Lift Your Game

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Reviving wage growth requires supply-side measures including economic liberalisation.

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The collapse to the supply-side of Australia's economy has been caused by two decades of public policy recalcitrance, exemplified by Australia's high corporate tax rate, rigid industrial relations system, and growing red tape burden. Australia's economy is in its 28th year of consecutive economic growth, the longest run of unbroken growth on record. This impressive sounding statistic, however, means little to the average person, family, or business not feeling much better off than a decade ago. This is because most of the aggregate economic growth in Australia is driven by rapid population growth underpinned by mass migration.

In the decade since the Global Financial Crises (GFC) of 2008-09, approximately 60 per cent of Australia's economic growth has been the result of population growth. Just 40 per cent has been driven by productivity growth or changes to the labour force participation rate. This is the inverse of the period between the Keating recession of the early 1990s and the GFC of 2008-09.

This fact is revealed by anaemic growth in output per capita, which divides the total amount of economic output across the population. Output per capita has declined throughout the previous three quarters for the first time in four decades. Output per capita is admittedly only a partial measure of living standards. It doesn't control for the myriad of other factors which affect people's day-to-day lives. Nonetheless, it is a superior measure of aggregate GDP as it at least accounts for the effect of population growth. Growing the economy by adding more people doesn't make the average person better off.

The underlying weakness of the Australian economy has preoccupied members of the economic establishment, epitomised by the Reserve Bank of Australia (RBA) and its Governor Philip Lowe. The official cash rate was fixed at 1.5 per cent since August 2016, until on June 4 this year the RBA reduced the rate to 1.25 per cent, and then again in July to 1.0 per cent. The last time the cash rate was increased was in November of 2010, when the rate moved 25 basis points from 4.5 to 4.75 per cent where it remained until late 2011. Since then the cash rate has progressively decreased to its current record low.

The latest cut occurred despite widespread belief the next move would be up. Each month product and service comparison website *Finder* provides data on the proportion of selected experts who expect the next RBA move to be a rate rise. The experts include Alan Oster of NAB, Shane Oliver with AMP, Bill Evans of Westpac. As recently as December 2018, 78 per cent of these "experts" expected the next RBA move to be a rate rise. In September 2018 that figure was 88 per cent. At an event hosted by *Bloomberg* in Sydney in December 2018, assistant governor Christopher Kent said "We have said that it's likely the next move is up". Also in December of 2018, Governor Lowe said "the next-move-is-up scenarios were more likely than the next-move-is-down scenarios".

> Low business investment rates cause slow productivity growth, which holds down wages growth

The softening of the economy has baffled the economic elites. Going back to the early 2010s, the standard narrative was the tapering off to the mining-investment boom would require the economy to restructure away from mining-led growth to growth in other sectors. Interest rates would decrease, the exchange rate would depreciate, and real wages growth would slow to facilitate the transition of resources out of mining toward non-mining sectors. While the change to relative prices has taken place, the expected transition has been far slower. Interest rates have been declining since November 2011. The exchange rate has depreciated 30 per cent from its 2011 high. Growth to real wages has been stagnant for three years. Yet business investment is just 11.8 per cent of GDP, which is lower than during the Whitlam years.

Declining investment in the mining sector has not been offset by a corresponding increase to investment in non-mining sectors. Mining investment as a percentage of GDP has declined from nine per cent in 2013, to three per cent today, while non-mining business has barely increased from nine per cent to a fraction under 10 per cent. Low rates of business investment are a key cause of slow productivity growth, which in turn is holding down wages growth. According to a recent report by the Productivity Commission, labour productivity growth in 2017-18 was just 0.4 per cent, which is well below the long-run average of 2.2 per cent annual growth since the mid-1970s.

Sector-specific challenges in the mining industry and resources sector, declining business investment, and moribund productivity growth are the consequences of close to two decades without substantial economic reform. There are three key areas in which this falls: the corporate tax rate, a rigid industrial relations system, and red tape.

CORPORATE TAX

Australia currently has a two-tiered corporate tax system, with a different rate applying to “small” and “medium and large” businesses. Businesses with a turnover of $50 million or more are subject to a 27.5 per cent rate of tax on their profits, which will drop to 25 per cent by 2021-22. All other businesses are subject to a 30 per cent tax rate. There are a number of deficiencies with this system. The 30 per cent rate is one of the highest in the developed world. For example, the current rate in the US is 21 per cent, in Singapore is 17 per cent, and in the UK it is set to drop to 17 per cent from 2020. This disparity reduces Australia’s attractiveness as an investment destination.

Further, the two-tiered corporate tax system reduces the incentive for business expansion and growth. All “progressive” taxes, whether of personal income or business profits, discourage growth, expansion, and aspiration because a larger percentage of income is confiscated as more is earned. However, the current structure of the business tax system is especially pernicious as it is not based on marginal revenue or profits, like the income tax system. Under the income tax system, when an individual moves into a higher tax bracket it is only the portion of income which falls into that higher tax bracket which attracts a higher tax rate, rather than the totality of an individuals’ earned income. Hence, average personal tax rates are always lower than personal marginal tax rates. But the current business tax structure doesn’t operate this way. When a business crosses the $50 million annual revenue threshold, its entire profits become subject to a higher tax rate. The system is so perverse that a company with revenue of $49 million would have higher after-tax profits than a company with $50 million revenue, if both companies had the same pre-tax profit.

The government should reduce the current top-tier of the corporate tax rate from 30 to at least 20 per cent, in line with key competitor nations. If the government isn’t willing to reduce the top rate of 30 per cent, it should at least make the tax schedule marginal rather than a step increase. That is, the 30 per cent rate should only apply to the portion of profit above 30 per cent, as with income tax.

INDUSTRIAL RELATIONS

Australia’s industrial relations system is among the most inflexible in the developed word. Each year the World Economic Forum’s *Global Competitiveness Report* ranks the economic competitiveness of 140 nations using 98 indicators such as macroeconomic stability, infrastructure quality, and labour market efficiency. Rankings are derived from a combination of statistical analysis and survey data. The 2018 report shows Australia ranked 110th of our 140 nations for hiring and firing practices, and 105th in the word for flexibility in wage determination. This means it is difficult and costly for employers to recruit suitable staff and for employees to find work.

This is reflected in labour market figures. While the headline unemployment rate of 5.2 per cent is relatively healthy, there are pockets of weakness. For example, some 750,000 Australians currently are in receipt of the disability support person, close to 350,000 Australians are in long-term unemployment, half of whom have been out of work and looking for work for more than a year, and some 400,000 young Australians are underemployed, meaning they are unable to work the number of hours they would prefer. Added to this, 265,000 young Australians are unemployed, giving a youth unemployment rate of 11.8 per cent. High minimum wages, penalty rates, and other add-on costs to employers are increasingly making employing young and low or unskilled Australians an unattractive prospect.

If the Morrison government is unwilling to engage with fundamental reform of the *Fair Work Act*, there are specific measures they could pursue to improve outcomes at the margins. These include making Individual Flexibility Agreements more widespread, replacing the better-off-overall test with a no disadvantage test, removing the “conveniently belongs” provisions from the *Fair Work Act* (which allows unions to monopolise workers within a given industry), reinstate an exemption from unfair dismissal laws for businesses up to 50 employees, and introduce variable minimum wage and penalty rates for states based on economic conditions.

RED TAPE

The final and most crucial pillar of economic reform is to reduce red tape. Surveys and analysis consistently show red tape and overregulation are two of the biggest impediments to business investment, job creation, and economic growth in Australia. The 22nd Annual Global CEO Survey released by Price Waterhouse Coopers in 2019 found overregulation was the equal biggest threat to the ease of doing business, alongside policy uncertainty. By contrast, climate change was the 13th biggest threat, behind factors such as exchange rate volatility and cyber threats.

Similarly, 48 per cent of business leaders said that regulation, in terms of its cumulative impact and constant change, was the most significant barrier facing Australian business success today, especially small and medium sized ones, according to a survey published by Westpac in 2018. This was far higher than the second highest response, which was “businesses taxes are too high” at 14 per cent. Notably, climate change did not rate a mention, although 2 per cent responded “other”.

The responses to the surveys are supported by quantitative analysis of the red tape burden. Research by the Institute of Public Affairs estimated the economic costs of red tape in Australia is at least in the order of $176 billion per annum , which is equivalent to 10 per cent of GDP. This is more than Australians pay in income tax, the GST, or business taxes. But this estimate captures more than just financial costs. It measures forgone human potential: all of the businesses which are never started, the jobs never created, and the pay rises which never materialised because of red tape.

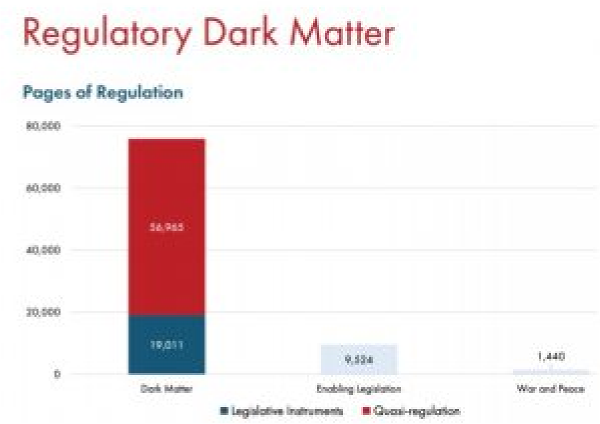
> Red tape takes power, authority and choice away

Red tape, in other words, is disempowering. It prevents Australian workers, businesses, families, and community organisations from applying their skills and talents to achieve a goal of their own design. People flourish in environments which allow, and support them, in achieving their potential. Red tape prevents this by taking power, authority, and choice away from Australians and giving it to politicians, bureaucrats, lobbyists, and consultants. Two sectoral examples demonstrate the pernicious effects of red tape on business investment and economic growth: the finance and resource sectors.

As alluded to earlier, monetary policy has been highly accommodative since 2011. So why does monetary policy appear less effective in stimulating economic activity than in the past? To consider this, it is important to remember that the key conduit through which changes to the cash rate are expected to influence the broader economy is through the financial sector. Traditionally, a lower cash rate would be associated with an expansion of economy activity, and vice-versa. The key transmission mechanism is via the effect the cash rate has on other interest rates in the economy. The cash rate is the market interest rate for overnight loans between financial institutions. As such, according to the RBA, “the cash rate serves as a benchmark for interest rates at which funds can be lent or borrowed in financial markets, including for different sources of bank funding, such as wholesale debt and deposits”. A lower cash rate reduces the cost of bank funding, which in turn can be passed on to borrowers through lower interest rates. Lower interest rates flow on to more economic activity, such as higher investment and spending. Accommodative monetary policy will only work its way through the economy if financial institutions behave accordingly. However, the major banks have been less willing to pass on interest rate cuts than in the past. The range of factors for this include the costs of international financing, risk aversion, and general economic conditions. But it is also partly a function of government regulation and red tape. Just the last three years alone has seen the Banking Executive Accountability Regime (BEAR), the imposition of the bank tax, $150 million extra to APRA, and the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry.

> Is it any wonder financial institutions are becoming more risk averse?

On top of these recent incursions sits the morass of further regulation identified in a recent IPA report, including macroprudential standards which dictate capital and liquidity requirements administered by APRA, corporate governance regulation administered by ASIC, competition and consumer regulations administered by the ACCC, as well as laws which have a general application. Is it any wonder financial institutions are becoming more risk averse?



Next, consider the resources sector. Declining investment and economic activity in the mining sector is partly, and perhaps in large part, due to changing global economic conditions beyond the influence of the domestic market or policy making in Australia. Nonetheless, public policy has made the decline sharper and faster. Some examples illustrate the point.

The Roy Hill iron ore mine in the Pilbara region of northern Western Australia required more than 4,000 licences, approvals, and permits for the pre-construction phase alone. While the Adani Carmichael Coal project in the Galilee Basin of Central Queensland took nearly a decade to achieve final approval, faced more than 10 legal challenges, and prepared a 22,000-page Environmental Impact Statement. Only the substantial swing against Labor in Queensland in the 2019 Federal Election convinced policymakers that further outstanding impediments to the project should be removed so as to allow the mine to proceed. And then there is Section 487 of the Environment Protection and Biodiversity Conservation Act (EPBC 1999), which extends special legal privileges to green groups to challenge federal environmental project approvals. Research by the Institute of Public Affairs found that from 2000 (when the EPBC Act was introduced) to 2016, proponents of major projects have spent approximately 7,500 cumulative days held up in legal challenges as a result of section 487.

On top of this are a range of policies which discourage economic development in the resources sector, including Renewable Energy Targets at both the Commonwealth and state level in Victoria, South Australia (until 2017), Queensland, and Tasmania, the Paris Climate Agreement, the prohibition on the development of a nuclear power facility in Australia, and state-based limitations on the development of onshore and offshore gas. The total effect of these policies is a resources sector which is far smaller than would otherwise be the case.

The cumulative effect of a high corporate tax rate, a rigid industrial relations system, and a large and growing red tape burden is a collapse of the supply-side of the Australian economy. Australia's economic potential— the ability of businesses, workers, and civil society to generate growth and prosperity— has been diminished by two decades of public policy failures of commission and omission. The imposition of new policy, such as higher income taxes, introduction of the Fair Work Act, and signing the Paris Climate Agreement, has met close to two decades of policy inaction in the areas of reducing red tape, reducing the corporate tax rate, and liberalising Australia’s industrial relations system to produce stagnant per capita income growth. Only by expanding the supply-side of the economy through a program of economic liberalisation will the Morrison government be able to lift Australia out of its per capita income recession.

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Photo: Ballooning in Canberra, Glenn Martin (digitally altered)