“Sustaining prosperity: the way ahead”

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Australia’s economic challenge

Structural weaknesses unmasked

Australia faces serious economic challenges that, until recently, had been masked by more than a decade of strong economic growth. A dramatic unmasking occurred last month when the Reserve Bank lifted interest rates. In explaining its decision the Bank pointed to inflationary pressures generated by rampant domestic spending smashing up against capacity constraints.

Why didn’t the Howard government recognise these emerging capacity constraints, given that Australia had been in its longest economic expansion in history? And why did the government fuel consumer spending through a $66 billion pre-election spending spree? The answer is that the Howard government is all geared up to govern for the political cycle but not for the economic cycle.

If Australia’s economic challenges are not addressed, Australia by 2010 could experience a cut of almost one-third in the economic growth rate per person enjoyed in the 1990s. This would be the slowest rate of economic growth per person since the decade of the Great Depression.

How do we know? Treasury’s Intergenerational Report projects this dramatic slump in growth from 2010 onwards.[1] And it is likely to get worse: by the mid-2020s Australia’s per capita growth rate could be half the rate of the past decade (Productivity Commission 2004c, p. 5.3).

[1] See also Banks (2004, Table 2).

These alarming official projections are the product of two insidious forces at work in the Australian economy: an ageing population and faltering productivity growth.

An ageing population

Over the next 40 years the proportion of the population aged over 65 is projected to double from 13 per cent to 26 per cent, leaving only a little over half of our population in work to support the old and the young.

The die was cast a half a century ago for the ageing of the Australian population. In the coming four decades ageing baby boomers born in the 1950s and 1960s will replace the small numbers of older Australians born in the 1930s and 1940s.

Official projections assume a slowing in the historic rate of increase in life expectancy over the next 40 years. Yet the past ABS projections have systematically underestimated the increases in life expectancy. Plausibly faster increases in life expectancy would strongly compound the ageing of the population.

The ageing of the population is the dominant cause of the expected slowing in GDP growth per person over the next 40 years (Henry 2004, p. 11).

Faltering productivity growth

The Intergenerational Report projects the strong productivity growth Australia has achieved since the early 1990s to slip back to its mediocre 30-year average from 2005 (Commonwealth Treasury 2002, Chart 15). These projections are fast becoming reality. The OECD (2004b, p. 83) warns that Australian productivity growth might be faltering:

> *"During the four years ending in the financial year 2002-03, capital deepening maintained its trend, but market sector MFP [multi-factor productivity growth] slowed down to an average rate of 0.5 per cent. <u>This could indicate the end of its strong trend increase in the 1990s</u>"[emphasis added].*

The national accounts for the December quarter 2004, released on the same day the Reserve Bank hiked interest rates, confirm that productivity growth has not only slowed, it has turned negative! Some of us were warning about the dangers of slowing productivity growth three years ago, before the Intergenerational Report was released.[2]

Weak exports

Exacerbating these emerging economic problems has been a sharp deterioration in Australia's export performance since 2000. Australia's record run of 39 successive monthly trade deficits cannot be explained – as the Government has sought to do – by

[2] See, for example, *Hansard*, 6 March 2001 and "Think big Labor: it's what we do best", Brisbane, 7 April 2002.

terrorism, SARS, bird flu virus and slow world economic growth (of five per cent in 2004!)[3]. These factors affect all exporting countries. Yet Australia's *share* of world exports has fallen to its lowest level since World War II. And this has occurred despite Australia enjoying its best terms of trade since the early 1970s – a lucky coincidence of soaring mineral prices and inexpensive Chinese manufactured imports.

Consumption today preferred to investment for tomorrow

Federal government policy has deliberately encouraged consumption over investment. From March 2000 to September 2004 almost 70 per cent of total domestic spending was consumption spending and only just over 30 per cent investment spending.

Australian households have been spending more than they are earning, financing the shortfall from borrowings against the equity in their houses. As pointed out by the Treasury, these household borrowings have been overwhelmingly responsible for Australia's current account deficit (Parkinson 2004), which has hit a record 7.1 per cent of GDP.

Whether an economy can successfully reduce large current account deficits without a serious economic slowdown depends on the conditions prevailing at the time. Current account adjustments can hurt growth where the economy is already overheated at the beginning of the adjustment and where the current account deficit is a symptom of domestic overheating (Goldman Sachs 2005). These are the conditions of the Australian economy right now.

Strong economic growth has generated an air of complacency within the Coalition government about the fundamental economic challenges confronting Australia. Of the government's $66 billion pre-election spending, at best $7.5 billion could be considered investment, the rest consumption spending. Where is the new reform agenda designed to secure ongoing increases in prosperity in the face of an ageing population and structural weaknesses in the Australian economy?

How did Australia's economic revival come about?

Labor in government embarks on an economic reform program

In the late 19th and early 20th centuries, Australia had the highest standard of living in the world. More than a century later Australia had slipped to around 18th in the world.

By the early 1980s our country had shifted from an open, competitive economy to a Fortress Australia. The Australian economy was inward looking, uncompetitive, incapable of generating jobs and prosperity.

The incoming Hawke Labor government was well aware of the structural weaknesses in the Australian economy. They were showing up in poor productivity growth, double

[3] Trade Minister Mark Vaile, blamed the "the slow level of global growth over recent years", *Hansard*, 16 March 2005.

digit inflation and unemployment and an acute vulnerability to any downturn in primary commodity prices.

Labor recognised that today's productivity growth is tomorrow's prosperity.

With all the inefficiencies in the Australian economy there was ample scope to boost labour productivity.

The new Labor government embarked upon an economic reform program designed to lift productivity growth while diversifying Australia's export base by engaging with Asia and promoting non-commodity exports.

Labor transformed Australia into an open, competitive economy and vigorously pursued the opening up of other countries' markets through a non-discriminatory multilateral and bilateral trade policy.

Australia's reward from Labor's economic reform program

Labor's transformation of Australia to an open, competitive economy unleashed more than a decade of record productivity growth and economic growth. Australia surged through the international field from productivity straggler to a leader of the pack.

Australia's strong productivity performance during the 1990s has boosted average household incomes by an estimated $7,000 (Productivity Commission 2003b, p. 3). For the 13 years to 2004, Australia's economic growth compared with other rich countries was our fastest ever.

There is now a general consensus that the economic reform program begun by Labor in the mid-1980s and extended by the Coalition has been overwhelmingly responsible for Australia's strong productivity growth and the prosperity it has created.[4]

Meeting the challenge

The three 'P's – population, participation and productivity

Australia's economic challenge can be summarised by the three 'P's: population, participation and productivity (Henry 2004, pp. 6-11). In principle, the adverse economic effects of an ageing population can be offset by a combination of immigration, rising labour force participation and strong growth in productivity.

Today I am setting out some personal views on appropriate policy responses. They are not presented as the views of the Federal Parliamentary Labor Party but as my own contribution to the policy debate.

[4] See, for example, Productivity Commission (2003, p. 6; 2004b, pp. 35 & 41); OECD (2003a, p. 90); OECD (2004b, p. 82); International Monetary Fund (2003, p. 14); Henry (2004, pp. 2-3).

The first ‘P’ - population

For the first time since European settlement Australia is facing the prospect of a declining population. Australia is expected to experience a natural decline in population some time in the mid-2030s (ABS 2003, p. 35). Immigration will be needed just to prevent our overall population from shrinking. Acute labour shortages can be expected in the Australia of the 2030s. Population ageing is a phenomenon common to the developed world. Australia will need to compete strongly against other rich countries for the world’s skilled and semi-skilled migrants.

Community attitudes towards migration will need to change; Australia’s future prosperity will depend on a bigger immigration program contributing to a bigger population. But migration will need to be directed to Australia’s dynamic regions through a set of strong regional migration incentives, to take the pressure off our congested major capitals. This will require an infrastructure investment program that anticipates population pressures rather than simply reacting to them - to achieve a better dispersal of Australia’s population.

The second ‘P’ - participation

The smaller the share of the population that is engaged in the workforce the greater is the burden on them to produce the income and taxation revenue to pay for those who are too young and too old to work.

As people get older they participate less in the workforce. The ageing of Australia’s population will reduce the overall participation rate.

From now on, even large increases in age-specific participation rates can have only modest impacts on the overall participation rate in the next 40 years and therefore on economic growth prospects over that period (Productivity Commission 2004b, p. 3.27):

> *“Substantial increases in participation rates for older Australians alone do not make a large difference to overall participation rates – and policies that elicit such increases cannot, by themselves, realistically be a panacea for the sluggish labour supply arising from ageing”.*

Australia’s participation rate is above the OECD average, but there is scope to lift it to the levels of Scandinavian countries (OECD 2004b, p. 164). If Australia were to achieve Scandinavian participation rates the aggregate participation rate would still only be around 60 per cent by the mid-2040s, mitigating the effects of ageing by around half (Gruen and Garbutt 2003; Productivity Commission 2004b, p. 3.28).

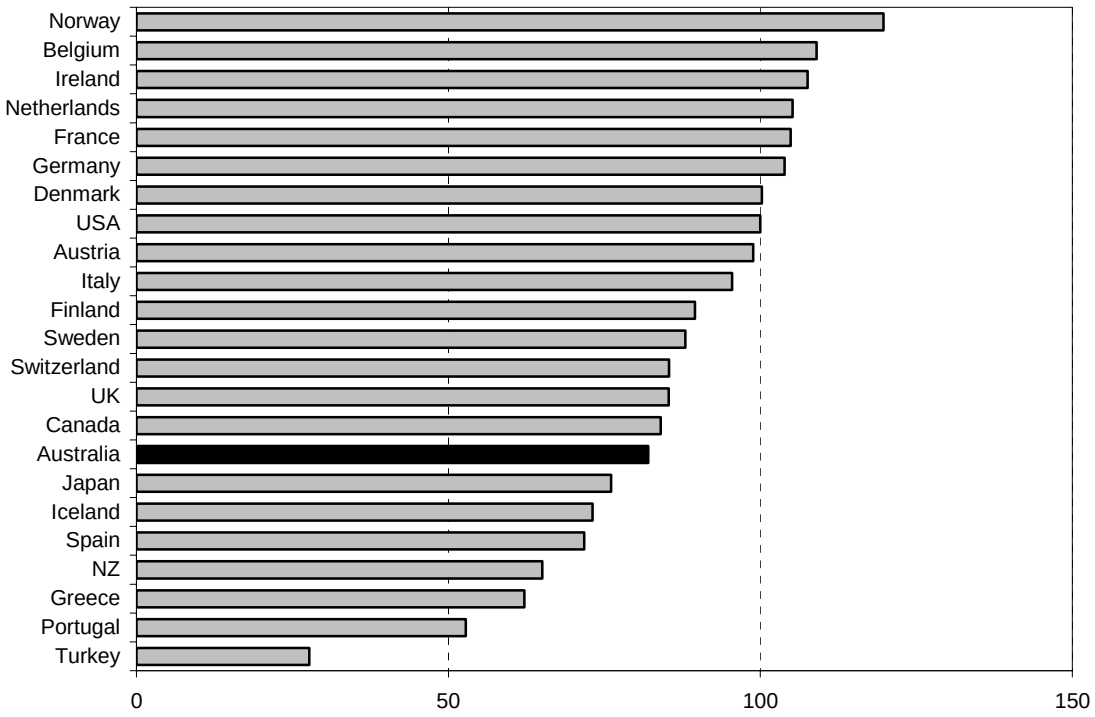
Though policies to lift workforce participation cannot be the dominant feature of any plan to cushion the economic impacts of population ageing they can nevertheless play a valuable role. That is why Labor – especially through Shadow Treasurer Wayne Swan – has been arguing strenuously for reducing high effective marginal tax rates to encourage the transition from welfare to work. Since Wayne has already spoken at this conference I will not traverse the participation ground again.

The third 'P' – securing a new round of productivity growth

Much of the heavy lifting in securing Australia's future will need to be done by productivity growth.

Australian governments must do everything possible to prevent productivity growth from slipping back from the rates achieved during the 1990s. How realistic is this? Part of the answer lies in a comparison of Australia's *level* of productivity compared with those of other advanced countries. Although Australia's productivity *growth* since the early 1990s has been impressive by international standards we have not attained the *levels* of other comparable countries.

Figure 1: GDP per hour worked in OECD countries, 2003
(Index[a] : United States=100)



a Index calculated in 'purchasing power parity' terms.

Source: Productivity Commission (2004b, p. 151).

Figure 1 shows that Australia ranks below 15 OECD countries in the productivity stakes. If Australia were to achieve say, US productivity levels, which are still below those of seven other countries, Australian household income would rise by an estimated 20 per cent or $22,000 a year (Productivity Commission 2004b, p. 151).

How can Australia maintain the 'miracle' productivity growth of the 1990s so essential in combating the ageing of the population?

Having opened the door to global and local competition in the product and labour markets through the reform program initiated by previous Labor governments, the same door cannot be opened a second time. Keeping the door open is essential to Australia's future productivity growth and it should be pushed wider where possible. But the biggest returns can be expected from the new sources of productivity growth in 21st Century Australia: skills, innovation and infrastructure.

Further labour market reform

When the Howard Government speaks of maintaining strong productivity growth it invariably asserts that further deregulation of the labour market is the biggest game in town.[5]

Most of the productivity-stifling restrictive work practices of the 1970s and 1980s have been removed through enterprise bargaining and award modernisation initiated by the previous Labor government and continued under the Coalition. Those who argue that further labour market deregulation is the key to the second round of productivity growth should identify the restrictive work practices that are retarding productivity growth.

No-one has been able to demonstrate beyond mere assertion that abolishing unfair dismissal laws for small business or expanding the use of Australian Workplace Agreements (AWAs) will unleash big productivity gains.

The Treasurer refers to an OECD survey of Australia about possible employment impacts of unfair dismissal laws and asserts that it shows the abolition of unfair dismissal laws for small business would create 77,000 jobs.[6] In truth, the OECD (2003a, p. 100; 2005b, p. 44) finds that Australia's employment protection legislation is one of the least strict in the OECD.

An OECD analysis of employment protection legislation concludes that:

> *"… a reasonable degree of employment protection legislation could be welfare-improving" (OECD 2004a, p. 63).*

The OECD recommends reasonable employment protection legislation in combination with a modest system of redundancy payments and effective re-employment services as contributing to an efficient labour market (OECD 2004a, p. 99).

Since the OECD finds that Australia's employment protection legislation is one of the least strict among OECD countries, and concludes that there are net economic and social benefits from moderate employment protection legislation, the Howard government has not established a credible case for abolishing unfair dismissal laws for Australia's small businesses.

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[5] For example, Treasurer Costello, *Hansard*, 1 December 2004 and 8 February 2005.
[6] Treasurer Peter Costello, *Hansard*, 27 May 2004, p. 29384.

Rather, a case exists for streamlining the unfair dismissal procedures for small business, including by removing unethical ambulance-chasing agents from the system. Labor, through shadow workplace relations minister, Stephen Smith, continues to advocate a set of such reforms.[7]

A market exists for competing contractual arrangements covering workplace relations between Australia's employers and employees. More than 75 per cent have chosen collective agreements and common law contracts. Another 20 per cent have engaged in employment under the award system, leaving only three per cent on AWAs.

If contemporary awards are as rigid and outmoded as the Howard government asserts, many more employers and employees would be opting for AWAs to boost workplace productivity and take-home pay.

In pursuing further labour market reform there will always be some scope for ongoing modernisation and simplification of awards. But if awards are to reflect the realities of modern workplaces the modernisation and simplification process is best done by the relevant parties rather than by prescriptive government legislation.

If sensible proposals for labour market reform are advanced they should be assessed rigorously for their productivity-raising potential. But the rhetoric of further labour market deregulation is being used as a political diversion from the more challenging task of identifying and supporting the new sources of productivity growth.

Further foreign trade liberalisation

The folly of preferential trade deals

Trade policy since the change of government in 1996 has been dominated by the negotiation of preferential trade deals. These deals discriminate in favour of the parties to an agreement and against countries excluded from it.

In successfully opening up markets in East Asia, Labor in government did not seek preferential access, only an opportunity to compete; negotiations were conducted on a non-discriminatory basis.

Advocates of preferential trade deals, including the Howard government, argue that they are building blocks, not stumbling blocks, to global trade liberalisation. Yet progress in the Doha Round of (non-preferential) multilateral trade negotiations has been slow, as country negotiators concentrate on concluding preferential trade deals. According to the WTO, many developing countries, having secured preferential access to rich country markets through discriminatory deals, are proving reluctant to give up their preferred access in the global negotiations towards genuine free trade (WTO 2004, p. 23).

The OECD (2004b, p. 119) has warned against the Australian government's predilection for preferential trade deals:

[7] See Stephen Smith, *Hansard*, 10 February 2005.

> *"… bilateral and regional trade agreements can have a trade distorting as well as a trade creating component. There is furthermore a danger that the coherence and predictability offered by multilateralism will be weakened if governments increasingly turn to regional agreements to manage their trade interests. A maze of conflicting regional regulations, standards and rules of origin risk becoming the new "walls" between blocks.*
>
> *Against this background, the recently negotiated FTAs with Singapore, Thailand and the US merit close scrutiny as they run counter to Australia's general unilateral/multilateral approach".*

The proliferation of preferential trade deals, with complex, restrictive rules of origin, will impose ever-increasing compliance costs on exporters. Different sets of records will need to be maintained, varying from country to country and even from one export product to another. A "spaghetti bowl effect" of criss-crossing rules of origin hardly seems a recipe for free trade.

Multi-lateralising Australia's preferential trade deals

An opportunity exists to convert bad, trade-diverting policy into good, trade-creating policy. Australia could begin multi-lateralising the preferential trade deals it has negotiated.

Recognising that a political climate has been allowed to develop in Australia against unilateral trade liberalisation, a conditional approach has been mooted (Garnaut 2004, pp. 9-13; 2005, p.55). Under this approach Australia would allow, in each new preferential trade deal it negotiates, the most favourable terms of access it has already granted in any of its existing preferential trade deals – so long as the other party does the same for Australia.

Parties to preferential trade deals with Australia could have no valid basis for objecting to Australia extending preferred access arrangements to other countries. Australia would simply be fulfilling its obligations as set out in Article 1 of the GATT to extend to all member countries of the WTO any favoured treatment given to a country with which it has reached a preferential trade deal.

Foreign investment liberalisation

It is possible that preferential agreements that also liberalise investment between the parties can create trade by promoting investment. But why should investment liberalisation be restricted to the parties to the agreement? If foreign investment is good, why liberalise only for particular countries?

In negotiations for the US-Australia free trade agreement the two countries decided to relax Australian controls on US foreign investment by raising the threshold for Foreign Investment Review Board approval of non-sensitive investment proposals from $50 million to $800 million.

A report commissioned by the Federal government estimates that this liberalisation will increase Australian living standards by more than $30 billion in net present value terms (Centre for International Economics 2004). No one seriously believes this estimate, but if it were anywhere near the mark the policy implications would be clear – extend this liberalisation to all countries and treble the benefits! This proposition enjoyed strong business support at the time and was supported by the CIE report but the Howard government has failed to act.

The Howard government should immediately raise the threshold for Foreign Investment Review Board approval of non-sensitive investment proposals from $50 million to $800 million for all countries.

Health and aged care reform

Providing health and aged care in a civil society

Government health spending as a share of GDP is projected to almost double over the next 40 years from just under six per cent to nearly 11 per cent. And government spending on aged care is projected to more than double (Productivity Commission 2004b, pp. 6.21, 7.10). The number of older Australians in high care residential aged care alone is projected to increase from less than 100,000 in 2003 to almost 300,000 in 40 years' time (Productivity Commission 2004b, p. 7.10).

A decent society provides quality health and aged care to all its citizens regardless of their financial capacity to pay.

A fee for service philosophy still guides the provision of most health and aged care services in Australia.

A provider who receives a fee for each service provided will have an incentive to provide more services and risk-averse medical practitioners will over-provide diagnostic and related services to minimise the risk of litigation.

Where health and aged care resources are limited and demand exceeds supply, the services will have to be rationed through the non-price mechanism of queuing. That is why waiting lists for GPs, elective surgery, hospital emergency department treatment and aged care facilities are so commonplace in Australia. Those queues are *not* occupied by the wealthy!

What is fair about lengthy waiting lists for Australians on low incomes when Australians earning high incomes are relieved of obligations to make a financial contribution to their health or aged care?

Co-payments exist in the delivery of GP services, in hospital and medical services covered by private health insurance and in residential aged care. A GP who does not bulk bill a particular consultation is requiring a co-payment from the patient. A private health insurer who does not cover 100 per cent of the cost of a procedure is requiring a co-payment in the form of a gap payment. And an aged care provider

requiring a payment out of the age pension or a nursing home bond is requiring a co-payment from the resident.

Medicare's guarantee of universal access to public hospitals without charge must be retained: Medicare must not be means tested. And neither should access to bulk billing be means tested.

But in particular circumstances, co-payments by the wealthy, within a universal health and aged care system, will be required if health and aged care is to remain affordable and accessible to all Australians. If bulk billing in an affluent locality falls it should not be a government funding priority to restore bulk billing in that locality.

Confronted with an ageing population, Australia must never accept a two-tiered system with a second-class health and aged care system for the poor. Though not the centrepiece of necessary reforms to health and aged care in Australia, co-payments from the wealthy should be used to help fund quality health care for the poor.

And co-payments should be extended in aged care for the wealthy.

There can be no valid philosophical basis for supporting nursing home bonds for low care places but opposing them for high care places – so long as bonds are restricted to the wealthy. If families with the financial capacity to pay decide they want to accommodate an ageing parent in a high-quality nursing home facility why should they be prevented from doing so? And if some of the proceeds of a nursing home bond from wealthy families can be used to cross-subsidise high-quality care for poorer residents surely it should be done.

Bonds should not be obligatory but nor should they be prohibited for willing, wealthy Australians. Some of the proceeds of bonds should be used to improve the availability and quality of aged care for disadvantaged older Australians.

More fundamentally, population ageing will necessitate a re-thinking of the role of residential aged care. It should become the care of last resort. The stress and trauma of moving into a high-care facility could be avoided by earlier movement into retirement villages that have all the necessary aged care facilities.

New sources of productivity growth

Extensive international research identifies skills development, innovation and infrastructure as key determinants of modern productivity growth.

Skills development

The nurturing of intellect and the acquisition of skills is by far the most potent source of productivity growth in the modern world (OECD 2003b, pp. 17, 78-79). Investing in skills also lifts lifetime workforce participation rates and improves health outcomes, further helping to combat the adverse economic effects of population ageing.

The Australian experience with skills development

The acceleration in human capital formation of the 1980s and early 1990s under the previous Labor government has slowed, such that skills formation has actually *detracted* from productivity growth in Australia (Banks 2003, p. 5).

This conclusion is confirmed by the OECD's empirical work which indicates that skill upgrading has made no recent contribution to Australian productivity growth (OECD 2003b, pp. 37-38).

Australia ranks a lowly 20th out of 30 OECD countries in the share of 15-19 year olds enrolled in post-compulsory secondary education (OECD 2004b, p. 171).

A range of indicators of educational attainment have been used to draw comparisons between Australia and other OECD countries, leading to the conclusion that:

> *"These international comparisons suggest that Australia's educational report card should be marked: 'Started well, but slackened off. Substantial room for improvement'" (Dowrick 2002, p. 17).*

Total government spending on education fell from 4.3 per cent of GDP in the early 1990s to 3.5 per cent in 2003-04. A small increase in private spending on education was insufficient to prevent an overall reduction in national spending on education over the period.[8]

Since 1995 the privately funded share of education spending has risen more quickly in Australia than in any other OECD country and Australia has been unique in failing to increase public education spending commensurately with the increase in private spending (OECD 2005a, p. 238).

As the ageing of the population continues the Intergenerational Report projections are for a *fall* in Commonwealth spending on education from 1.8 per cent of GDP in 2001-02 to 1.6 per cent in 2041-42 (Commonwealth Treasury 2002, p. 47).

In an ageing population and likely absolute reductions in the number of young Australians over the next 40 years a new approach is needed that focuses not on education spending as a proportion of GDP but on real spending per student.

Students are moving away from government schools

More than two-thirds of students were enrolled in government schools in 2003 but virtually all of the enrolment growth in the 20-year period from 1984 has been in private schools. Government schools should be equipped to continue playing their indispensable role of offering a quality education to every student whose parents choose the government system.

[8] ABS Catalogue 5204.0, Tables 8, 44, 51, 64 and 65.

But as parents move their children out of government schools into private schools the student populations remaining in many government schools are increasingly from disadvantaged backgrounds. Yet after adjusting for the differences in student population the overall performance of government and private schools is similar.

The observation that the performance of different schools is strongly influenced by the socio-economic status of their students has very important implications for reform of Australia's school system. The exodus of higher-performing students from many government schools is leaving them vulnerable and poorly placed to lift their standards.

Australia is headed for a period of squandered opportunity and much greater inequality unless a new needs-based school funding model is put in place.

While performing well in reading overall compared with students from other OECD countries the Australian student population exhibits above-average disparities in reading performance (OECD 2004b, p. 171; OECD 2005a, p. 101).

Australia's poor performance in educating disadvantaged children is a blight on our society and a huge lost opportunity for the nation. The reform proposals advanced here are designed to lift the educational performance of disadvantaged young people while maintaining a quality school education for all young Australians.

A new funding model

The Howard government has strongly favoured private schools over government schools.

Let's declare an end to the class war and abandon distinctions between government and private schools for funding purposes. Schools should be funded according to the needs of the child. It is the children who are important, not whether they are attending a government or private school.

Consistent with Labor's election policy, schools with large numbers of children from disadvantaged backgrounds should receive more government funding than those with children from more privileged backgrounds.

Commonwealth and state funding could be coordinated into a collaborative effort in moving to needs-based funding.

A standard amount per student could notionally be allocated regardless of whether the student is attending a government or private school. In accordance with the principle of needs-based funding, the amount would then be adjusted to take account of the private income of the school. Extra funding would be allocated for each student who is disadvantaged – whether because of socio-economic status or physical disability.

Extra funding for each disadvantaged student in government and private schools would be spent on programs such as remedial learning, nutrition, school nurses and securing the best teachers for the most disadvantaged schools.

Skilled Australians living abroad

At a time when Australia is facing acute skill shortages at least 750,000 mostly skilled Australians are living overseas on a long-term or permanent basis. Over the five year period to 2003 Australia appears to have lost about five per cent of its total stock of employed professionals (Birrell *et al* 2004, p. 50).

While it is true that Australia numerically has a net brain gain - with inflows of skilled migrants exceeding outflows of skilled Australians moving overseas - this is not an argument against attracting expatriates home and encouraging them not to leave in the first place. Of course, Australia can benefit from its best and brightest gaining experience overseas. But in the coming decades there will be fierce international competition for the world's pool of creative talent and it will not be good enough for Australia to accept 70,000 departures a year so long as overall there is a net numerical brain gain.

Very little research has been done on policies that could attract talented expatriates back to Australia. Is Australia's relatively high top marginal tax rate cutting in at moderate income levels the key constraint? Or is it a lack of synergies among researchers that are available in major research institutes in Europe and the United States? Does avoidance of HECS debts play any role?

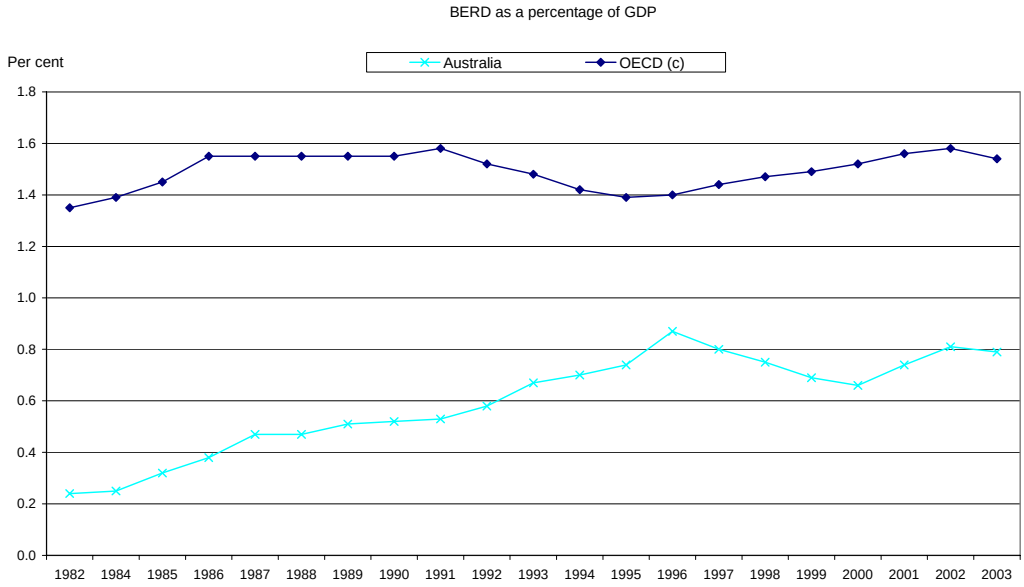
Australia needs a better understanding of the reasons for the loss of such large numbers of skilled Australians before we can develop appropriate policy responses. But the need for that better understanding is urgent if Australia is to maximise its share of the pool of creative talent that will be so fundamental to determining the prosperity of nations in the coming decades.

Encouraging new ideas

The Australian R&D experience

It is clear from the experience of total returns to extra R&D in the order of 60 per cent that Australia is under-investing in R&D (Dowrick 2002, p. 23). Australia's business expenditure on R&D as a share of GDP peaked in 1996 (Figure 2). The gap between Australia and the OECD narrowed consistently from the mid-1980s through the early 1990s. But following the incoming Howard government's cut in the 150 per cent R&D tax concession to 125 per cent, the gap between Australia's business R&D spending and that of the OECD has widened.

Figure 2: Business spending on research and development, 1982-2003



Source: Main Science and Technology Indicators 2003-2, ABS Research and Experimental Development, ABS Cat No. 8104.0
Year to June for Australia, Year to December for OECD.

A broader measure of Australia's R&D effort – a measure of investment in knowledge – aggregates public and private spending on R&D, higher education and computer software. On this measure Australia ranks a poor 14th out of 26 OECD countries surveyed (OECD 2003c, p. 17).

Australia's system of encouraging R&D needs a total overhaul. Following the cut in the R&D tax concession and the lowering of in the company tax rate, the subsidy value of the R&D tax concession has been reduced to such an extent that it appears to be eliciting little or no extra private R&D.[9]

This is not to say that there is no private R&D in Australia; but it is to say that the concession, costing $400 million a year, is mostly a gift from taxpayers to companies that would have undertaken the R&D anyway.

One option is to increase the rate of the R&D tax concession so that it again provides a genuine incentive for R&D spending by businesses.

Another option is to convert the R&D tax concession into government grants.

The tax concession could be cashed out to create a pool of public funds for encouraging private sector R&D. It could be combined with other, smaller R&D programs to create a large Australian Innovation Fund (AIF) of around $3 billion.

In determining the merit of applications for AIF funding, regard should be had for Australia's prospective comparative advantage. Australia's biological diversity is unique and the richest of all the continents. Biotechnology might therefore be an area

[9] Surveys conducted by the Australian Industry Group and the Business Council of Australia point to R&D spending decisions being only marginally related to R&D tax concessions.

of comparative advantage. So, too, might medical research, including research into cures for sun-induced melanoma cancer.

Investing in infrastructure

Critical parts of Australia's infrastructure have been allowed to run down over the last 20 years but most strikingly in the last decade. Inadequate infrastructure is hampering Australian exports. Infrastructure investment has been too small and too reactive.

Extra investment in infrastructure in the right places can be an important source of the much-needed second round of Australian productivity growth.

A national infrastructure plan should be developed that not only responds to existing infrastructure bottlenecks but anticipates future needs and identifies future opportunities to support a bigger, more dispersed population settled in Australia's dynamic regions.

Infrastructure proposals that complied with the plan could be subject to favourable financing and approval conditions. Non-complying infrastructure could still proceed with state and local government approval but would not be eligible for any favourable Commonwealth financial consideration.

Ecological sustainability

An infrastructure plan for Australia supporting a bigger, more dispersed population would need to be ecologically sustainable. Water has rightly been identified as a constraint on Australia's future population growth. Yet three quarters of the continent's water is used in the production of irrigated crops.

Why does Australia produce rice from its scarce water resources when rain tumbles from the sky during the monsoon season to irrigate the paddy fields of Asia?

Crops like rice can be imported cheaply, allowing Australia's water resources to be put to higher uses such as ecological repair and consumption by a larger Australian population.

Proper price signals need to be applied to water consumption to ensure water is allocated to its highest uses including restoring our rivers to health. Trading in water property rights would allow users producing low-value crops to sell their water to higher-value users including governments seeking to improve river flows.

Some might claim that Australia's soil types do not have the carrying capacity needed to sustain a larger population. But the soil types of the Northern Territory's coastal plains replicate those of southern China which has a massively denser population and the soil around regional centres is generally of high quality.

Financing productivity-improving investments

If Australia does not successfully meet the challenge of an ageing population, tax rates would need to rise sharply in the coming decades. Do we really want Australia's working-age population to go on strike, taxed out of any incentive to work? Wise early investment in productivity-raising education, R&D and infrastructure could avert the need for punitive tax increases later.

Federal and state governments have become debt-averse at a time when extra national investment is crucial. The Commonwealth should curtail its consumption spending in favour of investment spending. It should invest budget surpluses in excess of those needed for macroeconomic stabilisation into an intergenerational fund to finance investments whose expected national returns are large and greatly exceed their private returns. Eligible investments would include education and skills development, R&D incentives and support for infrastructure investment that complies with the proposed national infrastructure plan.

Sustaining prosperity

Sustaining Australia's prosperity in the face of an ageing population will require sacrifices now to fund productivity-enhancing investments for the future. Encouraging consumption today through pre-election Budget spending sprees is economically irresponsible and a betrayal of future generations of Australians.

To sustain prosperity Australia desperately needs a second round of productivity growth built on a new economic reform program. The way ahead is to abandon governing for electoral cycles and to invest in the modern sources of productivity growth – skills, ideas and infrastructure - to provide opportunity for all Australians.

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