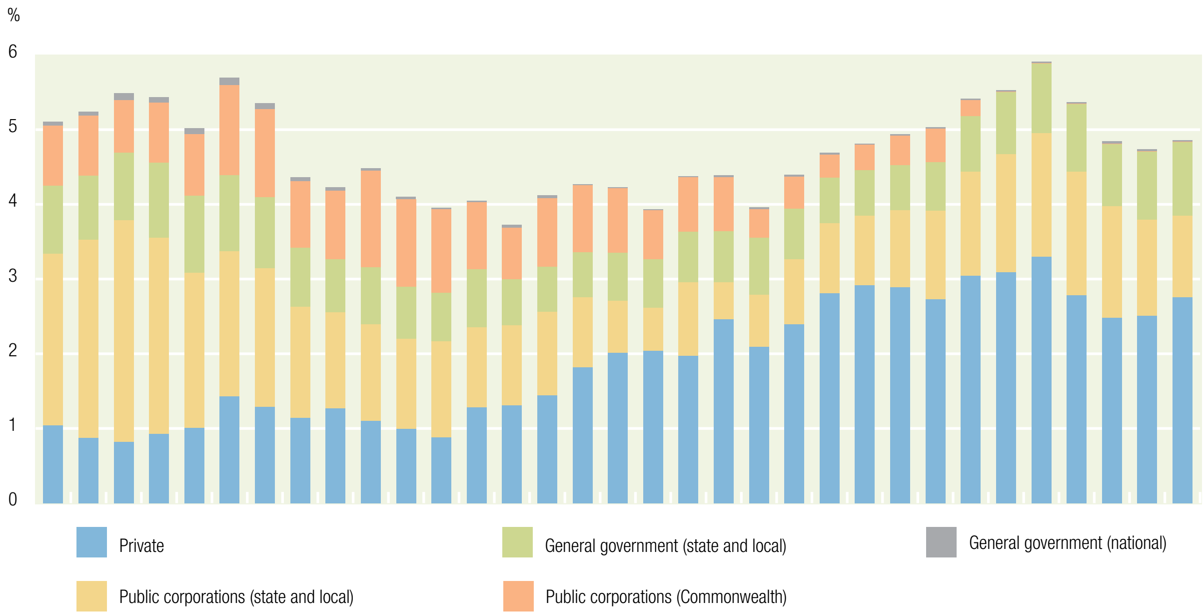
From a financial point of view, the two are quite different. Where a private provider could earn some monopoly profits, there will be no problem in financing the infrastructure through user charges. The standard role of government in this case is to limit the pricing power of the owner, usually through some form of a cap on the allowable return on investment. Once it knows the rules that apply, the private market will provide suitable finance. In Australia's history, many entities of this type were run as government businesses but the more recent fashion has been to allow them to operate privately with government regulation. The historical shift is clear from Figure 6.

There is a second set of infrastructure types for which the asset would be able to generate an adequate return if regulation of some sort allowed the private owner to restrict entry and to charge for it. Toll roads as part of a traffic network provide one example. There can be a conflict in these cases between government's desire to have the facility built, so it is inclined to restrict competition to boost revenues, and the interest of users of potentially competing facilities whose rights are restricted. This conflict was clear with the cross-Sydney tunnel. Rather than raise the funds through general taxation, the government in these cases is shifting the funding costs of the project onto specific groups of taxpayers.

The third situation involves cases in which the facility will never be profitable for a private investor, but government wants the project built for some non-commercial reason. This may be for equity purposes, as with public hospitals or public school, or to limit congestion of pollution, as with public transport services. The funding in these situations has to come from taxpayers (through government), although probably through an auction process to minimise the call on tax revenue.

Figure 6

Investment in transport, electricity, gas, water, waste and telecommunication infrastructure (% of GDP)



Source: Productivity Commission[3]

> “Australia has never had serious problems funding its growth. Good prospects, a strong legal system, and a stable investment climate have meant that foreigners have been willing to make up any shortfall of domestic savings. Compulsory superannuation will however change some of the underlying dynamics.”

Mixed models, such as public–private partnerships, are also possible. These share the financial risks of a project between taxpayers and private participants. Governments facing debt limits can also use them to shift funding burdens into the future, or to reduce the apparent cost of a project by taking on the liability for some contingencies that would be expensive for private investors to manage. They will not normally reduce the true costs of a project, only its upfront cost or its apparent cost.

Australian investors have proven to have a significant appetite for infrastructure assets. Large infrastructure businesses like Sydney Airport, Transurban, pipeline and grid companies are listed on the Australian stock exchange and have fairly typical funding profiles with somewhat more debt than equity as befits their low-risk, utility-like, status. Nevertheless the Productivity Commission found that only three per cent of the Australian stock market was made up of infrastructure assets compared with some six per cent in global markets.

By contrast, the Productivity Commission found that Australian superannuation funds allocated a larger proportion of funds to infrastructure than did others:

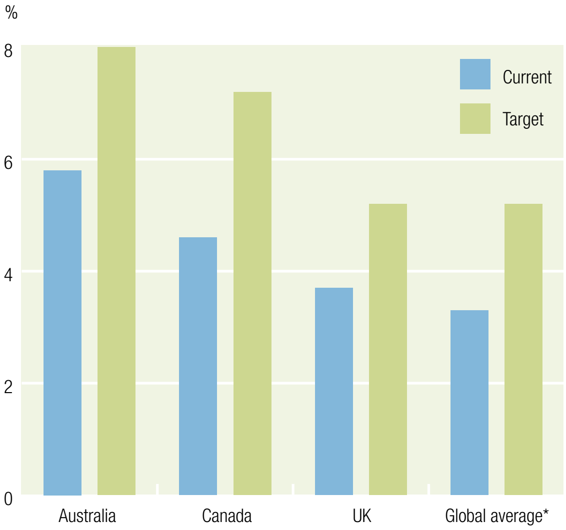
> “On average, Australian (and Canadian) superannuation funds are estimated to have invested about five per cent of their total assets in infrastructure, compared to less than one per cent by pension funds in the rest of the world.”[4]

The Reserve Bank of Australia (RBA) figures are slightly different but display the same pattern (refer to Figure 7).

While infrastructure assets listed on the stock market are relatively straightforward to manage, new projects provide a different challenge. Normally, superannuation funds have to form part of a consortium to fund a project and then they are locked into the project for a considerable period (until it is either floated on the stock market or it starts to produce returns so becoming saleable). As they become bigger and develop greater capabilities, such large

Figure 7

Pension funds' current and target allocations to infrastructure assets (share of total assets, 2012)



* Sample of 619 pension funds

Sources: Reserve Bank of Australia submission to the Financial System Inquiry, Preqin

investments requiring investors to take a long-term view will become the natural area of specialisation of superannuation funds. Again, their exposure is likely to grow significantly.

Banks and the bond market also have a role to play. Banks have made significant loans for infrastructure with their exposure to listed infrastructure companies amounting to over five per cent of their total loans so that, adding in the unlisted sector, their total exposure will be somewhat above that. As well as or instead of borrowing through banks, the bond markets provide an alternative funding source. While the domestic bond market appears to have a limited appetite for lower-rate bonds of infrastructure projects, Australian businesses have been able to access international markets quite readily. The Productivity Commission cites the following case:

> "Aquasure (the Victorian desalination plant special purpose vehicle) recently refinanced $3.7 billion, including about US$400 million of bonds in the US private placement market (with around one-quarter of that in Australian dollar denominated securities)."

Interestingly, neither the Productivity Commission nor the RBA sees any particular problem with the provision of finance to Australian infrastructure investments.

Conclusion

Australia has never had serious problems of funding its growth. Good prospects, a strong legal system, and a stable investment climate have meant that foreigners have been willing to make up any shortfall of domestic savings.

Compulsory superannuation will however change some of the underlying dynamics. Domestic savings are likely to be somewhat higher than they would be without compulsion, and the pool of savings will be managed differently by fund managers than they have been by banks.

Funds appear more likely to invest in new ventures, and new pieces of infrastructure, than are banks. They are also likely to invest more offshore. The willingness to fund new endeavours should assist economic dynamism and growth in Australia, and the increased investment in foreign entities is likely to reduce the risk of portfolios that are currently too exposed to Australia.

Endnotes

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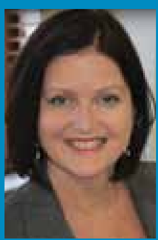
The views in this article are those of the author and should not be attributed otherwise.

Funding social equity



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The social challenge

Australia is embroiled in a political debate about our current economic and social health. This adversarial political context has created understandable confusion among the Australian public. The confusion makes for a difficult environment for securing broad consensus for future reform. Yet, when the evidence is considered, the case for reform is clear.

Australia has enjoyed over 21 years of sustained economic growth and is currently ranked as one of the wealthiest countries in the world.[1] A majority of people are enjoying living standards better than ever before.[2] Yet too many people in Australia do not enjoy even a basic decent standard of living, and some face potentially life-long poverty and disadvantage.

The recent *ACOSS Poverty in Australia* 2014 report confirmed that one in seven people, including one in six children, are living below the most austere relative poverty line widely used in international research (50 per cent of median income), and the rate of relative poverty is increasing.[3] Our poverty and inequality levels are 'middle ranking' by global standards,[4] with the health and wellbeing of Aboriginal and Torres Strait Islander communities representing the starkest gap compared with the overall population.

Despite some public perceptions fuelled by political debate, Australia spends less on transfer payments than almost all Organisation for Economic Co-operation and Development (OECD) countries, and has one of the most tightly targeted social security systems in the OECD.[5] Figure 1 shows government expenditure on cash benefits was the third lowest in the OECD in 2010.

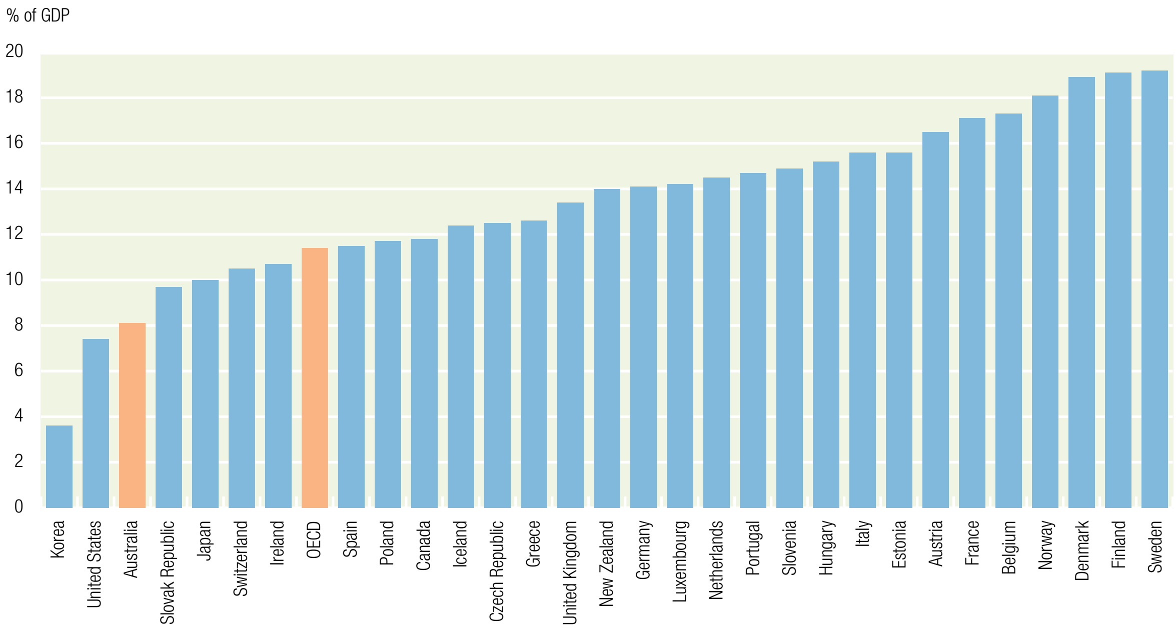
We also do not have a culture of chronic dependence on income support, as is often claimed. Indeed, our spending on income support for people of working age is less than it was a decade ago, as a proportion of the population.

Figure 2 shows that the total number of recipients of income support as a proportion of people of working age declined from approximately 22 per cent of the population in 1996 to 17 per cent in 2012.

Areas of expenditure growth

Real growth in expenditure is partly due to a lack of previous adequate investment, with the National Disability Insurance Scheme (NDIS) and the so-called Gonski reforms being prime examples that were well overdue. Both these reforms are now widely supported by the Australian public. Other areas of real expenditure growth, particularly in health and the Age

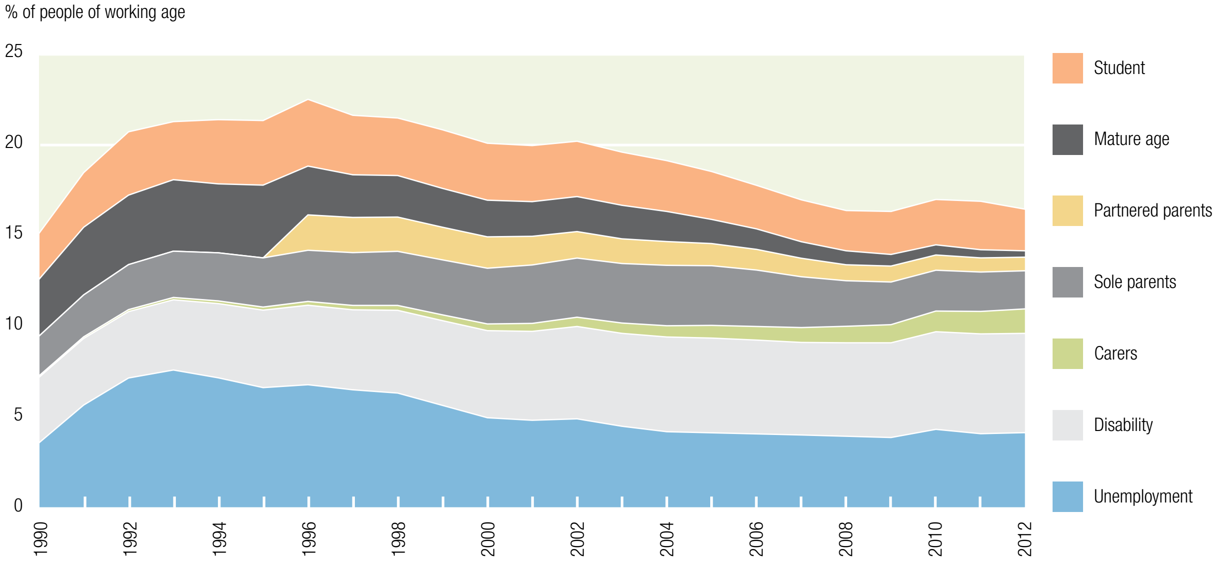
Figure 1
Government expenditure on cash benefits (2010)



Source: OECD Social Expenditure Database

Figure 2

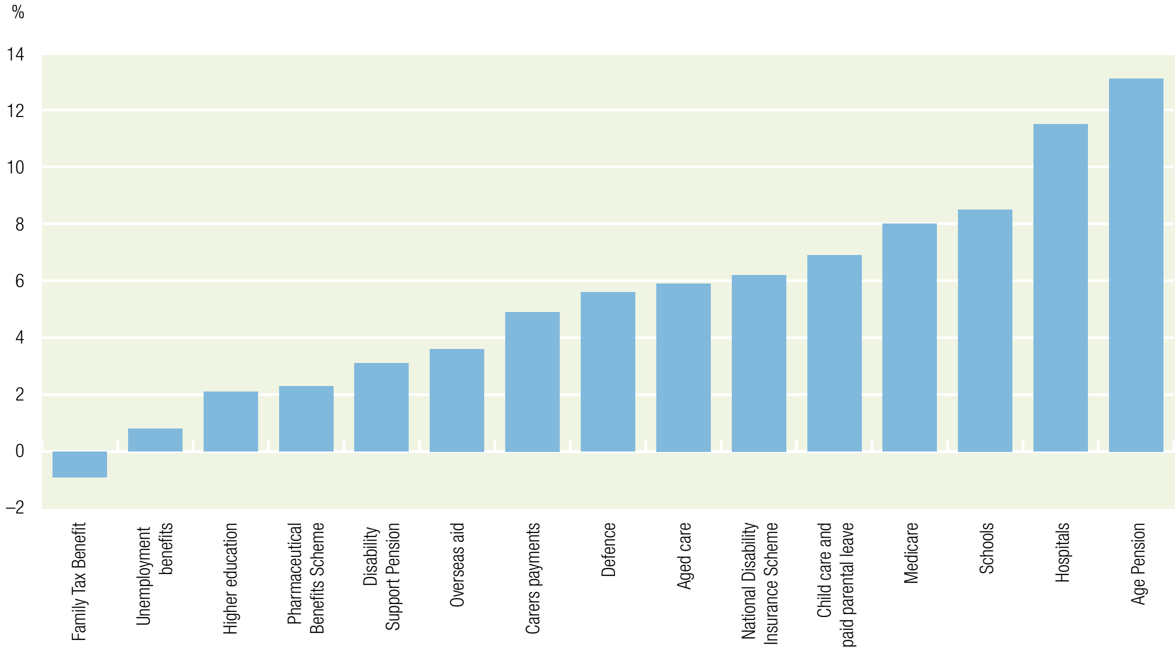
Income support recipients



Source: DSS, Statistical Summary of Social Security Payments.

Figure 3

Contribution to all growth in spending (2013–2023)



Source: DSS, Statistical Summary of Social Security Payments.

Pension, occur because of a complex range of both reasonable and problematic circumstances.

While Australia is still a strong performer globally in its educational outcomes, our performance is declining, and there is also a serious gap in terms of level of performance. As the Gonski report found, students from low socioeconomic areas were up to three years behind their peers from wealthy areas, and one in seven 15-year-old students has not developed even basic reading skills.[6] Australia weathered the Global Financial Crisis relatively well,[7] but unemployment reached 6.1 per cent as at December

"Jobs growth is fragile, housing costs have little prospect of softening any time soon, glaring gaps in our social safety net remain and participation rates of a growing ageing population are not increasing commensurate with improvements in longevity and health."

2014 and is at a 13-year high. Young people have been particularly affected, with youth unemployment rising steadily, including as a proportion of overall unemployment.[8] Long-term unemployment has also significantly increased with more than half of people on the Newstart allowance now out of paid work for 12 months or more.[9]

For people in their post-working age life, the welcome increase in the Age Pension in 2009 helped lift more people out of poverty in their later life, but the experience of retirement is very much a case of two parallel worlds. Wealthier people are enjoying the benefits of past policies of generous superannuation tax concessions, and the boom years, but a growing group of people are facing a meagre existence on the Age Pension and renting in the private market.

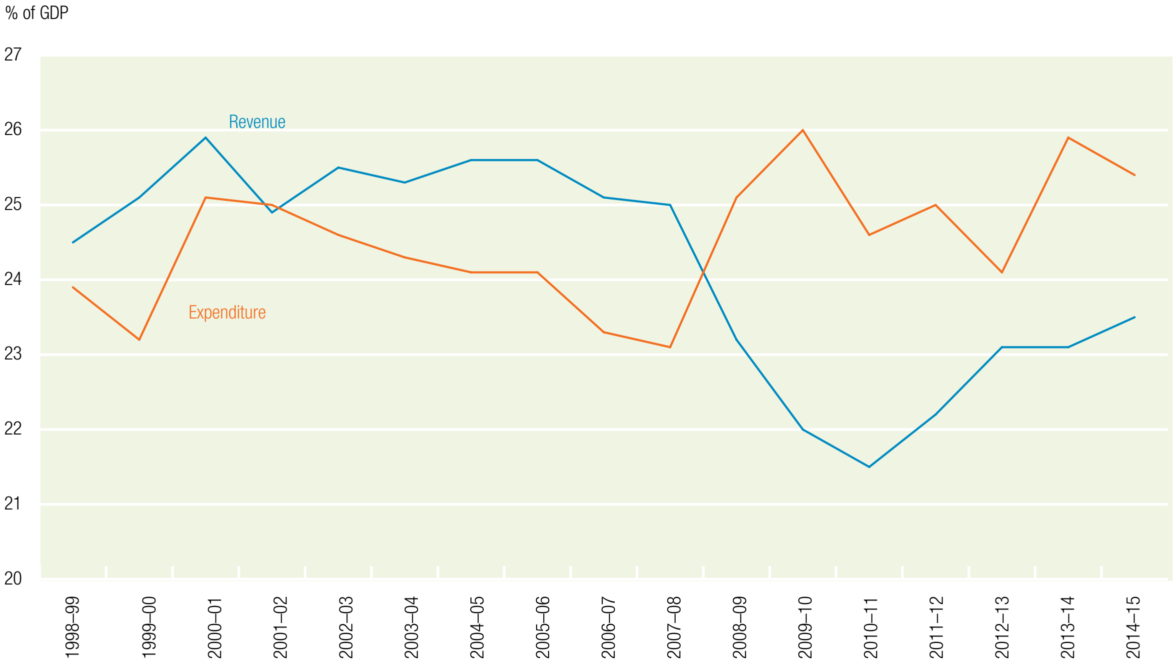
Housing costs are at historical highs, which increasingly places low and modest income earners under severe financial distress and at risk of homelessness. People locked out of the property market, particularly younger generations and women, are increasingly being denied the chance to achieve a secure home and accumulate wealth through property ownership. Our wealth inequality is also a major challenge, with wealth more unequally distributed than income. In 2011–12, households in the top 20 per cent of wealth distribution owned 60 per cent of all wealth while the lowest 60 per cent of the wealth distribution held 18 per cent of total wealth.[10]

A potentially challenging and less prosperous future is now almost with us. Jobs growth is fragile, housing costs have little prospect of softening any time soon, glaring gaps in our social safety net remain and participation rates of a growing ageing population are not increasing commensurate with improvements in longevity and health.[11] We face an increasingly divided society, with a shrinking 'middle Australia', and poorer economic and social outcomes overall.

The OECD now emphasises that increasing inequality is a major risk to a healthy economy. It is also a major risk to our social and cultural cohesion. Without major reforms, poverty and inequality will continue to rise, and we will have squandered our opportunity to seriously invest in a much brighter future for the common good. Right now, our future national prosperity is very much a question of the choices we make.

Figure 4

Australian government revenue and expenditure



Source: Australian Treasury (2013) Mid-Year Economic and Fiscal Outlook, 2013–14, Commonwealth of Australia

The budget challenge

While we do not have an immediate budget crisis, we have a structural budget imbalance that needs to be corrected over the medium term to place our fiscal settings on a sustainable path to invest in stronger economic, social and environmental outcomes.

Australia remains a low-taxing and low-spending country, and a full three-fifths of our deterioration in the budget is in fact on the revenue side.

The source of the Australian Government's fiscal problems can be traced to well before the Global Financial Crisis (GFC). The Federal budget has been in structural decline since the early 2000s. Governments wasted the revenue windfall from the housing and mining booms of the 2000s on eight successive income tax cuts and a range of cash bonuses and poorly targeted programs, including the Private Health Insurance Rebate (introduced in 1999), the Baby Bonus (2004), the Child Care Rebate (2006) – which should not to be confused with the well-designed but inadequate Child Care Benefit (introduced in 2000) – the relaxing of the assets test for a part-Age Pension (2006), the Seniors Supplement (2004), the Education Tax Refund (2009) and the School Kids Bonus (2012).

Successive governments have also consistently over-estimated revenue projections. With the slowing of the economy and the decline in the terms of trade from around the end of the decade, there has also been a sharp decline in company income tax and capital gains tax revenues. Compared with their average levels over the decade prior to the GFC in 2008, as at 2014, revenues had fallen by three per cent of gross domestic product (GDP) (equivalent to $40 billion in today's dollars) and expenditures had risen by two per cent of GDP ($27 billion).[12]

Beneath these cyclical trends lies a set of deeper problems that must be resolved to put the budget on a sustainable course. The structure of government expenditures, including tax expenditures, is out of balance in at least three ways:

1. At a time when population ageing is about to sharply increase our demand for health and aged care services, less than one in five individuals aged over 64 years pays income tax;
2. In many areas of expenditure such as health and employment, there is too much focus on cure and too little on prevention; and
3. While during the boom, governments over-spent on public assistance for people who arguably had no need of it, they missed the opportunity to repair the gaps in the safety net.

"Lack of education from early childhood through to adulthood has long been recognised as a driving factor in poverty and disadvantage."

The latest official estimates indicate that the Commonwealth Budget is in deficit by $40.4 billion, or 2.5 per cent of GDP, in 2012–13. The deficit is projected to fall to $31.2 billion, or 1.9 per cent of GDP, in 2015–16. To put the Government's budgetary position in context, net debt as a proportion of GDP is very low by OECD standards, at around 15 per cent compared with 100 per cent of GDP for the OECD as a whole. However, given 20 years of economic growth, the size of the deficit at this stage of the business cycle is cause for concern.

With the slowing of the economy and the decline in minerals prices, reform to the tax system is essential. Any serious effort at tax reform must lift overall revenue at least to its pre-GFC levels to secure the revenue base needed for our investment in improving better social outcomes. As the NDIS has shown, when the public has confidence in the merits of expenditures, support for tax reform to raise more revenue will grow.

Directions for reform

In the face of these economic and social challenges, there are some important reforms to prosecute. There remain glaring gaps in our social safety net, including the severely inadequate level of the unemployment payment, Newstart, which is now just $36 a day for a single person. Successive federal governments have moved whole classes of person onto this much lower payment, including single parents and people with disability.

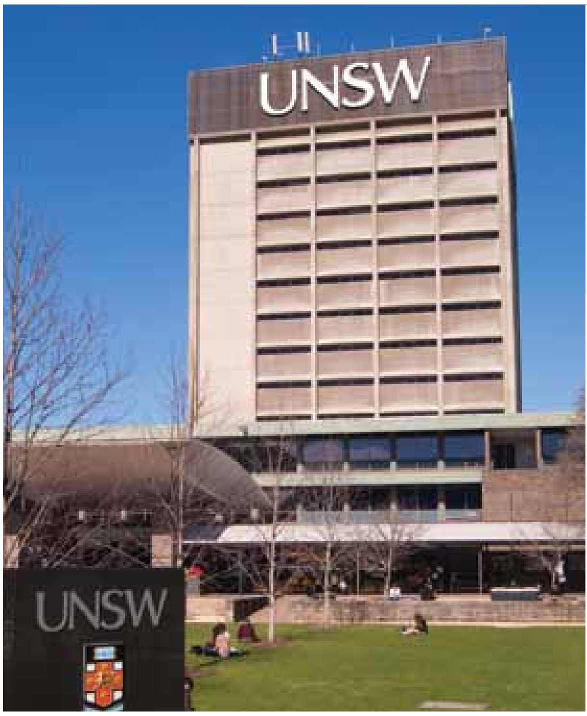
There remains little employment assistance and training for people at risk of long-term unemployment, and the job market presents few real employment opportunities for people already disadvantaged or facing discrimination. Housing and energy affordability are at crisis point for many people on low incomes.

Health, education and retirement income policies will also be crucial. In each of these policy areas, there is a need to foster a public debate, including among those of us who can afford to contribute more or receive less, so that we can invest in a smarter way for the common good. The NDIS and the Gonski reforms are two prime examples.

Education and early childhood

A well-educated population is essential to Australia's economic and social wellbeing. Education is an essential universal right. It is also widely recognised as one of the most important factors in ensuring that every person, regardless of circumstances at birth, has a genuine equal opportunity to achieve their full potential. Reforms need to be carefully crafted, in collaboration with experts, the sector and the wider community, as a policy area in which we all have a major stake. However, significant numbers of children and young people are not achieving their educational potential. Lack of education from early childhood through to adulthood has long been recognised as a driving factor in poverty and disadvantage.

It is clearly arguable that, in the area of schools funding, Australia has already had the debate about making school education a funding priority and ensuring that funding is adequate to target its investment towards students who are disadvantaged. The work of the *Gonski Review* has been widely supported both by experts on education policy and more broadly in the Australian community. The relative



"Reforms to tertiary education require a considered, expert and evidence-driven approach and could draw on lessons from the Gonski process in this regard."

success of this reform process to date has been due in large part to the careful, considered, wide-ranging work of the Gonski Review Panel, and extensive community engagement and dialogue. It is unsurprising then that the incoming Federal Government has encountered widespread opposition to a retreat from this investment.

In contrast to the Gonski reforms, the more recent proposed reforms to university funding have had little of these features. The policy direction of the Federal Government was unveiled on Budget night in 2014 with no open, transparent process leading up to development. The Federal Government then largely embarked on a marketing approach, most recently through its advertising strategy. Reforms need to be evidence-based. It is a mistake to conceptualise education as a commercial market and presume that the access and quality of university education will inherently be improved by deregulation. The pursuit of these university reforms have unsurprisingly floundered with a range of experts and education advocates expressing opposition, grounded in concerns about the further marketisation of university education and sharply reduced access and quality for people from low and modest socioeconomic backgrounds. Reforms to tertiary education require a considered, expert and evidence-driven approach and could draw on lessons from the Gonski process in this regard.

We also cannot forget the vital role of early childhood education. Studies show that access to high-quality early childhood education and care plays a critical role in children's educational outcomes throughout formal schooling, including in areas such as school attendance, completion rates, behavioural outcomes in class, and interest and motivation.[13] In addition, research conducted by Melbourne University found that children who attended preschool achieved markedly higher NAPLAN literacy and numeracy scores than those who did not.[14]

Compared with the OECD, the workforce participation of Australian parents is noticeably lower: around 62 per cent of Australian mothers with a child aged under 15 years undertook some form of work in 2009 compared with an OECD average of 56 per cent.[15] In addition to providing an important educational foundation for children, access to affordable, quality and flexible care for children strengthens women's workforce participation. However, such access is poor in Australia, particularly for lower income and single-parent families. The current system of childcare payments is particularly complex and inequitable. There are different payment types for low and higher income families and, by international standards, low levels of spending on child care overall. Indeed, despite above average public expenditure on families (through the family payments system), Australia spends less on childcare services than most OECD countries: 0.6 per cent of GDP compared with the OECD average of 0.7 per cent.[16] The Child Care Rebate is inherently regressive as it covers part of the gap fee between the income-tested Child Care Benefit and fees charged. In addition, the level of subsidy available for low income families is generally not sufficient to finance quality care. As a matter of equity, funding should be directed to give most assistance to families that are in most need.

An immediate priority should be to combine the Child Care Rebate (CCR) and Child Care Benefit (CCB) into a single payment with higher levels of subsidy for lower income families. This would support a more universal yet equitable approach to government assistance.

Health

The design, funding and administration of the health system are powerful determinants of healthcare access, equity and effectiveness. There is much that could be done to improve the equitable distribution and effectiveness of current spending within the health Budget and to improve access to critical services, including dental and mental health. The real and projected growth in health expenditures is due to a combination of factors, including population growth and ageing, failure to address chronic health conditions, poorly targeted and overly generous private health insurance arrangements, and inefficient subsidisation of medicines.

While the Government has raised concern about the sustainability of the health system in Australia, we continue to track in line with the OECD average for health expenditure: 9.6 per cent of GPD went to health expenditure in Australia in 2012–13, only slightly above the OECD average of 9.2 per cent.

Universal healthcare that is publicly funded through progressive taxation is the most effective, efficient and equitable way to ensure the delivery of adequate healthcare to the Australian public. It is also the best way to ensure a broader social commitment to its operation and integrity, with a shared stake in its efficiency and success. As well as being more effective in reducing the cost of healthcare, this approach enables spending to target the kinds of services and areas of health to drive longer term improvement in health outcomes. ACOSS believes that a significant proportion of essential health services should continue to be delivered through Medicare.

ACOSS has serious concerns regarding proposals to introduce new individual health co-payments. Additional individual co-payments in healthcare would further undermine access to essential healthcare services and disproportionately affect disadvantaged groups in the community already not sharing in the good health experienced by most in our community. The opposition to a general practitioner (GP) co-payment is a part of a wider concern

"The design, funding and administration of the health system are powerful determinants of healthcare access, equity and effectiveness."

about increasing the privatisation of healthcare, as evidenced by moves to bring private health insurance into the provision of services across primary care, emergency care and pharmacy.

There is inefficiency in the healthcare system and there is waste. It would be much better to focus on areas where there are real savings to be made, including removing the Private Health Insurance (PHI) rebate and the Extended Medicare Safety Net, both of which have not delivered on their original stated policy intent of reducing pressure on the public health system and reducing out-of-pocket expenses. The PHI rebate is regressive and has led to only a small increase in the taking up of PHI. Many accessing

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the PHI rebate still use public hospitals and the rates have increased the most for younger people, who are low users of public hospitals. Many claimants face significant out-of-pocket expenses in any event.[17] Implementing these changes is estimated to lead to a saving of about $3.5 billion.

The Federal Government needs to overhaul the Pharmaceutical Benefits Scheme to flush out unfair and ineffective subsidies and over-pricing of drugs. As the Grattan Institute proposes, Australia should introduce independent expert management of drug pricing coupled with strict regulation of pricing for generic drugs, drawing on the world leading New Zealand model.[18] The Grattan Institute estimates these changes would achieve at least $3 billion in savings.

We need to invest more in primary healthcare, with one of the significant cost drivers currently being the rate of preventable chronic illness. While markets can be useful in regulating services, single purchasing mechanisms are likely to be more efficient. Current proposals being floated to allow private health insurers to partially fund GP services is likely to increase costs on the public purse as well as users of these services. ACOSS is also concerned that the last Federal Budget reduced investment in early intervention and health promotion initiatives, including the National Partnership Agreement on Preventive Health and deferral of the commencement of improving equitable access to basic dental health services under the National Partnership Agreement for Adult Public Dental Services.

Retirement incomes

Retirement income policy is arguably one of the most complex policy areas, involving interactions between the tax and transfer system, and the market. Reform is also difficult to achieve, with diverse and powerful vested interests, both among wealthier individuals and industry representatives. Yet, this area is one of the most important to get right.

The Age Pension plays a vital role in protecting the incomes of low and middle income earners from a sharp decline after they retire. On the whole, it is well designed and cost effective in preventing poverty in old age, and is more tightly targeted than equivalent payments in most other wealthy nations. With the indexation of the Age Pension linked to wages, the rate of the Pension has been relatively effective in keeping up with rises in costs of living, particularly for people not paying rent or large mortgages, unlike the rate of Newstart, which is indexed to the consumer price index (CPI). Indexation of income support payments needs to be brought into alignment but not by reducing the Pension to CPI as the Federal Government currently proposes. As the

OECD conservatively note, reducing indexation of the Age Pension 'will likely become unsustainable over the long term', noting that the current replacement rate of the Pension 'is a little under 60 per cent (the OECD average is 67 per cent)'.[19] Instead, indexation of allowances should be improved so that these payments are also linked to wages.

For many years, the Age Pension was designed so that social security support did not extend to people with relatively high incomes or income-yielding assets – around the top 20 per cent of people of pension age. However in recent years, Age Pension entitlements and associated supplements and concessions have been extended to a cohort of older people who arguably do not need them. In 2006, the Age Pension asset test was made more generous to such an extent that a home-owning couple with a million dollars in investment assets (other than their home) can now qualify for a part pension. This entitles them to a range of pensioner concessions and supplements, even if their residual pension entitlement is only a few dollars a week. This decision needs to be reversed, with the OECD supporting such a move.[20]

The Seniors Supplement should also be abolished, as the Federal Government is attempting to do. Individuals over 65 years who have assets that disqualify them under the pension rules can qualify for a Seniors Supplement of $850 per year ($650 if partnered) if their taxable incomes fall below $50,000 for singles and $80,000 for couples. As many retirees on relatively high incomes draw their income mainly from superannuation which is non-taxable, they may be eligible for the Supplement despite having incomes well above these thresholds. People receiving the Supplement are also likely to have investment assets worth more than a million dollars (if partnered) and to fall within the top 20 per cent of the retiree income distribution.

To keep the economy growing and to fund essential services as the population ages, it is vital that more mature age people retire later, and retire gradually by working on a part-time or temporary basis after leaving their full-time jobs. The most important step that policymakers could take to encourage people to do this is to raise the preservation age for access to superannuation. Such a policy would be much fairer and cause less financial hardship than an increase in the pension age itself, since the people who rely most on the Age Pension are those who have little choice but to retire at 65 or earlier. People forced into retirement typically derive little benefit from early access to superannuation because the balances in their superannuation accounts are small.

On the other hand, a higher preservation age is likely to have a substantial impact on the workforce participation decisions of those who do have a choice to retire later. Early access arrangements should be established for individuals who have little choice but to retire earlier, for example due to health, disabilities or caring roles.

"To keep the economy growing and to fund essential services as the population ages, it is vital that more mature age people retire later, and retire gradually by working on a part-time or temporary basis after leaving their full-time jobs."

"Tax breaks for superannuation are the most expensive tax expenditures, costing almost $40 billion a year."

Tax breaks for superannuation are the most expensive tax expenditures, costing almost $40 billion a year, roughly the same as the Age Pension, and growing strongly. The original intent of superannuation was to boost retirement incomes and reduce the cost to government of providing financial support to people after working age by encouraging people to save for their own retirement. While modest tax support for retirement saving is desirable, the present superannuation concessions are poorly targeted and wasteful.

The Treasury estimated that in 2012, 32 per cent of the value of the concessions went to the top 10 per cent of income earners while the bottom 50 per cent received just 19 per cent of their total value.[21] This is inefficient as well as unfair. The previous Government effectively removed the 15 per cent tax from employer superannuation contributions for individuals earning less than $37,000 by legislating the Low Income Superannuation Contribution (LISC). The current Government has legislated to abolish the LISC from 1 July 2017, which would have an adverse impact on the retirement incomes of people in low wage jobs, the majority of whom are women.

The unfair and complex system of tax breaks for superannuation contributions should be replaced with a simpler taxation structure in which contributions are taxed at the employee's marginal tax rate and a superannuation rebate is paid into employee's superannuation accounts. To boost the superannuation savings for people on low incomes, the rebate would be paid at the rate of 100 per cent of contributions up to a low flat annual contributions cap. Beyond this it would be paid at 20 per cent of additional contributions up to a higher cap. The cap would be lower than the existing cap on concessional contributions and set at a rate sufficient to encourage an appropriate level of saving beyond Superannuation Guarantee contributions by an employee on an average full-time wage. The rebate would apply to the sum total of all contributions, whether compulsory or voluntary, which would improve simplicity. The proposal would improve equity, while being revenue neutral, and is consistent with the superannuation reform proposals in the *Henry Report* (except that it would not reduce employees' current disposable incomes).

The tax concessions for superannuation contributions and fund earnings in the pension phase are also unfair and unsustainable, the more so as the population ages. Two problems stand out. First, many superannuation fund members aged over 55 years are able to contribute to superannuation and withdraw a superannuation pension at the same time. While it is desirable to give people the flexibility to ease their way into retirement, these arrangements are open to abuse. The 'churning' of wages through superannuation accounts is being heavily promoted by superannuation funds and financial advisers, jeopardising the personal income tax base as more people reach retirement age and make use of this strategy.

Secondly, the tax-free status of earnings in the pension phase may have been appropriate at a time when there was a clear distinction between a contribution phase (pre-retirement) and a pension phase (post-retirement) but as indicated, the same individual can now contribute to and be paid a superannuation pension at the same time. It is likely that remaining age-based limits on contributions will be removed in future, further blurring the distinction between these two phases. There is a strong case for applying the standard 15 per cent tax rate to fund earnings in both phases. This change would raise substantial revenue in future years to help finance health and aged care services. It would also improve equity in the tax treatment of different types of investment income received by people of different ages and simplify the system.

As David Murray recommends, the first essential step in providing a solid basis for reforming superannuation is to set its legislative core purpose as being 'to provide income in retirement to substitute or supplement the age pension.[22]' Superannuation needs to be designed to keep people out of poverty when we leave the workforce, reducing the pressure on government transfers. Right now, the system is failing with the largest beneficiaries being people who are likely to be able to provide for their own economic security in retirement.

Conclusion

Australia is fortunate in that we still have some major choices available to us. With the right policy decisions, and solid broad participation in building consensus for necessary major reforms, we have the capacity to seriously reconfigure our investment approach to ensure a better future. With health, education and retirement income policy as examples, it is clear there is ample scope for the right structural reforms. Social security, employment and housing reforms will also be crucial.

It is disturbing that the Federal Government appears committed to further stripping away supports for people unemployed rather than backing demand-led employment reforms advocated by both ACOSS and the Business Council of Australia. It is alarming that recent funding decisions by the Federal Government may signal a potential full retreat from housing policy, when secure and affordable housing and associated infrastructure is essential to social equity and improving participation and productivity in the real economy.

Prime Minister Abbott made a commitment upon taking government that 'he would leave nobody behind'. His Treasurer also committed that government would be there for the people who needed it. These statements reflect founding principles underpinning the proposed reforms set out in this chapter. We have within our means the ability to guarantee everyone a life of dignity including in later life. However, this will require some of us to give up government largesse and contribute more to our revenue base to support better investment in areas of real need. Achieving social equity is up to all of us.[23]

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

Endnotes

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23 See ACOSS 2015 Federal Budget submission for an extended version of this article.

acknowledgements

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Snowy Hydro

Strategex

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Aurora Energy

Hydro Tasmania

Nekon

Tas Department of Premier & Cabinet

TasNetworks

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Mackay Consolidated Industries

Medibank

Melbourne Water Corporation

META

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Monsanto

National Australia Bank

NHP Electrical Engineering Products

NICTA

Open Universities Australia

Oracle

PGA Group

Pinnacle Group

Pitcher Partners

Port of Hastings Development Authority

Programmed

Public Transport Victoria

PwC Australia

RMIT University

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Georgiou Group

GFR – Masters of Water

Grose International

INPEX

Jackson McDonald

K&L Gates

King & Wood Mallesons

LandCorp

Leighton Contractors

Main Roads WA

Murdoch University

Pilbara Development Commission

Public Sector Commission

SAP Australia

Toro Energy

University of WA

WA Department of Agriculture and Food

WA Department of Commerce

WA Department of Planning

WA Department of Regional Development

WA Department of Treasury

WA Treasury Corporation

Water Corporation

Wellard Group

Wesfarmers

Whelans Australia

Woodside Energy

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