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Investing in full employment

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Summary

At a time of change, Australians are seeking security. In economic areas, they look back several decades to times of apparent income security, full employment and rising incomes, and seek these for the future.

These good things are in fact available to Australians in the late twentieth century. If they make certain policy choices, they can reasonably aspire to them. The opportunity has been created by economic reform since the mid 1980s. This has lifted Australia's economic performance in most respects in the 1990s, relative to other OECD countries, and relative to Australia in earlier decades.

Australia's performance, however, remains dismal on unemployment. The persistence of high unemployment is the central reason why the community mood has turned against reform before Australia has achieved world class economic performance in all important respects. The correction of the unemployment exception is now our most pressing national economic task.

Income security and progress towards the elimination of unemployment have become pre-conditions for the continuation of economic reform and therefore economic growth.

At the same time, the continuation of economic reform, and the associated higher economic growth, is one of three conditions for sustained progress towards full employment.

The economic growth required for full employment must be driven by unequivocal commitment to open trade and by intolerance towards any obstacles to high productivity growth.

But reform-induced growth alone is not sufficient to reach full employment.

The second condition for the restoration of full employment is the avoidance of extremes of boom and bust, which three times in a quarter century have caused the ratcheting up of unemployment and retreat from policies conducive to high productivity and growth.

The third condition is a high degree of flexibility in terms of employment, alongside income security and adequate incentives for employment. Wage flexibility with full employment can only be achieved if the former is supported by tax and social security reforms, with reductions in effective marginal tax rates, especially at the lower end of the income scale. If this third condition is met, it will in itself have substantial beneficial effects on growth.

The third condition is fiscally demanding. It can only be achieved if there is sustained, reasonably strong growth for a number of years, accompanied by restraint in other areas of government expenditure.

The taxation and social security reform is necessary to provide income security as wage flexibility is introduced to support full employment. Rising employment and economic reform generate economic growth. Economic growth and public expenditure restraint support the necessary tax and social security reform.

The interrelationship between economic reform and growth, full employment and integrated tax and social security reform means that Australia is likely to get a good deal of all three, or little of any one of them.

The rewards to Australia are large if it now commits itself to economic reform, economic growth and full employment. For the next two years, through to late 1999, with no apparent threat to current trends, economic growth would edge upwards to over 4 per cent. Unemployment could be expected to fall to the current non-accelerating-inflation-rate of unemployment (NAIRU), which may be around 7.5 per cent. With tax and social security reform to support a freeze in nominal minimum award wages from some date in the second half of 1999, economic growth would accelerate to over 5 per cent and unemployment fall to a new NAIRU of perhaps 4.5 per cent around 2004–5. Minimum award wages in real terms would fall by about 12 per cent over this period. Average paid wages would rise in real terms, but some categories of low-skill wages are likely to fall by the full extent of the fall in the real value of minimum awards. The tax and social security reform would generate increases in real disposable incomes of low-skill workers, whether previously employed or unemployed, even if their paid wages fell in real terms.

Within the integrated tax and social security system, with a highly restricted form of negative income tax for members of the labour force only, the marginal effective taxation rate on personal income would commence at 47 per cent, and as the fiscal dividend of growth was invested in lower tax rates, by 1 July 2003 would fall to 36 per cent.

After 2004–5, employment growth would ease to around the rate of increase of the work-age population. Economic growth would fall to around 4 per cent. Australia could, if it chose, continue to invest the fiscal dividend of

economic growth in reducing the marginal tax rate to 30 per cent within a full negative income tax system by 2009–10. Or it could ease public expenditure restraint in other areas. It would make these choices as a confident, successful economy and society, providing income security to all of its members, and full employment.

Section 3 discusses how Australia's system of minimum wages inhibits movement to full employment, within current public policy settings. This results from strongly held Australian views of fairness, which make it impossible to obtain community support for major reductions in the disposable incomes of the low-skill employed or of the main categories of social security recipients. There is already a problem of low incentives for social security recipients to move into employment and this would be exacerbated if there were any decline in low-skill wages in the absence of social security reform. If full employment were seen as a centrally important objective—for its social and economic consequences as well as for its role in building support for productivity-raising reforms—then ways would need to be found for making income security consistent with wage flexibility.

The solution is to integrate the tax and social security systems, to turn social security entitlements into tax credits that are paid in cash if not utilised against tax obligations, and to ensure that the integrated system imposes moderate and preferably low marginal effective rates of tax. This is a fiscally demanding reform. It is feasible only in the context of continued economic growth (and therefore of economic reform), and of restraint in other areas of public expenditure as the tax and social security reforms are introduced.

Successful economic reform and growth in Australia lead to and require deeper integration into the international economy and much higher export shares of production. Export growth since the mid 1980s has depended on non-traditional export sectors (manufactures and services) and on markets in East Asian developing economies. Section 6 examines the recent trends and their sustainability, including in the light of recent developments in East Asian financial markets. It discusses an issue that is commonly connected to questions of export growth in popular discussion: will the balance of payments and accumulation of external debt stop growth?

Table 13.1A sets out average rates of growth in economic variables, and Table 13.1B changes in levels in key variables, that would be feasible over the next 13 years, if Australia chose economic reform, economic stability, income security and full employment. The year 2010–11 is taken as the end-point, because that is the year in which Australia is committed within APEC to free trade, and is therefore the year by which all parts of the Australian economy are under notice that, to survive, they must be able to compete in an open

Table 13.1A Base case scenario—real average growth rates for key variables, 1997–98 to 2010–11

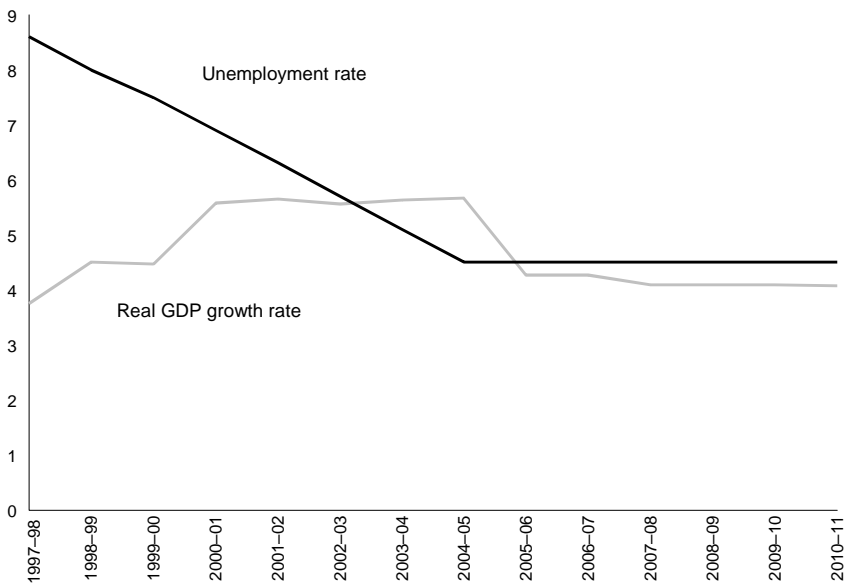
Variable	Average growth rate (per cent per annum, real terms)
GDP	4.8
Population	1.1
GDP per capita	3.6
Population aged 15–64	1.2
Employment	1.9
Aggregate labour input (hours)	2.1
Investment	4.8
Capital stock	3.9
Total factor productivity	2.0

Table 13.1B Base case scenario—changes in levels of other key variables, 1997–98 to 2010–11

Variable	Level 1997–98 (per cent)	Level 2010–11 (per cent)
Current account deficit as a ratio of GDP	3.9	0.3
Net external liabilities as a ratio of GDP	58.9	36.0
Commonwealth underlying budget surplus as a ratio of GDP	-0.7	1.5
Stock of Commonwealth debt as a ratio of GDP	19.3	0
Labour force as a proportion of population aged 15–64	74.4	77.9
Unemployment rate	8.6	4.5
Average hours worked per week	34.5	35.5
Company tax rate	36	30
Maximum marginal income tax rate	47	30
Maximum effective marginal tax rate for social security recipients	100	30

economy. It is also far enough in the future for reforms over the next few years to have had their full effects on investment and productivity growth. The growth numbers in Tables 13.1A and 13.1B are high by the average standards of the past quarter-century, but, as we will see, they are the numbers that emerge from systematically working through the implications of unequivocal commitment to reform and full employment. The growth rates of each of labour, capital and productivity determine total economic growth, and there are good reasons why each of these can be expected to be high by developed country standards over the next decade if Australia chooses the policies that are the premises of the scenario.

Figure 13.1 Base case scenario—projected unemployment rate and real GDP growth rate, 1997–98 to 2010–11 (per cent)



Figures 13.1 and 13.2 outline the anticipated time path of economic growth, unemployment and top marginal tax rates over the projection period.

Different policy choices are likely to generate a much less favourable set of outcomes. It would be possible, if Australians chose a different set of policies, for unemployment to be stuck at levels that are unacceptable to the Australian community; for resistance to economic reform to grow, leading eventually to retreat from reform; for growth to be slower; for the chances of economic instability to be higher; and for the risks of even worse outcomes to be high.

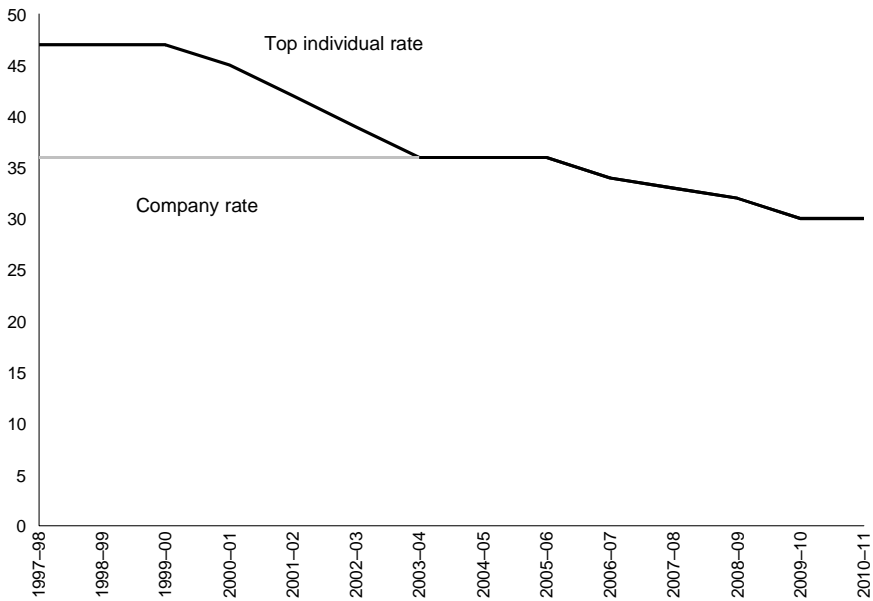
Employment incentives with income security

How tax and social security have grown

The Australian income tax and social security systems have grown separately from each other. Each has undergone frequent change, as *ad hoc* reform has been introduced to deal with particular issues and problems as they arise.

Many Australians think of their social security and tax systems as progressive—as redistributing income from the relatively wealthy to the poor. To some extent the systems have this effect, but mainly through the provision of cash incomes through the social security system, funded through taxation

Figure 13.2 Base case scenario—projected maximum individual and company income tax rates, 1997–98 to 2010–11 (per cent)



Note: Tax only. Ignores effects of social security tapers prior to integration of tax and social security systems in 1999–2000.

on the whole community. The income tax system in practice is less progressive than it looks and tends to become less so over time, with the internationalisation of the professional labour market, and as opportunities are found for avoidance of its effects on high incomes.

The social security system has become increasingly comprehensive, with a relatively small number of Australians outside employment now being denied benefits, and with many people in employment now receiving benefits. The main categories of 'outsiders' are spouses of members of the labour force, and people living from capital income who are excluded by wealth and income tests.

Social security transfer payments have been rising rapidly, to the extent where in 1997 they absorb about AS\$5 for every AS\$7 raised by the personal income tax. There is a long tradition of indexation of social security benefits against consumer price increases. The introduction in the 1997–98 Budget of automatic increases in pensions proportionately to average weekly earnings growth is an important change, leading to rises in real terms as real wages rise. Future cuts in income tax would further narrow the gap between income tax

receipts and social security payments. Australia is approaching the stage where personal income tax and social security transfers together can almost be seen as one system of income redistribution, with one being applied almost entirely to the financing of the other, and together contributing little revenue to finance the general purposes of government.

The social security system in Australia provides a high level of income security to those who would command low or no income in the labour market. In this role, it has underpinned economic reform since the mid 1980s. There would, no doubt, have been stronger resistance to productivity-raising economic reform in Australia if the social security system had been less comprehensive and substantial.

Ad hoc and separate growth and change in social security and tax have led to a total system that is now highly damaging to economic growth and to full employment. Integrated reform of the tax and social security systems is now centrally important to any program to restore full employment and to raise economic growth on a sustained basis.

The marginal tax problem

High marginal income (including capital gains) tax rates at all levels in the income range inhibit productivity growth in Australia.

At higher levels in the range they inhibit personally risky innovation. They reduce the competitiveness of Australia as a base for footloose, high-skill industries. In addition, the divergence between corporate and income tax rates introduces uneven opportunities for avoidance that reduce community respect for the taxation system.

High effective marginal tax rates (EMTRs) at lower incomes inhibit productivity growth, are a major deterrent to labour force participation, and block the labour market deregulation that is necessary for full employment. Here the problem of high effective marginal tax rates derives from the inter-relationship of the tax and social security systems. This inter-relationship generates severe 'poverty traps'. It is a tribute to the foresight and work ethic of Australians that low-skill people enter the labour force at all, since for some millions of Australians the short-term net financial benefits of doing so are small and often negative when the additional costs of going to work (including transport and clothing) are taken into account. High EMTRs also introduce large incentives for tax evasion through employment in the 'black economy'.

Current social security taper rates contribute to high EMTRs, which are sometimes upwards of 90 per cent. The taper rate is the rate at which social security benefits are withdrawn as one's income increases, and when the tax rate applying to this income is added to the taper rate we get the effective

marginal tax rate. Under the environment of high EMTRs, the incentive for unemployed or underemployed people to increase their supply of labour is low.

It is true that there has been recent effort to tighten eligibility for unemployment benefits. Notably, greater importance is now placed on the unemployed person demonstrating that work has been actively sought. Nevertheless, when the incentive to be in employment is low due to a low increment in disposable income combined with costs of employment, the effort to find employment will be affected. Interview preparation, performance and presentation are affected by low incentive to employment.

A gap that is only small between the disposable income of a person who is unemployed, and one who occupies a low-paid job does not encourage good work performance. It fosters another important but often overlooked problem. With the current system, the incentives for good and improving performance are low. The costs for employers by way of increased job turnover and reduced productivity are potentially large.

Reform with income security

We take as a premise what we see as a reality: that there is no willingness in Australia at this time to accept reforms which involve reductions in the disposable income of recipients of major categories of social security transfers, or of relatively lowly paid workers. Reform must be premised on income security. The question is how to increase incentives for employment, and to make room for employment-expanding flexibility for low-skill wages, consistently with this premise?

The answer is through some variation on the theme of negative income tax. The first step towards a negative income tax is to integrate tax and social security into a single system, administered by the one agency. In its most general and simple form, the negative income tax involves provision of a uniform tax credit to every adult in the community, with higher tax credits for people who have responsibility for dependent children. All income is then taxed at a flat marginal tax rate, which translates into a progressive system for average tax rates when account is taken of the tax credits.

Income security is provided by allowing any part of the tax credit that is not absorbed by tax liabilities to be received as a cash payment. The effective marginal tax rate is then the same on all income, whether or not earned by people receiving social security benefits.

A tax credit scheme has large administrative advantages over the existing separate tax and social security systems.

The scheme can be varied to reduce its fiscal cost by denying tax credits to some categories of people. The wealthy might be excluded by an assets test, as with the major categories of social security benefits at present. The full credit could be denied to some spouses of members of the labour force, as with the current unemployment benefit. Fiscal savings through restrictions on the tax credit are achieved at the expense of administrative complexity, the introduction of some opportunities for 'avoidance' of restriction, and the introduction of some disincentive either to saving or to employment. Nevertheless, 'cheaper' versions of the negative income tax system can yield large improvements in economic efficiency over the current system.

Any tax credit system along these lines is expensive to introduce. Once in place, it yields for the public revenue a share of incremental national personal income for the existing population that is high (the marginal tax rate) relative to the existing share (the much lower average rate). Once the system is in place, the fiscal costs of the tax credits rise more or less in line with the population, and the fiscal benefits more rapidly, more or less in line with national income.

The fiscal challenge of the system is therefore the high cost of its introduction. The fiscal costs come immediately, the fiscal benefits come with economic growth over time. Fiscal constraints would require the system to be introduced at high tax rates, which may make it look unattractive. It would look much more attractive if reduction of tax rates were given high fiscal priority, and if the scheme were judged not only on how it looks at the beginning, but on how it evolves over several years of economic growth.

We therefore suggest the introduction of a restricted form of the tax credit system, at effective marginal rates that, while high, are lower for the majority of members of the labour force than those in the current tax and social security systems. If the first step focused on reducing the effective marginal tax rates of recipients of unemployment benefits, it would provide the income security for low-skill workers that would allow reductions in the real levels of minimum award wages without any reduction in disposable income. Once the system has been introduced in this limited form, the high elasticity of revenue with respect to income then allows a combination of reduction of tax rates and expansion of eligibility for tax credits, as the fiscal dividend from economic growth is invested in improvement of the system.

If a tax credit system could be applied in a way that reduced EMTRs for low income workers below 50 per cent in the first instance, the following benefits would be realised

1. The system would provide income security for low-skill workers whatever their earnings in the labour market, and therefore provide a favourable environment for withdrawing or rendering unimportant the role of minimum awards in wage determination.
2. The motivation for people on unemployment benefits to find employment, whether casual, part-time or full-time, would be substantially enhanced.
3. The financial incentive for performing well in employment would increase substantially, leading to important productivity dividends and improvements in labour turnover, as well as upgrading of labour quality and eventually the wage income of the worker.
4. The incentive for black market labour would be significantly diminished.
5. There would be large increases in disposable income for low-paid workers, providing an acceptable context for economically and socially justifiable but politically contentious reductions in the rates of taxation on corporate and middle and higher personal incomes.
6. Being favourable for low income earners, it could be seen as providing compensation for any perceived regressive effects of a value added tax, and would ease politically the task of introducing such a tax.

Tables 13.2A, 13.2B, and 13.2C in the appendix to this chapter show how a tax credit system (where tax credits are allocated to members of the labour force whether employed or unemployed for each adult at the unemployment rate, with additional credits per child equal to benefits to the unemployed under the current social security system) affects disposable income for workers in various circumstances. It demonstrates how the system would compensate even for large reductions in wages.

Dawkins et al. (1997) and others in a recent paper have estimated that a 'revenue neutral' full negative income tax scheme introduced now would require a flat tax rate of 57 per cent. While this would greatly reduce the EMTRs for social security recipients and low income workers, its overall effect on economic efficiency would be dubious at best. It would, in any case, be outside the range of politically acceptable choice. The negative income tax is not feasible now in an unrestricted form.

We suggest a staged introduction of a tax credit system. As a first step, a tax reform package to be implemented in 1999–2000 would integrate the tax and social security systems, and allocate tax credits to members of the labour force (unemployed and employed) at the current unemployment benefit rate. All

A youth, 18, single and independent

Suppose a youth is unemployed and renting accommodation. The unemployment benefits of \$132.35 per week are supplemented by rental assistance of \$37.40, giving a total benefit of \$169.75 per week. Compare this with the situation under which employment is obtained in a typical low-paid position, for example, a shop assistant, or waiter/waitress. The typical minimum rate for a full time 18 year old is \$285 per week which translates to an after tax rate of around \$243 per week. The difference between this and the disposable income of the unemployed is not great considering the sacrifice in leisure time required. This is especially true if the person were to incur typical transport costs of \$15–\$30 per week in getting to and from work. Consider that an additional \$30 per week can be earned without affecting entitlements, with the extra income being subject to tax. One could then pick up a little part-time work and earn an additional \$30 per week to bring disposable income to around \$195 per week. What incentives are there to move from such a situation to full-time employment when the gain in income, net of tax and transport costs, is perhaps \$20 per week? A person working 38 per hours per week is little better off materially than one who works 3–4 hours a week.

Beyond private earnings of \$30 per week, benefits are reduced by 50 cents per dollar earned up to \$70 per week and 70 cents per dollar earned thereafter. After taking into consideration income tax, the effective marginal tax rates become 70 per cent and 90 per cent respectively. Suppose for example, an opportunity arose where a person would work as a casual for, say, a couple of shifts, and earn \$140 per week (the casual rate is around \$8.70 per hour). The increment to disposable income would be just \$43 per week, or around \$2.70 per hour worked, bringing total disposable income to \$213 per week, excluding any transport costs. This translates to an average tax rate of nearly 70 per cent, excluding transport costs.

Whereas there is some incentive for an unemployed 18 year old to work 3–4 hours per week, there is very little incentive to increase labour supply beyond that. Typically, an 18 year old will have only secondary education and little or no work experience, and hence will have low skills. The openings in the workforce are therefore mainly in positions with low skill requirements. It is therefore impossible for Australia to remove high youth unemployment so long as differentials between income in employment and unemployment remain so low, and EMTRs so high.

A single income family with two children, one under 13 the other 13–15

In the event that the principal income earner is unemployed, the entitlement to social security benefits totals around A\$408 per week. Included in this rate are supplements to the basic unemployment benefit allowance in the forms of 'family payment' and parenting allowance'. Now suppose the breadwinner of the family finds full-time low-skill work earning a typical low wage of around A\$400 per week. The family's disposable income would increase to around A\$493 per week – a small differential considering the additional transport and work related costs that must be incurred. The effective marginal tax rate is 79 per cent. There is little incentive to gain experience and on the job skills and to put effort into the work so as to achieve promotion. A semi-skilled person receiving, say, A\$600 per week will see the family's disposable income increase to just A\$505 per week. The increment to income of A\$200 per week provides an increment of just A\$70 per week to family disposable income—an effective marginal tax rate of 65 per cent. These high effective tax rates continue until the breadwinner's income goes well beyond A\$600 per week and so breaks free of the 'poverty trap'.

The black market for labour

The black market for labour in Australia is thriving despite efforts over the years to stamp it out. It is an inevitable consequence of the huge incentives on offer for both the employer and employee. Persons or families receiving unemployment benefits or some other benefits such as Austudy are attracted to the opportunity of avoiding the extremely high EMTRs through cash payments for employment, which is not recorded by the employer. Typically, the employer pays a bit above what would otherwise be the net rate of pay after tax. The benefit for the employer is the ability to pay a substantially lower wage since gross wage payments are avoided, as are other substantial on-costs of labour regulation such as workers compensation, superannuation, payroll tax and training levy. Further, there is the avoidance of administrative costs and other regulation such as unfair dismissal laws. The loss of tax deductions for the business is not a constraint on many small businesses with cash sales, because unrecorded wages can be funded from unrecorded sales.

Black market labour is a mutually beneficial arrangement which thrives because the incentives for both parties are so strong. Most of this is likely to be casual labour, for example, a couple of shifts at a bar or restaurant, driving a taxi, working as a shop assistant, and so on. In developing nations we refer to this type of unrecorded employment as informal labour. Suppose a recipient of unemployment benefits gets a couple of nights 'informal' work in a bar earning a low AS7 an hour. The business gains by substantially reducing, perhaps halving, its labour cost after allowing for on-costs and penalty rates. The worker supplements the benefit income by say AS100 a week. This brings total disposable income to AS270 per week, well in excess of what would normally be available for an 18 year old in full-time (formal) employment. The same applies for our example of Box 2. A couple of shifts would perhaps earn the worker in this case AS150 a week on the black market. The disposable income this would provide for the family of Box 2 would otherwise only be attainable with a full-time job paying around AS570 a week.

other social security payments would be maintained essentially in their present form. If all other Commonwealth Budget expenditures and revenues remained as projected in the 1997–98 Budget papers, and the budget surpluses were held at 0.5 per cent of GDP, a marginal tax rate of 47 per cent would be applied to all income. Other elements of the 1999 tax package, taken together, would need to be revenue neutral.

Minimum award wages would be frozen in nominal terms from the date the new tax and social security arrangements came into effect.

The tax reform package would announce a schedule of reductions in the flat tax rate, as the fiscal dividend from anticipated economic growth was applied rigorously to reductions in marginal tax rates. The growth outlook would support reductions in marginal tax rates to 36 per cent by 2003–4.

After 2003–4, the fiscal dividend would be applied more broadly to the expanded allocation of tax credits, further reductions in tax rates, and if preferred, some easing of general public expenditure restraint. The expansion of eligibility for tax credits could be accompanied by raising the level of the credit for those who for reasons of infirmity (including the aged) or disability

have restricted opportunities to earn income, in the same way that current rates of old age and disability pensions exceed unemployment benefits.

Successful, disciplined commitment to a strategy of raising economic growth performance would support a full negative income tax system with a tax credit at the current unemployment benefit rate for members of the labour force, and higher rates for the aged and disabled, and a basic tax rate of 30 per cent by the end of the first decade of the twenty-first century.

There would be merits of effectiveness of tax administration and incentive to productivity-raising innovation to apply the basic tax rate to all incomes. There would also be advantages in taxation administration in aligning the company tax rate with the basic personal income tax rate. The removal of higher marginal tax rates on higher incomes would be seen by many Australians as providing an unfair windfall gain to the wealthy. In practice, it would have relatively small effects on the after-tax income of the wealthy, who currently avoid high marginal rates of taxation through conversion of personal into corporate incomes, through conversion of other income into capital gains, through negotiation of higher pre-tax incomes, through offshore location (business people in Hong Kong and sports-people in the United States, for example), and through other well-known responses to high tax rates. It is only owners of internationally immobile assets whose particular circumstances prevent conversion of personal into corporate income who earn very high incomes and who pay high tax rates on a large proportion of their income. The imposition of higher marginal rates of tax on higher incomes is therefore largely of symbolic effect, and has relatively small effects on tax paid.

If higher marginal tax rates on higher incomes were judged to be symbolically and therefore politically important, an intermediate position might be to maintain the basic tax rate of 30 per cent for the large majority of Australians, and to introduce a moderately higher rate of tax on very high incomes. In any case, it would be wise to phase in reductions of marginal tax rates on very high incomes more slowly than reductions in the basic income tax rate. The costing of the reform package discussed below is based on a single tax rate of 30 per cent. However, the cost of reform would be only slightly lower if a moderately higher marginal tax rate were retained at very high incomes.

Our own suggestion for the development of the system after 2003–04 would be to move towards a universal tax credit system with a basic income tax rate of 30 per cent applying to at least the great majority of taxpayers, with a single restriction on the allocation of credits. The restriction would be an assets test analogous to that applied to aged pensions for people of 65 years. If the assets test excluded, say, 10 per cent of the fiscal costs of the tax credits, it would

Excellence in administrative efficiency

A side-benefit of integrating the social security and tax systems and providing a tax credit is the simplicity it offers in tax administration and in the delivery of benefits to the unemployed. Consider, for example that we have in place a tax credit system where all eligible members of the labour force receive their credit in fortnightly payments into their bank accounts. Now every dollar that anyone earns in any form of employment will be taxed by the employer at the fixed marginal tax rate and remitted to the Australian Tax Office. There will be no confusion for the employer about what rate of tax to apply. There will be no incentive for people to provide false tax file numbers to employers. The tax office need only focus on checking that employers are fulfilling their obligations of deducting and remitting tax, and of course ensuring that people do not claim more than one tax credit. Interest income could also be taxed and remitted as a matter of course by the savings institutions.

Consider a person who goes in and out of unemployment in the course of the tax year. Under the current system, the tax paid during the year is likely to be very different to the actual tax liability. Under the integrated system, the tax payments will exactly match the liability apart from any work related deductions or non-wage and non-interest income. When the person moves into unemployment, he or she will already be in receipt of the safety net payment. There will be no need to go to the Department of Social Security to apply for income support.

In the early stages of a tax credit scheme, there could be a restriction to members of the labour force (the employed and those actively seeking work), plus those who are unable to work (the aged, people with disabilities), so as to reduce the fiscal demands of its introduction. The restriction to members of the labour force means that there would still need to be a test of willingness to work. Even with expanded fiscal capacity in later years, it may be thought wise to maintain a work test. This would be more effective with the restoration of full employment.

bring forward the date at which the system could be applied in its full but (restricted) form at a rate of 30 per cent to 2007–08. The requirement to declare assets would be thought invidious by some potential recipients of tax credits, as it has been in relation to existing social security benefits. The requirement would be avoided by any individual who chose to make no application for a tax credit. We have not, however, embodied an assets test in our base case scenario.

Growth

Economic growth is at the heart of any program to provide income security with full employment and rising incomes. It provides the fiscal capacity to finance the tax and social security reform which, in turn, reconciles wage flexibility (and therefore full employment) with income security.

The national economic growth rate can be seen as the sum of three components

- The growth in total hours worked (multiplied by the share of wage incomes in GDP).

- The growth in the capital stock (multiplied by the share of capital returns in GDP).
- The growth in total factor productivity (TFP).

The third element, productivity growth, can be measured only as a residual, after taking account of the more directly measurable growth in the stock of labour and capital. But even growth in labour and capital is fuzzy at the boundaries: much human capital is inseparable from the supply of labour. Measured growth in the capital stock is highly sensitive to the rate at which capital is presumed to depreciate or to amortise, which, in turn, is related to the rate of technological change and therefore productivity growth. Nevertheless, the distinction between growth in labour, capital and productivity helps us to understand the sources of growth.

Total factor productivity growth can be seen as having two separate origins. One is the more productive use of capital and labour within each industry. The other is the shift of resources from less to more productive industries. The standard statistical measures lump these together.

Growth in GDP per head of population can be seen as deriving from

- (a) an increase in the number of hours worked per head of population, which, in turn, can come from an increase in the proportion of the population in employment or from an increase in the number of hours worked on average by each employed person.
- (b) an increase in the capital stock relative to the number of hours worked
- (c) an increase in total factor productivity.

The good news is that after a long period of trailing below other developed countries, Australia's per capita GDP growth in the 1990s is well above that of its peers.

Australian productivity growth in the 1990s is well above OECD average levels after two decades below, and the trend rate in recent years has been high by the standards of the two preceding decades.

The recent lift in relative and absolute levels of total factor productivity (TFP) growth is most plausibly attributable to the internationalisation of the economy, intensification of competition and microeconomic reform from the mid 1980s. The lags between policy reform and increases in productivity in the real economy are long in Australia, as they have proven to be in other countries. This means that loss of momentum in reform in the mid 1990s would be reflected in slower productivity growth into the next decade.

Improved relative growth performance has been accompanied by lower relative inflation.

Australia's improved relative performance in the 1990s on each of GDP growth, TFP growth and inflation is much more pronounced for the last few years than for the early 1990s.

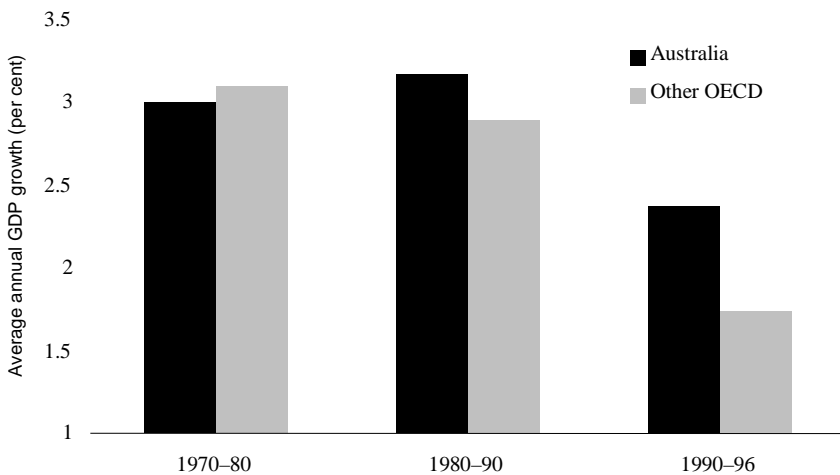
The very low inflation of recent times has been bought at high cost in terms of foregone investment and output. Real interest rates (and therefore the real exchange rate) have had to be held exceptionally high over a long period, as the Reserve Bank established its anti-inflationary credentials and low inflationary expectations were entrenched in the community.

That credibility and those expectations are now a considerable asset for economic growth. They have made some easing of monetary conditions (which remain firm in real terms in late 1997 (see figure 8.7)) consistent with continued low inflation.

One of the ways in which the return to expectations of low inflation has helped economic growth is through the lowering of long-term interest rates to good international levels (Figure 13.8).

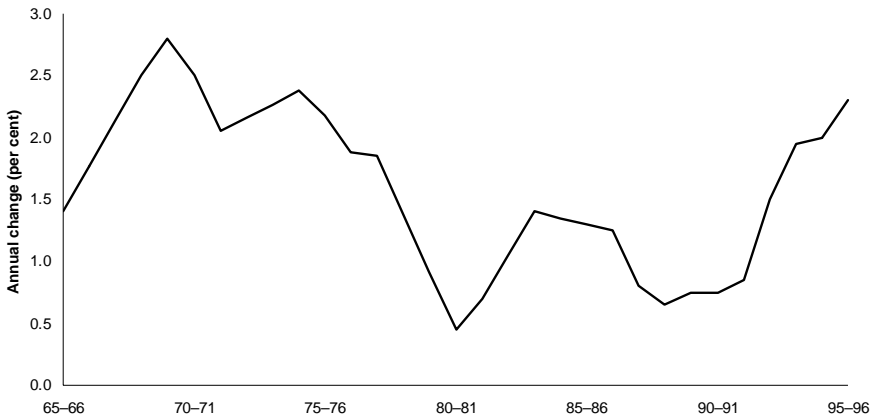
Growth in both private and total investment has been reasonably strong in response to favourable macroeconomic conditions and increases in productivity.

Figure 13.3 Relative growth better in 1990s



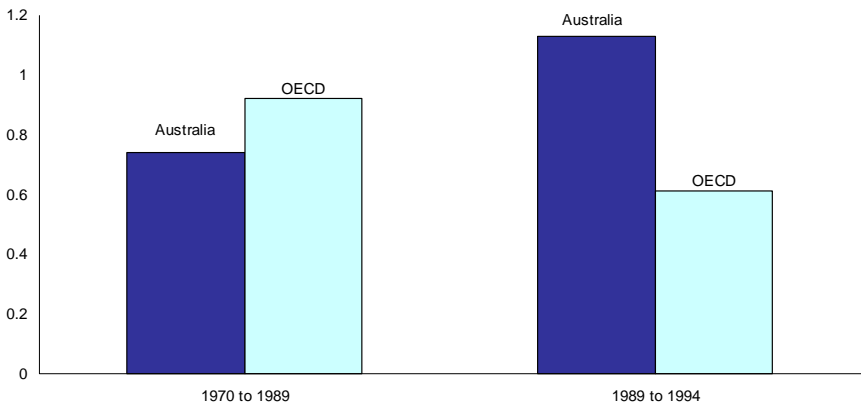
Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

Figure 13.4 Annual change in trend multifactor productivity, 1964–65 to 1995–96 (per cent)



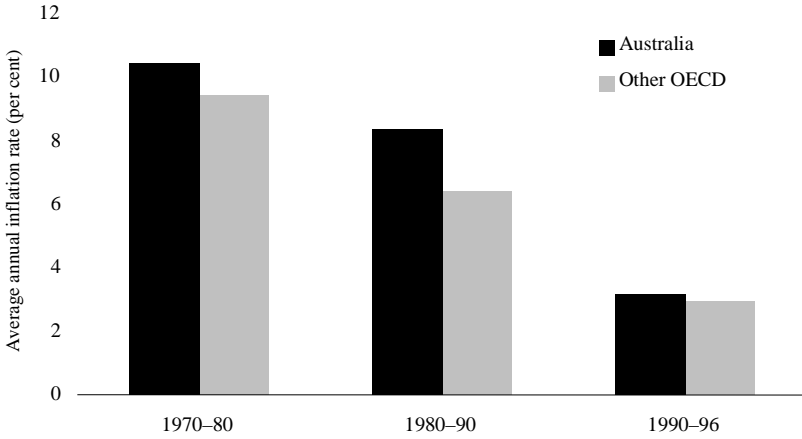
Source: Industry Commission, 1997. *Assessing Australia's Productivity Performance*, AGPS, Canberra: Figure 2.

Figure 13.5 Australia's comparative productivity growth rates, 1970 to 1994 (per cent)



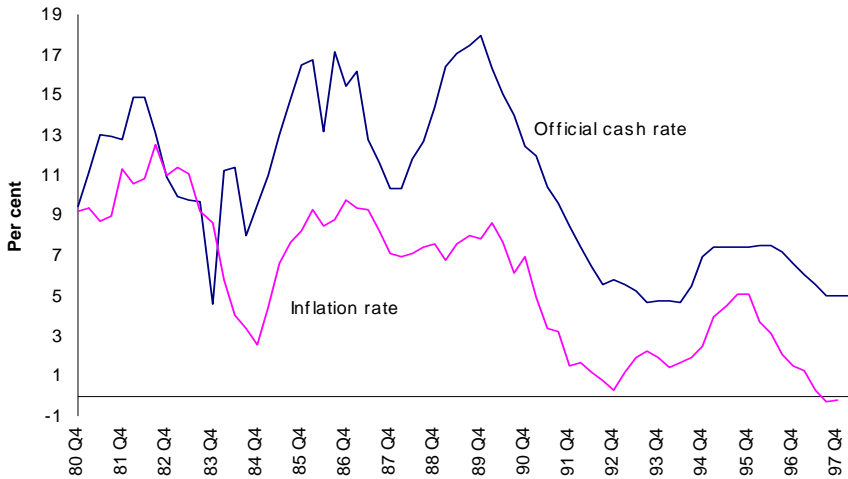
Source: Industry Commission, 1997. *Assessing Australia's Productivity Performance*, AGPS, Canberra: Figure 3.

Figure 13.6 Inflation back with the pack

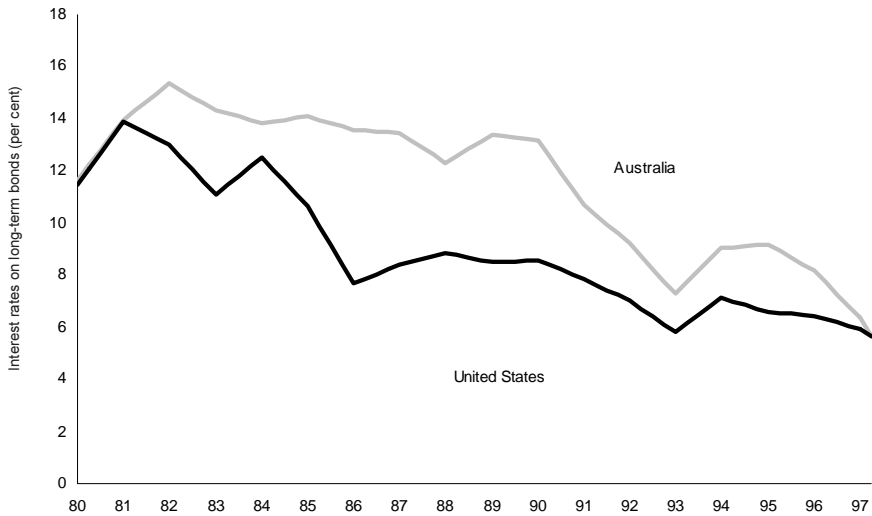


Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

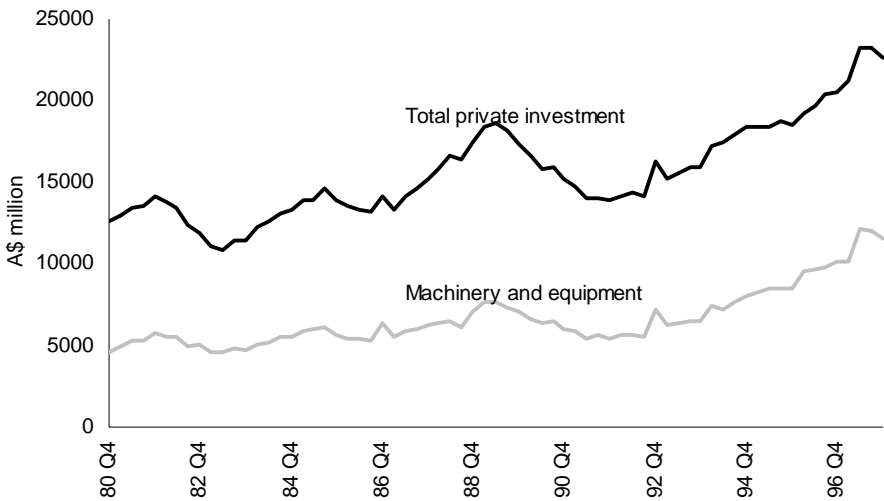
Figure 13.7 Low inflation holds up real interest rates



Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

Figure 13.8 Competitive finance

Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

Figure 13.9 Private gross capital formation (1989–90 prices)

Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

The various factors that have led to recent lifts in both investment and total factor productivity growth in Australia, have laid a base for better growth performance in the years ahead. We will now look more systematically at what we might expect in the way of growth in labour inputs (numbers employed and hours per worker), the capital stock (through investment) and productivity, with a view to assessing what good policy might deliver in the way of economic growth over the next decade or so.

Labour force and employment growth

Australian growth in total and especially work-age population is high by OECD standards. This follows from Australia's substantial immigration program, which slows ageing at the same time as it raises population growth.

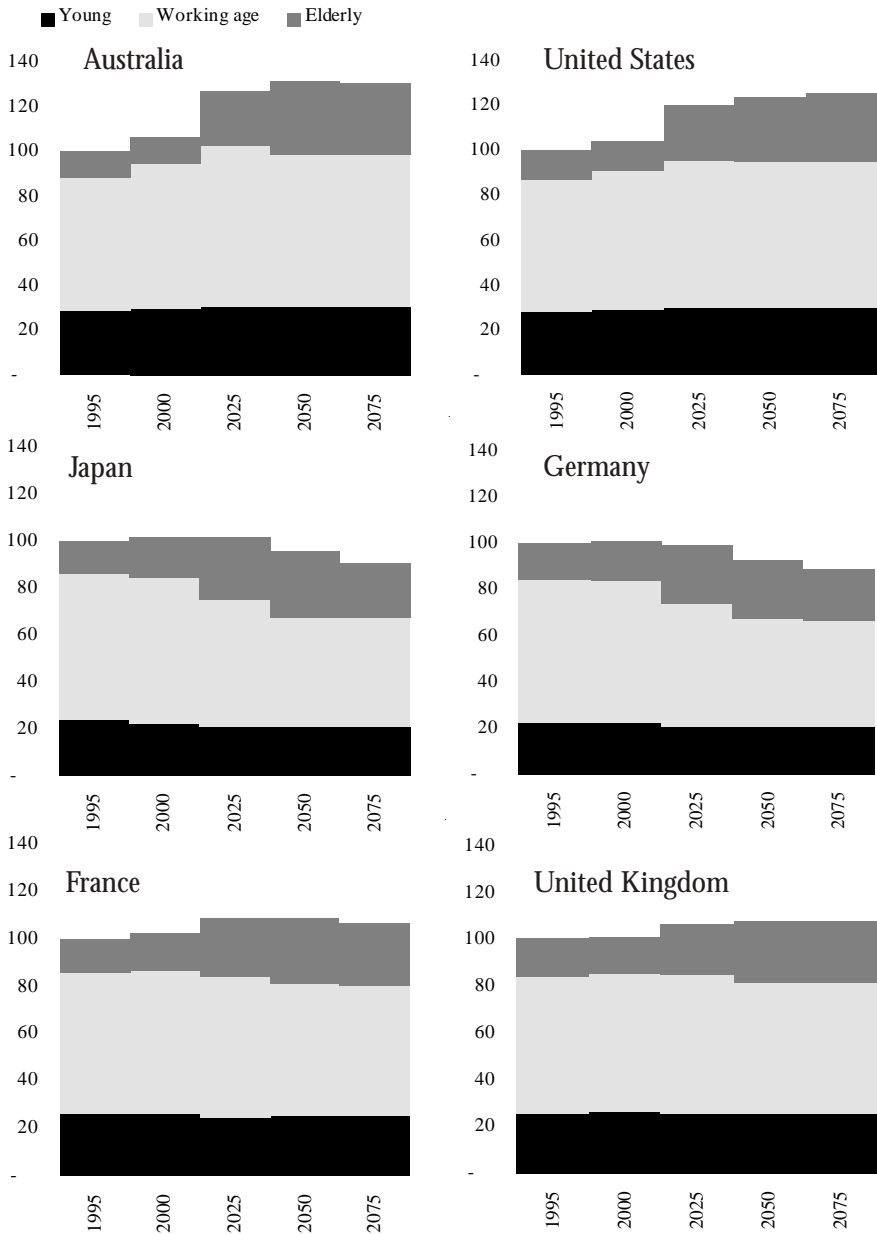
Immigration therefore has important direct implications for economic growth, through its effect in raising potential labour force growth.

In this era of low fertility in the high-income economies, immigration also has longer term, less easily identified, but in our view powerful effects on economic growth. Absolute population decline and rapid ageing are the dominant demographic prospects into the next century of those developed countries without substantial immigration. This is a prospect of falling economic ambition, structural rigidity, declining innovation, slow adoption of new technologies, and increasing social security demands on the public finances. We have begun to see in the 1990s the emergence of a gap that will become much wider in the twenty-first century—a gap between countries of immigration and other developed countries—a gap in capacity for innovation and structural change and therefore for economic growth. The younger and growing populations of the countries of immigration contribute to productivity growth and therefore to investment. In Australia's case, the stronger emphasis on economically valuable characteristics of migrants in recent times will have increased immigration's contribution to economic growth.

The differences between growth and the rate of ageing of the population in the countries of immigration, and in other developed countries, are very large. Work-age population is expected to rise through the first half of the next century in Australia and the United States, and to fall dramatically in Japan and Germany (Figure 13.10). One implication is, on the assumption that current retirement incomes policies are retained, large increases in the fiscal demands of old-age pensions in many of the developed countries that have low levels of immigration.

The ways in which ageing and population decline reduce capacity to absorb innovation and structural change are more difficult to demonstrate statistically, but probably more powerful. Important though the indirect and longer term

Figures 13.10 Growing old slowly and not dying out (total population, 1985=100)



Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

implications of immigration for economic growth may be, the focus here is on the direct and measureable effects on the size of the work-age population and therefore on the potential labour force.

Australia in 1997 is going through one of its occasional retreats from immigration. If it persists for long, it would have significantly adverse effects on economic growth. Such retreats have tended to follow periods of high unemployment.

Australia's economic prospects and choices will be better if rates of net immigration rise to at least the average levels (100,000 per annum) of the past decade. We expect that that would be acceptable to the community in the context of rapid employment growth and explicit commitment to the restoration of full employment. On the basis of average net immigration to 2010–11 at the levels of the past decade, Australia will continue to experience an increase in work-age population (1.2 per cent per annum) slightly in excess of total population (1.1 per cent per annum) over the next decade. This is rare in OECD countries, and in stark contrast to those high-income countries that do not allow substantial net immigration.

The amount of labour contributing to economic output is determined by the work-age population, the proportion of the work-age population in the labour force, the proportion of the labour force that is respectively employed and unemployed, and the number of hours worked per employed person. The second, third and fourth of these variables would each be changed in ways that are favourable to growth by the full employment strategy proposed in this chapter.

The integrated tax and social security reform accompanied by lower effective marginal tax rates can be expected substantially to increase the size of the labour force and the hours of work sought by each member of the labour force. By how much?

This is unknown territory. But we see no reason why, with adequate incentives, the proportion of work-age Australians in the labour force should be lower than the proportion in the United States. The US proportion is held down by a higher prison and criminal population, and a proportionately larger 'underclass' that is poorly socialised to regular employment. The Australian proportion may be held down by more generous social security payments to people outside employment, even with the large reductions in EMTRs that are proposed here. Our projections are based on the presumption that the proportion of the Australian work-age population in the labour force will rise to the US level over the years in which Australia returns to full employment.

This presumption means that about as many new jobs will be necessary to provide for the increase in labour force participation as to reduce unemployment. With unemployment falling to 4.5 per cent, the employed labour force increases by 2.2 million to 2010–11, of which 0.45 million is required to cover each of the increase in labour force participation and the reduction in unemployment. The balance is required to cover the increase in work-age population. About two fifths of the labour contribution to economic growth in this period derives from the movement to full employment.

In fact, the proportionate contribution may turn out to be a bit more than two-fifths. Contemporary unemployment partly takes the form of employed people working fewer hours than they would prefer. Average weekly hours at present (34.5) are 11–12 per cent lower than in the full employment years of the late 1960s. Part of the reduction in hours worked over the past 3 decades undoubtedly represents changing preferences, so only part of the difference would be restored with a return to full employment. We have anticipated restoration of 1 hour per week of the 4.5 hours reduction since the late 1960s.

These three mechanisms—falling unemployment, rising labour force participation and increasing hours worked—lift the average increase in labour's contribution to output from 1.2 per cent to 2.1 per cent per annum over the 13 year period.

This arithmetic shows that labour will be available to support expansion of employment at a high rate. Will labour demand meet this availability?

Moderate economic growth alone without support from integrated tax, social security and wage reform, would generate some expansion of the labour force and reduction of unemployment. But it is unlikely that unemployment would fall by more than a percentage point or so below current high levels in the absence of far-reaching reforms in these other areas. Provided moderate rates of economic growth are maintained, unemployment rates over the long run are determined mainly by two factors: the extent of wage flexibility in response to changes in labour market conditions; and the relationship between (relatively low-skill) wages and social security payments.

Much has been made recently of the low unemployment in the United States, and to a lesser extent the United Kingdom, relative to continental Western Europe. Divergent performance derives from differences in labour market and social security systems.

It is commonly said in Australia that low unemployment in the United States is not worth the price of wide dispersion of wage incomes, and relatively parsimonious unemployment benefits. Certainly economic reform has to take account of Australian distaste for change which would have the effect of lowering

disposable incomes of the employed or recipients of social security. The proposals for integrated tax and social security reform outlined in this chapter are designed to make labour market deregulation and the restoration of incentives for (low-skill) employment socially and politically acceptable in Australia.

What would be the lowest rate of unemployment in these circumstances that could be sustained without bottlenecks in higher-skill categories of labour and accelerating inflation (the NAIRU)?

The United States is a useful benchmark. There, unemployment is now below 5 per cent, similar to the 1950s and 1960s. The comparative experience of Australia in the 1950s and 1960s (when unemployment was typically around 2 per cent), and the relatively low incidence in Australia of socially and educationally deprived members of an underclass, both argue that Australia could do as well or better on unemployment than the United States if there were a favourable policy environment. A reduction to 4.5 per cent would seem to be within reach. This is our estimate of Australia's NAIRU after the proposed reforms to tax, social security and regulated minimum wages.

Wage flexibility in the context of income security provides the mechanism for matching labour demand and availability. Average wages in real terms can be expected to rise with capital intensification and growth in total factor productivity. Wage flexibility is likely to be important in the relatively low part of the skill range, where the unemployed are overwhelmingly concentrated.

How much would real wages of low-skill workers need to fall to generate full employment? Recent debate has suggested that a fall of 10 per cent in the real level of minimum wages would reduce unemployment by 2 to 3 percentage points. We have suggested freezing minimum awards in 1999–2000, the year of introduction of the income security package of integrated tax and social security reform.

With other wages rising with economic growth through subsequent years, *relative* minimum awards would fall at a rate higher than the inflation rate. There are long lags in labour market responses to changes in relative wages, but it seems likely that, if the wage restraint were maintained, general unemployment would have become unimportant by about 2005–06. By this time, real minimum awards would be 11–12 per cent lower than at present. A fall in low-skill wages to this extent, or much further, is consistent with a substantial increase in the disposable income of the low-skill employed within the income security package proposed in this chapter. It is possible that the restoration of full employment could take longer, with a larger downward adjustment in the real value of minimum awards. The tax and social security package would provide income security in these circumstances.

The extent of the fall in real wages for low-skill workers that is necessary for full employment depends on any developments that change the proportion of low-skill people in the labour force.

The larger, more effective and more widespread the public and private investment in education that contributes to value in the labour market, the less the number of low-skill workers that need to be placed in employment, and the less the decline in low-skill wages that is necessary for full employment. In addition, there is a continuing and valuable role for training and transitional employment programs targeted on people who would otherwise command the lowest wages in an unconstrained marketplace. The long-term unemployed, especially, require targeted training. Labour market programs with such focus are a valuable complement to the full employment program.

Stronger focus on economically valuable skills in the immigration program in recent times also reduces the extent of downward wage adjustment that is necessary on the path to full employment.

The extent of the fall in real wages for low-skill workers also depends on the character of the expanding industries. There has been a worldwide tendency over the past quarter century, especially in the developed countries, for the balance of demand for labour to shift towards relatively high skills. This is likely to continue to be the general tendency in Australia as elsewhere.

In many developed countries, including Australia, there is a concern that trade liberalisation and expansion of trade with developing countries has shifted the balance of demand away from unskilled labour. Particular attention is given to the expansion of imports from developing countries of such labour-intensive manufactured goods as textiles, clothing and footwear.

The international evidence is that changes in trade patterns along these lines have been small in their effects on demand for and wages of unskilled labour, relative to technological and other economic changes. In Australia's case there are other factors which swamp the effects of expanding imports of labour-intensive manufacturers on demand for unskilled labour.

In Australia, trade expansion associated with the internationalisation of the economy has involved large increases in exports of services, many of which utilise unskilled labour intensively. In Australia, the most important category of imports of labour-intensive goods from developing countries is textiles, clothing and footwear. In the decade after 1985, Australian net imports of clothing and footwear increased by A\$600 million. If the whole of the increase in net imports had instead been supplied domestically, the direct and indirect increase in unemployment would have amounted to 25,000 jobs. It happens that over this same period there was an increase in net exports of textiles of

A\$813 million, 'embodying' directly and indirectly 26,000 jobs. The expansion of trade in textiles and clothing was small compared with the increase in exports of travel services of A\$5,799 million, embodying 215,000 jobs, which was facilitated by the general internationalisation, reform and increased East Asian focus of the Australian economy. The 'travel services' jobs are mostly in tourism, and education. A substantial proportion of the increase in jobs in the travel services industries embodies relatively unskilled labour in accommodation, restaurants and related activities.

It is not at all clear that the direct and indirect effects of trade liberalisation and expansion in Australia have been in the direction of reducing demand for low-skill labour. A focus on growth in imports of a few labour-intensive manufactured goods gives a highly distorted impression.

Investment growth

The strong increase in business investment in recent years has lifted the investment share of GDP to a level which, if sustained, would support growth in the capital stock at a rate (3.9 per annum) substantially in excess of the increase in total hours worked, even in the years in which unemployed and discouraged labour were being absorbed. It would, therefore, support capital intensification of production, which would contribute to rising productivity levels and average incomes.

The rate of investment is sensitive to a range of factors that will be provided or encouraged by the program of economic reform, growth and full employment.

Investment is encouraged by economic stability, including low inflation and the low interest rates that accompany it. Higher productivity increases incentives for investment in expansion of Australia's most productive export-oriented plants and industries. Rapid expansion of domestic demand provides a favourable environment for industries supplying domestic markets. More stable immigration policies and a return to historically more normal levels, would be favourable for investment in dwellings and related industries.

The reform in the Australian tax system proposed here, and especially the reductions in marginal tax rates after 1999–2000, will become more favourable to investment in knowledge-intensive industries near the frontier of world productivity, which make heavy use of internationally mobile labour. These industries will need to expand disproportionately in the high growth economy that emerges from the full employment strategy. The proposed reduction in the corporate tax rate from 36 to 30 per cent is a long way in the future, commencing after 2003–04. But as it occurs, it will improve Australia's competitiveness as a destination for direct foreign investment.

Amongst the various proposals for reform to raise productivity, one has received much recent attention recently in Australia: a proposal to establish free trade areas to attract investment in export-oriented industries. It is true that there are important advantages in operating in a free trade environment, with access to the world's best inputs into production at international prices without transactions costs being artificially inflated by border taxes and red tape. The reform program that we are suggesting, as discussed below, envisages making these advantages available to the whole economy, with the goal of providing the whole of Australia with a free trade environment by 2010–11.

Not all industries will expand with economic reforms. Average wages and the real exchange rate will tend to rise with sustained high growth, especially after the return to full employment. The more productive plants, firms and industries will expand at the expense of the less. Growth and structural change will be associated with increased export orientation and greater specialisation in production, accompanied by rising imports for products and components the Australian-based suppliers of which are unable to meet the competition for resources in a fully employed economy.

The program of economic reform and full employment is the main incentive to the investment necessary to achieve the program's objectives. Is anything more required to underpin the necessary rates of investment?

We suggest that consideration be given to three such measures, beyond the general productivity-raising reforms.

First, there are external economies in the pioneering provision of some infrastructure, so that government support in some form is necessary if optimal levels of investment are to occur. This will mainly be important in new industrial locations, or in new transport and communications linkages. The existence of benefits to the general economy, beyond the reach of the private investor, would need to be demonstrated by disciplined analysis independently of the political process. Where infrastructure expenditure meets this test, there is a case for government support in some form—with identifiable benefits to private entities being recouped with some form of user charge.

Externalities of this kind are likely to be most important early in the life of an industrial, transport or communications centre. There would usually be opportunities for privatising government participation once a facility had achieved a high level of use. Funding for investment along these lines could come from proceeds of privatisation of earlier public infrastructure investments beyond those absorbed into current Commonwealth forward Budget estimates, to avoid entanglement with the other objectives of fiscal policy.

Second, Australia is separated by high transactions costs from the world's main sources of venture capital in the United States. This is an impediment to

Australian firms seeking to expand production in Australia on the basis of new technology and ideas. Paradoxically, the maintenance of the identity and the expansion of small Australian firms with commercially sound ideas would be facilitated by seeking deliberately to integrate our own financial markets more deeply into those of the United States. What is required is systematic examination of our regulatory and taxation arrangements affecting the supply of venture capital, with a view to harmonisation with the United States on all issues on which there is no clear and economically valuable purpose in differentiation.

Third, there is a potential problem for the timing of investment in a phased reform program announced well in advance. The announcement that more favourable investment conditions will become available at a later date may delay some investment. For example, an export-oriented investment facing high taxes on inputs in the current system, may find it expedient to await a value added tax which is due to be introduced on an announced date, so as to become eligible for rebates of taxes on inputs. In the early years of the proposed reform program, there may be a case for government to establish mechanisms which bring forward access to some specified future benefits of reform, where there is a clear danger of disruption to the economically efficient timing of investment.

There is some concern in Australia that internationalisation of the economy over the past decade has been associated with the downgrading of Australian enterprises to branch office status. If this were to go very far, it would have adverse economic effects, including on the quality of the business contribution to the national policy debate.

Australia as a branch office economy is a potential problem without a specific solution. Australian firms' direct investment abroad since the removal of exchange controls in 1983 has made Australia the international headquarters for some important multinational companies. Continued and greater success in this area would be a helpful counterweight to the opposite tendency. World's best costs and practices in international communications and civil aviation—and reform has not yet got us to this point—would reduce the disadvantages of Australia's geography for location in Australia of headquarters of international companies.

Success in domestic economic reform and growth will cause firms with large operations in Australia to expand and to prosper disproportionately. These will tend to be Australian-owned and Australian-based companies to an exceptional degree. Success in reform and growth is therefore an important encouragement to firms with headquarters in Australia, assisting resistance to the downgrading of Australia to a branch office economy.

Total factor productivity growth

The recent improvement in Australia's total factor productivity growth has transformed Australia's economic choices. The current trend rate of 2.3 per cent per annum is almost three times the rate of growth recorded in the mid-to-late 1980s, and well above the average over the past three decades of 1.5 per cent a year.

The main cause of the lift in Australia's productivity growth has been the microeconomic reform implemented in Australia from the late 1980s. The primary impetus for reform has come from the increasing international orientation of the Australian economy since the mid 1980s, a process begun by the floating of the currency and financial market deregulation, and cemented by the phased reduction in tariffs and other trade barriers.

The abolition of exchange controls in December 1983 opened the way to internationalisation of Australian companies' operations and rapid expansion of Australian direct investment abroad. Trade liberalisation has brought intensified international competition, and changed incentives in a way that has spurred a large increase in the export share of manufactures and services production. These two developments have focussed the attentions of firms in the tradable sector of the economy on achievement of world's best practice—in their own operations, and also in the business and policy environments in which they operate in Australia. Amongst much else, it has made Australian business less tolerant of inefficiencies in infrastructure services and the labour market. This has helped to build momentum for reform on a broad front, most of which has yet to be reflected fully in improved productivity. Significant gains are apparent in telecommunications (with prices falling significantly following the introduction of competition), aviation (with deregulation being followed by a reduction in average airfares of around one-fifth), electricity (with real average electricity prices falling by 13 per cent between 1988 and 1995), and the performance of government business enterprises (Productivity Commission 1996). But these gains leave Australia well short of best practice in most areas.

A number of recent studies have estimated the benefits of further microeconomic reform in Australia (Business Council of Australia 1994; Industry Commission 1990, 1995; Filmer and Dao 1994). They suggest that significant long-term gains in GDP are likely to flow from broad ranging microeconomic reform. While individual reforms do not produce large gains, a combination of reforms on a broad front does. A broadly based reform program is likely to involve lower adjustment costs than piecemeal reform because losses accruing to particular industries and firms from some reforms will tend to be offset by gains from others.

These studies refer cover different rates of possible reforms, from different starting points. They all indicate that broad-ranging reform leads to an expansion of all sectors in the economy (although some industries within those sectors may decline).

The reforms implemented to date provide a solid foundation for continued total factor productivity growth rates near the current trend level over the next decade. As a result of the lag with which productivity growth responds, reforms that have already been implemented will continue to yield dividends over the next few years. Sustaining productivity growth at the current trend level will, however, require further reform on a broad front.

The internationalisation of the economy remains the main driving force for future productivity growth. For that reason, any stalling or retreat on the commitment to complete free trade within a reasonable timeframe (2010) would be damaging.

Beyond the continuation of the liberalisation of international trade, the opportunities for further substantial gains from reform are probably greatest in the areas of industrial relations, the implementation of the national competition policy, and taxation. Reforms to education and training and government expenditure can also make large contributions.

Most important of all to building an Australia with income security, full employment and rising incomes is a general attitude of support for change in policy or institutional arrangements whenever there is an opportunity to raise productivity. This can provide an offset to the resistance by special interests that inevitably accompanies any particular reform step. The objective must be to focus attention on the large and widespread benefits that would accompany realisation of the whole vision.

Taxation reform

Reform of Australia's taxation system offers considerable scope for raising productivity. The gains from the implementation of a broad based consumption tax stem from an improved allocation of resources as the indirect tax system becomes more neutral in its impact on economic decisions, with a lower average tax rate spread over a broader range of taxable items. Gains from replacement of the wholesale sales tax alone would be considerable. The Business Council of Australia (1994) estimated that replacing a range of indirect taxes levied by three levels of government with a broad based consumption tax could result in an eventual permanent increase in real GDP of 1.9 per cent.

In addition to indirect tax reform, lowering marginal income tax rates, as proposed in this paper is likely to have an important positive impact on productivity growth. The key mechanisms will be a greater incentive for

individuals and firms to invest in innovation and a greater incentive for people to invest in further education and skills upgrading. There are opportunities for considerable gain from revenue-neutral reform of income tax beyond the rate reductions (already considered), including from earlier rate reductions financed by reducing opportunities for avoidance.

There is currently a great deal of caution about the rate at which a comprehensive value added tax (VAT) could be introduced in Australia. On productivity grounds, it would be desirable to replace a wide range of Commonwealth and State indirect taxes with a VAT. If this occurred, the overwhelming proportion of revenue collected from governments would come from two relatively efficient sources—a flat rate income tax within a progressive, highly integrated tax–social security system; and the VAT. The inclusion of the social security reform in the tax package may raise the ambition that can be held for indirect tax reform at that time.

Economic growth from economic reform

A feasible growth scenario

To illustrate the possibilities offered by an economic strategy focused on macroeconomic stability, continued productivity-raising reforms and a progressive integration of the social security and tax systems, we have developed a feasible growth scenario for the period 1997–98 to 2010–11.

The scenario is based on plausible assumptions about labour, capital and total factor productivity growth, the growth of government outlays and revenue, and the path of private savings. These assumptions are brought together in a consistent framework which comprises a simple (Cobb-Douglas) aggregate production function for the Australian economy and linked modules.

The base case scenario is the main reference point for the discussion in in this chapter. In the Appendix, we develop a second scenario requested by the Business Council, embodying a significantly higher rate of net migration to Australia.

Base case scenario

The 4.8 per cent average growth rate of real GDP is underpinned by consistent 2 per cent per annum growth in total factor productivity, average capital input (real net capital stock) growth of 3.9 per cent and average labour input (aggregate hours worked) growth of 2.1 per cent per annum.²

The assumed total factor productivity growth rate is consistent with (a bit below) the current trend rate in Australia. It is judged to be sustainable through to 2010 with continued implementation of productivity raising policy reform.

The capital stock growth rate is driven by real investment growth at the same rate as real GDP. This rate of investment growth is supported by a steadily increasing rate of return to capital flowing from the growth in total factor productivity.

Labour input growth is driven by four factors: average growth in the working age population (15–64) of 1.2 per cent per annum; an increase in the proportion of people participating in the labour force, a decline in the unemployment rate; and a slight increase in average hours worked per week. An important assumption underlying the rate of growth of the working age population is that net migration continues at the same level as the average over the past decade (100,000 net inflow each year). The key factors supporting growth in hours worked are labour market responses to productivity-driven economic growth and the labour market tax and social security reforms outlined in the paper.

The scenario is constructed around a phased reform process. There are three main phases in the scenario.

Phase I: From 1997–98 to 1999–2000, GDP grows at a respectable 4.5 per cent per annum in real terms, underpinned by total factor productivity growth spurred by microeconomic reform (including past and ongoing tariff reductions). On 1 January 2000, the first step is taken to integrate the tax and social security systems. This is facilitated by a fiscal dividend flowing from strong revenue growth (in line with GDP growth) and outlays restraint (as embodied in the 1997–98 Commonwealth Budget papers) in the first three-and-a-half years of the projection period. This first step of the tax-social security reform process involves

- providing a non-means tested tax credit (equal to the unemployment benefit) to the unemployed and to all those in paid employment
- providing a non-means tested family tax credit for all people with dependent children (replacing family payments and family tax initiative)
- providing means (income and assets) tested tax credits equal to the level of existing benefits for all other social security recipients (for example, age pensioners, disability pensioners etc.)
- introducing a flat rate income tax on all income of 47 per cent.

This initial tax reform is strongly progressive (people in the top decile of the income distribution lose an average of A\$56.60 per week in disposable income, while those in the bottom decile gain an average of A\$38.60 per week). This facilitates community acceptance of a freeze in nominal wages at the

bottom end of the wages spectrum (the so-called 'wages safety net'). As part of the labour market reform that is necessary to reduce unemployment, nominal minimum wages (as defined by the safety net) are frozen until full employment has been achieved (in this scenario, 2005–6).

The progressivity of the income tax–social security changes also means that this reform is helpful to community acceptance of the simultaneous replacement of the existing range of Commonwealth and State/Territory indirect taxes with a more efficient, comprehensive value added tax.

Phase 2: With inflation averaging 2.5 per cent a year (the mid point of the RBA's target range), the nominal wages freeze results in minimum wages falling by 11.25 per cent in real terms. Together with a continued high rate of labour productivity growth (brought on by strong investment and ongoing total factor productivity growth), this real wage reduction feeds into growth in demand for unskilled labour and a reduction in the unemployment rate from 7.5 per cent in 1999–2000 to 4.5 per cent in 2004–05.

Continued outlays restraint and robust taxation revenue growth from strong GDP growth yields an annual fiscal dividend. This fiscal dividend is invested in reducing marginal individual income tax rates. The flat rate income tax rate is reduced to

- 45 per cent on 1 July 2000
- 42 percent on 1 July 2001
- 39 per cent on 1 July 2002
- 36 per cent on 1 July 2003.

As a result of these marginal income tax reductions in an environment of rising employment and falling unemployment, labour force participation rises significantly with the ratio of the labour force to the population aged 15–64 rising from 74.4 per cent in 1999–2000 to 77.9 per cent in 2004–5. Average hours worked per week also increase somewhat in response to the added incentive offered by lower marginal tax rates, from 34.5 in 1999–2000 to 35.5 in 2004–5. Together with the rapid reduction in unemployment, these factors drive the growth rate of real GDP up to an average of 5.6 per cent per annum between 2000–1 and 2004–5.

Phase 3: Between 2005–6 and 2010–11, the annual rate of growth of real GDP gradually slows to 4.1 per cent, reflecting slower labour input growth as the participation, hours worked and lower unemployment effects taper out. The continuing real GDP growth rate of over 4 per cent per annum depends on continuation of high productivity growth. The latter is supported by further tax reform, with a full non-means tested negative income tax being introduced on 1 July 2005, with a tax credit equal to the most generous social security benefit being paid to all adults and a universal family tax credit accruing to all

people with dependent children. The initial flat income tax rate is kept at 36 per cent. However, as further fiscal dividends accrue from restrained outlays and strong growth, this flat income tax rate is reduced progressively to

- 34 per cent on 1 July 2006
- 33 per cent on 1 July 2007
- 32 per cent on 1 July 2008
- 30 per cent on 1 July 2000.

The company tax rate is reduced in tandem with the individual income tax rate.

Fiscal assumptions underlying scenario

Commonwealth Government fiscal policy is projected to support stable economic growth and to make room for the integration of the social security and income tax systems. The Commonwealth budget balance is projected to move to an underlying surplus of 0.7 per cent of GDP in 1999–2000 and to remain at above 0.5 per cent of GDP for the remainder of the projection period.

Commonwealth outlays (apart from public debt interest (PDI) payments and social security outlays) are projected to grow in line with the 1997–98 Budget forward estimates until 2000–01, and thereafter to grow (in real terms) at the population growth rate. The post 2000–01 assumption involves moderate fiscal restraint. As a comparative benchmark it should be noted that the real outlays (apart from PDI) growth estimated in the 1997–98 Budget for the three years to 2000–01 is lower than the population growth rate.

Real PDI payments are progressively reduced throughout the projection period as inflation (projected to be constant at 2.5 per cent per annum—the mid point of the RBA's medium-term target range), asset sales, loan repayments from State/Territory governments (only asset sales and loan repayments included in the 1997–98 Budget estimates are included in the projections), and underlying budget surpluses reduce the real stock of outstanding Commonwealth debt. Real PDI payments also fall from an assumed reduction in the average interest cost of the Commonwealth debt stock brought on by the assumed constancy of 10-year Treasury nominal bond yields at 6.5 per cent throughout the projection period.

Social security outlays are projected to grow in line with the 1997–98 Budget forward estimates until 1998–99. From 1999–2000, the social security and individual income tax systems are integrated. This results in tax credits displacing social security payments. The budgetary cost of a given tax credit scheme is assumed to rise with the population growth rate in real terms.

Real Commonwealth revenue (apart from individual income tax revenue) is projected to grow in line with real GDP for the entire projection period. Indirect tax revenue as a proportion of GDP does not change but its composition does. In particular, a broad based consumption tax is assumed to replace wholesale sales tax and make up for declining tariff revenue (as tariffs fall on the way to free trade in 2010–11). Company tax revenue also grows in line with GDP. The individual income that is the base of the personal income tax is assumed to grow in line with GDP (that is, remain at its 1994–95 ratio of 51.7 per cent of GDP)—a conservative assumption given the likely effect of declining marginal income tax rates in reducing the incentive to tax avoidance and evasion.

State, Territory and local governments are assumed, in aggregate, to maintain their existing levels of net lending (saving less investment) as a share of GDP.

The current account deficit is projected to fall gradually from 3.9 per cent of GDP in 1997–98 to 0.3 per cent in 2010–11. Gross national investment remains constant as a share of GDP throughout the projection period. The fall in the current account deficit therefore comes from a steadily rising ratio of national saving to GDP. Public saving increases by the extent of the turnaround in the Commonwealth underlying budget balance (which varies during the projection period, but does not fall below 0.5 per cent of GDP after 1999–2000). The private saving rate is assumed to increase gradually over the projection period. It is assumed that private saving rises by 0.1 per cent of GDP each year of the projection period, leading to a total rise of 1.3 percentage points. This seems a moderate outcome in the circumstances of rising disposable incomes, falling marginal tax rates and low inflation. It amounts to restoration of part of the decline in the private savings rates that has occurred over the past two decades. Reflecting the declining current account deficit, the ratio of net external liabilities to GDP steadily falls throughout the projection period, from 58.9 per cent of GDP in 1997–98 to 36.0 per cent of GDP in 2010–11.

Stable growth

Recession is the enemy of sustained growth and full employment. Recession directly lowers long-term average growth (because some of the production lost in recession is never recovered). It breaks the normal pattern of accretion of labour skills, especially for young people. And it usually generates retreat from policies that are necessary for sustained, strong growth, including open foreign trade. The inflationary boom conditions that typically set the scene for recession are commonly associated with unsustainable increases in wage and other costs that have long-term dampening effects on growth.

It is now 23 years since inflationary boom conditions ended 23 years of more or less steady growth with low inflation.

Australia since then has been plagued by wide cyclical swings in the stance of fiscal and monetary policy, together with wide fluctuations in economic activity.

The variations in fiscal and monetary policy were meant to moderate the cycle in the real economy. The tightening of monetary policy to counter inflationary pressures from earlier excessive expansion on several occasions precipitated or deepened recession. At least a major part of the easing of fiscal policy has come so late in the cycle that it has strengthened upswings which already had considerable momentum, leaving a challenging task of fiscal correction for later, sometimes less robust times.

A consequence of unstable fiscal and monetary policy was 3 severe recessions in less than 2 decades, each associated with a deeper slump in domestic demand than its predecessor. Each recession brought higher unemployment, usually receding less in the subsequent recovery.

Australia is trying something new in the mid 1990s—more stable demand policies.

Greater stability and less discretionary adjustment by the authorities became apparent first in monetary policy. In the early 1990s the Reserve Bank of Australia, seeking to consolidate the new low inflation, began to articulate its intention to run monetary policy so as to deliver inflation in the range of 2–3 per cent over time. It began to assume and to discuss publicly an independence in the conduct of monetary policy towards this end.

By 1997, there was growing confidence in the RBA's commitment to and capacity to deliver sustained, relatively steady monetary growth and low inflation. This was encouraged by the Bank's willingness to tighten policy at signs of inflationary pressure as recovery gathered strength in late 1994 and early 1995.

There was some political debate in the 1990s about the merits of legislating a higher degree of independence for the Reserve Bank of Australia, alongside less equivocal commitment to a low inflation objective. In the event, a considerable shift to de facto independence and an inflation target of 2–3 per cent has been achieved without legislation. The Howard Government has endorsed the RBA's target, and the Governor of the Reserve Bank now talks of a tradition of independence.

Mistimed fiscal expansion as recovery accelerated and then continued from 1992 to 1995 significantly complicated the task of sustaining growth from 1996. The strong recovery of 1992–5 was the wrong recovery, depending excessively on fiscal deficits which had their main stimulatory effect after recovery was already proceeding. This required firmer money and a stronger exchange rate through 1995 and 1996, slowing growth in manufactured exports, and traded goods and services production more generally.

The untimely fiscal expansion of 1992–95 was driven as much by the imperatives of the electoral cycle as by misjudgment of the business cycle.

The Howard Government in 1996 responded to community reaction to this episode by announcing a Charter of Budget Honesty. This could have been expected to moderate some of the politicisation that has been a substantial source of economic instability in Australia. The Charter of Budget Honesty requires the senior official financial and economic advisers to the Government to sign off on periodic statements on the budget outlook, making explicit the premises of the economic projections, annually and in the period preceding elections.

The Charter's power, however, was diminished when legislation to give it legal force was withdrawn after running into opposition in the Senate. This makes it vulnerable to expedient politics. The Government has indicated an intention to re-introduce legislation into the Parliament. Failing successful legislation, it is important that the Charter comes to be entrenched in community expectations about the conduct of fiscal policy. The recent history of monetary policy suggests that this is possible, although the more direct link to government makes it more difficult with fiscal policy.

In a series of steps, although less decisively on the fiscal side, a new basis for stable monetary and fiscal policy has been built in Australia. Together with the more internationally open and competitive economic environment and the re-establishment of low inflation, it holds out the prospect that the moderate growth that is now in its sixth year can be sustained for a considerable period.

There will always be cyclical fluctuations in economic activity deriving from domestic or external shocks or inevitable variations in the pattern of business confidence, innovation, investment and stocks. But it will be worthwhile progress if fiscal and monetary policy can be run more steadily, to avoid policy making things worse.

Immigration policy is a third area in which greater steadiness over the business cycle would be helpful to the moderation of fluctuations in activity. Here, too, the motive for short-term variations in policy settings has been stabilisation—in this case too, and rather more for immigration than for fiscal or monetary policy, long lags in policy adjustment have meant that changes have often been pro-cyclical. One special effect of immigration policy is that cuts in intake have often led to uncertainty about demand for housing just as interest rates are starting to rise again in the lift out of recession.

Structural reform is itself helpful to the maintenance of stable economic growth.

The floating of the Australian dollar and abolition of exchange controls in December 1983 removed one source of instability: large fluctuations in domestic monetary growth through the balance of payments. The importance of this development is underlined by the recent experience of monetary instability in Southeast Asia.

Trade liberalisation also assists in the maintenance of stability. The general cost-increasing effect of protection confines exports to a narrow range of products in which comparative advantage is strongest. In Australia's case, that means industrial raw materials and foodstuffs, which are subject to exceptional fluctuations in international prices. Trade liberalisation has been accompanied by export diversification, most notably with the expansion of manufactured and service exports.

Manufactured and service export growth have gone some way towards insulating output and employment in these sectors from fluctuations in domestic demand. This effect is demonstrated by comparing the behaviour of manufacturing output and employment in the early 1980s recession with the 1990s recession. The 1991–92 recession was associated with less sharp contraction of manufacturing output and employment relative to the decline in domestic demand than the recession of 1982–83.

The achievement of greater wage flexibility through labour market deregulation would contribute a great deal to stable economic growth. With flexible prices and wages, cyclical variations in demand need not be reflected in output and employment.

Rigid wages in Australia have meant that reductions in demand that survive stabilising exchange rate and net export movements are absorbed mainly as reductions in output and employment. The new, more flexible wages arrangements suggested in Section 3 would allow more of the adjustment to be taken in prices and wages.

In these several ways, internationally-oriented reform has established, and can take further, a stronger basis for moderation of cyclical fluctuations in the Australian economy. It will not remove instability. But, when accompanied by good judgement on the part of monetary and fiscal officials in the exercise of the discretion that will inevitably remain part of macroeconomic policy, it holds out reasonable prospects of avoiding a fourth deep recession over the decade ahead. The suggested approach to income security, wage flexibility and full employment will strengthen those prospects.

External constraints

The lift in total factor productivity growth that supports the growth and full employment strategy adumbrated in this paper depends on the deep integration of Australia into the international economy: high levels of two-way investment and trade, with both expanding more rapidly than output. In particular, the large increase in the export (and import) share of GDP that has characterised the

past dozen years of improvement in Australia's relative economic performance will need to continue, probably to over 30 per cent for each by 2010–11.

Will external factors get in the way of sustained steady growth towards full employment in Australia? Two areas need to be examined: market constraints on export growth from Australia's most productive industries as they emerge from the process of reform; and the balance of payments.

Markets

Virtually the whole of the large increase in the export share of GDP from 1985–96 was contributed by manufactures and services (Figure 9.1).

At the same time, virtually the whole of the increase in the export share of GDP was contributed by developing East Asian markets, in both Northeast Asia (the three Chinese economies and Korea, from 1983) and Southeast Asia (more rapidly from a lower base from 1986) (Figure 10.4).

In the 1990s, to the present, Australian export dynamism has been strongly concentrated in Asian developing countries, with developed country markets dragging down the average.

East Asian developing economies account for a high proportion of prospective global import demand for bulk foodstuffs (with China especially prominent), energy, minerals generally and metals. Their continued economic growth and trade liberalisation are therefore critical to the prospects of continued expansion of Australia's traditional exports.

East Asian developing economies have also been the locus of the most rapid growth in Australian exports of manufactured goods and services. (Note that in Figure 13.14, 'East Asia' is the sum of Japan and developing East Asian economies).

The external market environment is likely to be less than favourable for Australia's traditional exports in the remaining years of this century. Longstanding unfavourable trends for agricultural exports will be exacerbated by competition from reforming producers in Latin America, Eastern Europe and the successor states to the Soviet Union. Australia's largest commodity export, coal, will suffer from adverse changes in its relative importance as an energy source under almost any version of the global greenhouse regimes under current discussion. The second commodity export, gold, is experiencing extremely low prices as a result of market responses to evidence that central banks are re-assessing its role as a monetary reserve asset. The best prospects for maintaining momentum in minerals and metals and to a lesser extent food export growth will lie with the processing industries, which will depend on the success of the microeconomic reforms.

International trade policy priorities

Australia's ability to achieve employment and productivity growth is critically linked to its own commitment to trade liberalisation. For Australia, over 80 per cent of the potential gain from international trade liberalisation derives from its own reductions of tariffs and other barriers to trade.

Domestic trade liberalisation will be facilitated by getting international trade policy priorities right.

In the 1980s, Australian decisions to reduce domestic barriers to international transactions were supported by a major effort to build closer links with Asia Pacific economies and to contribute to the Asia Pacific (APEC) and global (the Cairns Group, the Uruguay Round and the WTO) institutions for trade liberalisation.

The record of trade growth, significantly into the markets of East Asia, is evidence of both the success and the further potential of this strategy.

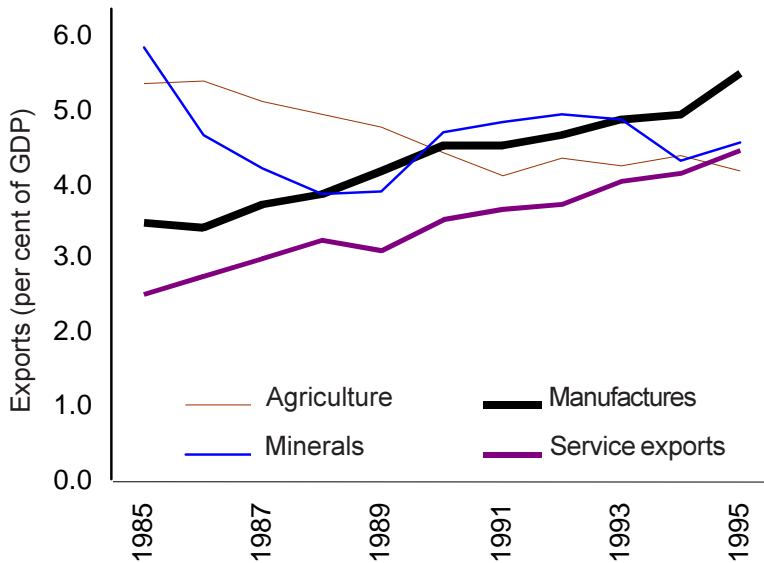
Internationalisation of the world economy has been driven by the revolution in communications and transport over recent decades, as well as by national commitments to outward-looking economic reforms throughout the world economy. It has been buttressed by multilateral initiatives, including the Uruguay Round and the establishment of the WTO.

The implementation of the Uruguay Round and continuing progress with the APEC agenda (see Figure 13.14) will continue to open up opportunities for Australia's trade growth through to the early years of the twenty-first century.

Australia's capacity to be a positive force towards the achievement of the APEC objective of free trade in the Asia Pacific region and, through APEC's influence on the WTO agenda, global trade liberalisation in the first two decades of next century, requires continued progress on its own liberalisation agenda. Weakening of that commitment would also undermine efforts to expand access in markets of particular importance, such as China.

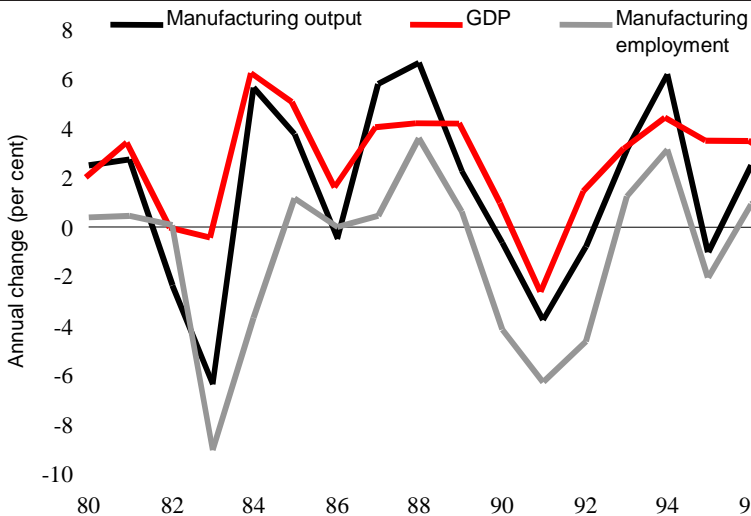
In recent years, APEC has reinforced tendencies towards unilateral reform and liberalisation in East Asia. Continuing liberalisation and reform is an essential ingredient of success in East Asia's industrialisation, but its particular shape and impact on Australia's trade opportunities will be influenced significantly by whether Australia is an active participant in multilateral (WTO), regional (APEC) and bilateral trade diplomacy.

Thus far, progress on trade liberalisation in APEC has been in ways that invite constructive response from Europe and other countries outside the region because of the emphasis on non-discriminatory trade liberalisation. At first, the APEC emphasis was on successful completion of the Uruguay Round, with its inclusion of previously excepted and neglected sectors of importance

Figure 13.11 Australia's sectoral exports as a share of GDP, 1985–95

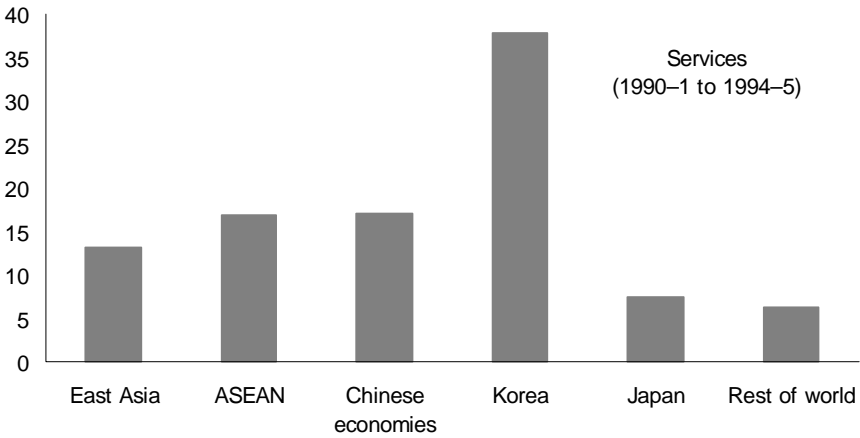
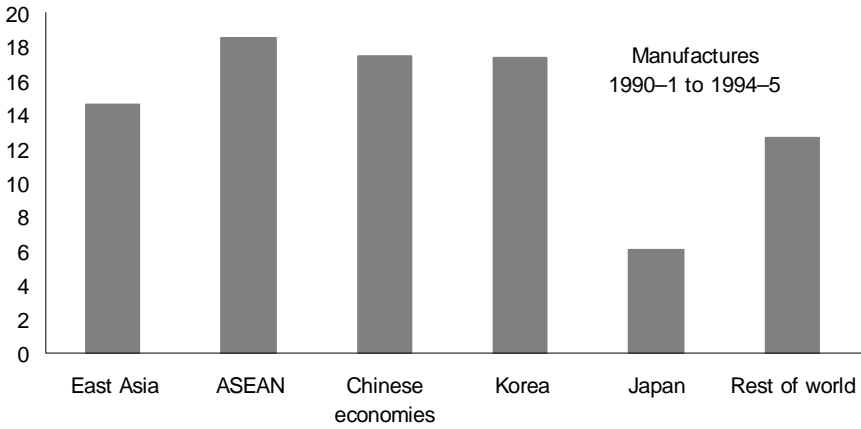
Note: Manufactures include SITC 5, 6, 7 and 8.

Source: Trade data are from UN Trade database; GDP and services data are from World Development Indicators 1997, World Bank, International Economic Databank, The Australian National University.

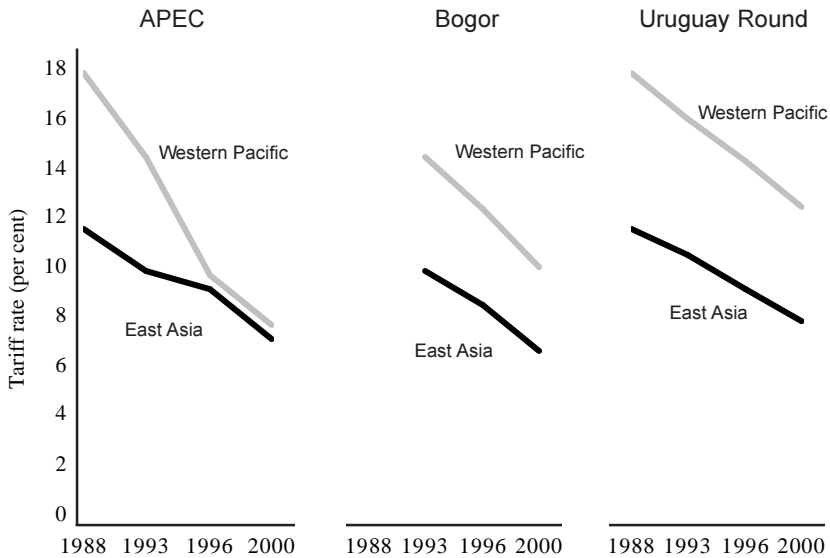
Figure 13.12 Cycles in GDP and manufacturing

Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles*, 1997, FT Newsletters & Management Reports, Hong Kong.

Figure 13.13 Growth in new exports in East Asia and elsewhere (per cent per annum)



Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

Figure 13.14 Progress on trade liberalisation, East Asia and Western Pacific

Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

to East Asian and Western Pacific economies (notably agriculture and textiles). More recently the focus has shifted to WTO initiatives in sectoral free trade and to extending WTO membership to include China and Taiwan. Appropriately, given the weaknesses exposed in Southeast Asian financial markets recently, this focus includes financial market reform and liberalisation.

It is important to the continued success of APEC's trade liberalisation agenda that, by early next century, a foundation is established in the WTO for negotiation of global free trade. The United States polity will need to have noticed and be impressed by the reality of Western Pacific liberalisation in the intervening years for movement towards a goal of global free trade to be worth the domestic political cost in that country.

At this point, not many years away, success will also depend on the European Union's readiness to join APEC in achieving global alongside Asia Pacific free trade.

These objectives provide focus for Australian international trade diplomacy supportive of Australia's national economic and social goals.

The recent turmoil in Southeast Asia's currency and financial markets broadens the agenda for regional cooperation supportive of Australia's goals and interests, but does not change its fundamental objectives.

The origins of Southeast Asia's recent problems lay in short term macroeconomic mismanagement associated closely with the unsustainability of exchange rate regimes in which local currencies were closely pegged to the appreciating US dollar, and in a cyclical downturn in the international market for electronics exports. Putting in place regional facilities to supplement IMF programs for dealing with such crises extends the agenda for regional cooperation and reform. Australia is right to be at the forefront of these initiatives. While growth in East Asia will be slower in the next year or two than it has been in the past decade, the effects of slower growth in Southeast Asia and in some parts of Northeast Asia, will be moderated to some extent by continuing fast growth in the Chinese economy in the short term, and subsequently by recovery to the long-term growth potential of other East Asian economies.

There is another element in the external environment that may threaten Australia's growth prospects over coming decades: the evolution of global policies on greenhouse gas emissions. Policies that seek to limit greenhouse gas emissions clearly would have substantial effects upon Australia's energy sector. There is the prospect of long term decline in the terms of trade for coal, with which Australia is richly endowed, and big changes in the mix of energy sources.

The Kyoto Convention will be the beginning of the process of the development of a policy regime on this issue. Australia has a vital stake in active diplomacy to shape the outcome in ways that make the adjustments required manageable and efficient, and to ensure that constructive involvement in the process of defining the regime protects against political isolation in the international market place. A special challenge is to ensure that any global regime maintains incentives to locate emissions-intensive economic activity (including metals processing) in environmentally efficient places, including in many cases in Australia. This requires international explanation of the paradox, that efficient global reduction in emissions may require an increase in some countries, and in Australia's case increases in a developed country that happens to provide environmentally efficient locations for much emissions-intensive production.

The balance of payments

Recent developments in East Asia underline the potential for unfavourable international financial market perceptions of current account deficits to disrupt economic growth.

Ultimately, the current account of the balance of payments, and therefore the rate of change in net external liabilities, depends on the relationship between domestic savings and investment.

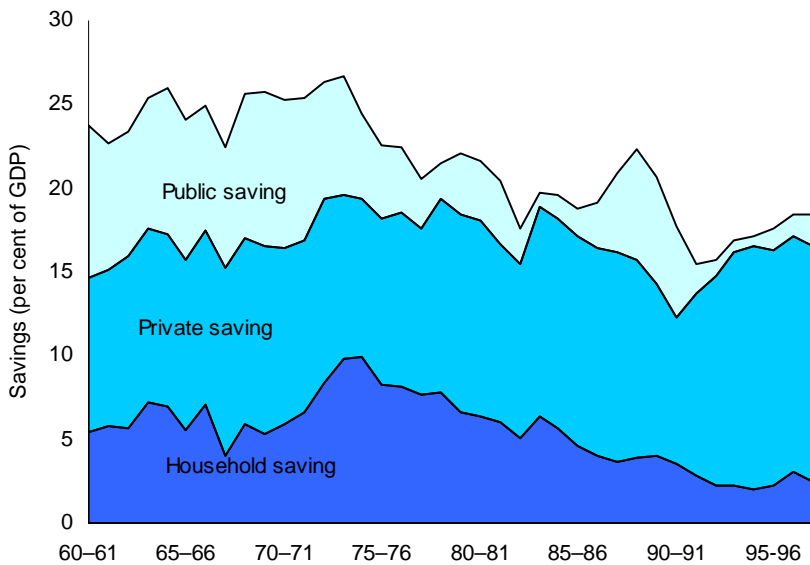
The large decline in the savings share of GDP since the early 1970s has been associated with the emergence of high current account deficits at modest levels of investment.

With investment growing in line with GDP in the projections, the reduction in the current account deficit as a proportion of GDP from 3.9 to 0.3 per cent over the projection period is secured through Commonwealth fiscal consolidation and a small lift in private savings (by one tenth per cent of GDP per annum).

The latter may turn out to be an understatement of the overall savings response to the growth of superannuation, historically high and stable per capita income growth, the removal of poverty traps and more generally reduced marginal tax rates. The profile of the current account deficit and net foreign indebtedness in the base case scenario (Figure 13.16) leaves Australia some cushion against adverse shocks from the international economy, or from domestic demand. The possible need for this cushion is an important reason for the caution in fiscal policy that underlines the base case.

The most likely sources of major shocks to the balance of payments over the projection period are sharp deterioration in the terms of trade, or surges in domestic investment above projected levels.

Figure 13.15 Savings low, but turning?



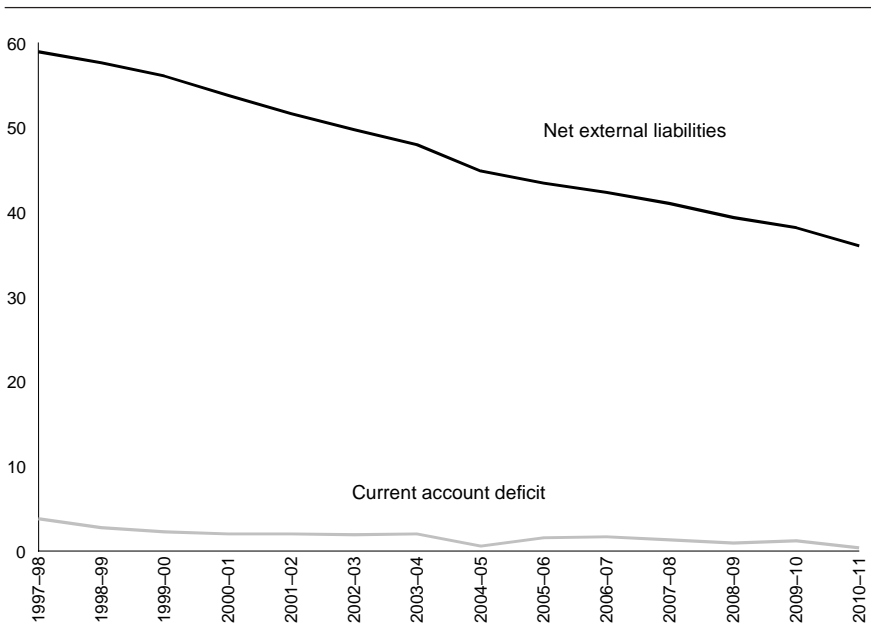
Source: Asia Pacific Economics Group, 1997. *Asia Pacific Profiles, 1997*, FT Newsletters & Management Reports, Hong Kong.

It is possible that Australia faces the first of these shocks in the year ahead. The extension of the recent Southeast Asian financial weakness into Northeast Asia will reduce growth in global demand for minerals, metals and agricultural raw materials, and regional demand for Australian service exports including the largest single export product, tourism, on top of established adverse tendencies in the coal and gold markets. Low inflation, a sound budget and a financial sector that emerged with greater strength from the recession of the early 1990s allow the main adjustment to such a shock to be taken through depreciation of the floating exchange rate. This underlines the value of the fiscal and monetary caution that has established these favourable conditions.

If an adverse shift in the terms of trade persisted over a number of years, an appropriate response would be to slow somewhat the rate of reduction of tax rates after 1999–2000, while permitting exchange rate depreciation to push inflation to the upper edge of the RBA's target range.

It is possible that realisation that Australia was committed to the program of reform directed at economic growth and full employment would encourage a surge in business investment above projected levels. This would be reflected in

Figure 13.16 Base case scenario—projected net external liabilities and current account deficit as a ratio of GDP, 1997–98 to 2010–11 (per cent)



an increase in the current account deficit. This would not in itself require corrective action in monetary policy to reduce investment. However, within the established framework of monetary policy, there would be some tightening of policy to keep inflation within the target range.

Opportunities and managing risks

Australia has income security, full employment and rising incomes within the range of policy choices available to it.

The achievement of these goals takes time, but much progress can be made within a time frame that is short enough to excite the interest of the community. After more than two decades of high and periodically rising unemployment, the prospect of full employment by the middle of the next decade would be judged worthy of effort if the community thought it really were achievable.

The carrying forward into the first decade of the twenty-first century of recent progress in sustaining economic growth would make it possible. This requires continued momentum in economic reform, commitment to which has been undermined by the persistence of high unemployment.

So the starting point in implementation of a vision for economic success in Australia must be a commitment to full employment.

That leads in Australia to a requirement for income security and increased incentives to employment to be provided through integration of the tax and social security systems, supporting reform of the role of minimum award wages.

On this basis, and with unequivocal commitment to productivity-raising reform, it is realistic to look forward to a period of economic growth and employment expansion over the next 7 years that breaks the past quarter century's mould of high unemployment.

This can only happen if the community's attention comes to focus on the feasible, attractive long-term outcomes that follow from certain policy choices and disciplined commitment to the pursuit of their implications. If government is not at this stage ready to commit itself to long-term growth goals, other elements of the community, including the Business Council, can lead the building of support for an attractive, realistic long-term vision for Australia. This support is necessary to overcome the inevitable resistance by vested interests to each individual step in reform.

Economic progress never follows straight lines for very long. The reform program itself reduces the risk of disruption through cyclical recession. We have noted in Section 5 that the internationalisation of the economy, the prospect of greater real wage flexibility and new and steadier approaches to fiscal and monetary policy provide a first line of defence against disruption of the progress towards full employment by deep recession.

A second line of defence is the fiscal caution built into the projections upon which we have based our reform package. A budget surplus averaging over 0.5 per cent of GDP, official debt falling rapidly to zero, and a downward trend in the current account deficit and net external indebtedness all provide a cushion against adversity. The reduction in government debt allows for no asset sales beyond those already announced in the forward Budget estimates. The sale of the government's remaining equity in Telstra would reduce public debt interest payments by about \$2 billion in the first year.

There is caution also in our not taking into the projections any increase in the income taxation base as a result of lower effective marginal tax rates. Is an unrealistic degree of fiscal discipline required? Is it realistic to expect to hold real outlays growth to the population growth rate, at least to the middle of the next decade? In fact, real outlays have grown at an even lower rate in recent years and are projected to do so for the next three years.

In Australia, unusually for a developed country, the growth in the proportion of aged people in the population will not have large fiscal effects. A greater challenge is growing expectations of improved and more expensive social and medical services for the aged, provided by government.

In the end, the question is one of the priority of reform to reduce unemployment through a lengthy transition period.

The maintenance of economic stability over the long period through which our vision extends will require adjustments in the timing of some reform steps in the interests of stabilisation. We have noted that there is some doubt about the speed of the employment response to adjustments in wages. If unemployment were falling less rapidly than envisaged in the projections, the appropriate response would be to extend the freeze in award wages, within the framework of income security provided by the tax credit scheme. Slower growth after 1999–2000 from these or other causes of a structural kind would require some moderation of the rate at which marginal tax rates were reduced.

While acknowledging risks, and the need to adjust the timing of policy implementation if adverse risks were realised, it seems to be within the policy choice of Australians to reduce unemployment to 4.5 per cent and to raise average incomes in real terms by half within a decade. If Australians make this choice, Australia in a decade will be well placed to sustain full employment and strong growth beyond that time.

Australians will not choose reform and growth unless there is confidence in progress towards full employment.

Nor are they likely to choose full employment and growth at the cost of substantial reductions in the living standards of the low-skill employed or recipients of social security payments.

Whatever their choice on these matters, Australians are likely to retreat into resistance of change in any new recession, as they have done three times in the past quarter century.

These realities link economic, tax and social security reform, full employment, growth and stability inextricably together. We are likely to make progress on all of them, or none.

Notes

- ¹ In developing this paper, I was assisted by Dr Theo Levantis who amongst other things drafted the boxes on the social security system, Professor Peter Drysdale shared the development of the Asia Pacific trade policy perspectives. Professor Peter Dawkins provided important comments on the references to wage flexibility and income security.
- ² Tables 13.1 and 13.1A in Section 1 summarised the changes in key economic variables over the 13 year projection period under the base case scenario.

Appendix 13.1: How disposable income varies with wage income under tax credit scheme

Table 13.2A Disposable income for a youth, single, 18 years old, paying rent

	Current regime	New Tax credit scheme with flat tax rate		
		50%	40%	30%
Unemployed	170	170	170	170
Employed at minimum wage (\$285/week)	243	313	341	370
with 10 per cent fall in gross wage		298	324	350
with 20 per cent fall in gross wage		284	307	330
Fall in wage to reduce disposable income to current regime (per cent)		49	57	63
New gross wage required to make disposable income equal to current regime		146	122	104

Table 13.2B Disposable income for single income family with 2 children, one partner participant in workforce^a

	Current regime	New tax credit scheme with flat tax rate		
		50%	50%	40%
Unemployed ^b	408	408	408	408
Employed earning \$400 per week	493	608	648	688
with 10% fall in gross wage		588	624	660
with 20% fall in gross wage		568	600	632
Fall in wage to reduce disposable income to current regime (per cent)		57	65	70
New gross wage required to make disposable income equal to current regime		170	142	121
Employed earning \$600 per week	570	708	768	828
with 10% fall in gross wage		678	732	786
with 20% fall in gross wage		648	696	744
Fall in wage to reduce disposable income to current regime (per cent)		46	55	61
New gross wage required to make disposable income equal to current regime		324	270	231
Employed earning \$1000 per week	755	908	1008	1108
with 10% fall in gross wage		858	948	1038
with 20% fall in gross wage		808	888	968
Fall in wage to reduce disposable income to current regime (per cent)		31	42	50
New gross wage required to make disposable income equal to current regime		694	578	496

Notes: ^a For this exercise, one child is assumed to be under 13 years old, the other between 13 and 15.

^b The social security benefits received by this family include: 1. New start allowance (unemployment benefit) of \$145 per week; 2. parenting allowance (for the dependent spouse), \$145 per week; 3. Family payment for 2 children, \$1 10 per week; and 4. Family tax payment of \$8 per week.

Table 13.2C Disposable income for a single adult

	Current regime	New tax credit scheme with flat tax rate		
		50%	40%	30%
Unemployed	198	198	198	198
Employed earning \$400 per week	332	398	438	478
with 10% fall in gross wage		378	414	450
with 20% fall in gross wage		358	390	422
Fall in wage to reduce disposable income to current regime (per cent)		33	44	52
New gross wage required to make disposable income equal to current regime		268	223	191
Employed earning \$600 per week	461	498	558	618
with 10% fall in gross wage		468	522	576
with 20% fall in gross wage		438	486	534
Fall in wage to reduce disposable income to current regime (per cent)		12	27	37
New gross wage required to make disposable income equal to current regime		526	438	376
Employed earning \$ 1 000 per week	693	698	798	898
with 10% fall in gross wage		648	738	828
with 20% fall in gross wage		598	678	758
Fall in wage to reduce disposable income to current regime (per cent)		1	17	29
New gross wage required to make disposable income equal to current regime		990	825	707

Appendix 13.2: higher migration scenario

The Business Council Task Force requested the development of a 'Higher Migration' scenario. We have done this on the assumption that the characteristics of the additional immigrants are similar to those of immigrants in the base case.

Under the higher migration scenario, all assumptions underlying the base case scenario are maintained, with the exception that, from 1998–99, net migration increases from 100,000 per annum to 165,000 per annum.

Tables 13.3A and 13.3B summarise the changes in key economic variables over the 13 year projection period under the higher migration scenario.

The higher migration scenario produces a significantly higher average rate of growth in population, working age population, labour input and real GDP. Investment grows faster to keep a constant share of investment of GDP. We think this is a reasonable expectation about the investment response to more rapid growth in labour supply in the framework of the reforming economy. This results in a marginally higher growth rate of the net capital stock.

Real GDP per capita growth is marginally lower in the higher migration scenario than in the base case. Greater capital deepening (growth in capital-labour ratio) occurs in the base case scenario, which raises relative labour productivity and hence GDP per capita. However, this effect is counterbalanced to a large extent by a relatively faster rate of growth of the ratio of the working age population to total population (which raises employment per capita and hence GDP per capita) in the higher migration scenario.

As a result of the faster rate of real GDP growth in the higher migration scenario, net external liabilities as a share of GDP are marginally lower than in the base case scenario. The current account deficit is marginally higher in the higher migration scenario throughout the projection period as a result of a slightly lower Commonwealth budget surpluses. The latter are driven by a higher rate of outlays growth (which is tied to the population growth rate) than in the base case, that is largely, but not fully, offset by a higher rate of revenue growth (which is tied to the GDP growth rate, but modulated by the taxation reform, which is presumed to follow a similar timetable to that in the base case).

Table 13.3A High migration scenario—real average growth rates for key variables, 1997–98 to 2010–11

	Average growth rate (per cent per annum—real terms)
GDP	5.0
Population	1.4
GDP per capita	3.5
Population aged 15–64	1.5
Employment	2.2
Aggregate labour input (hours)	2.4
Investment	5.0
Capital stock	4.0
Total factor productivity	2.0

Table 13.3B High migration scenario—changes in levels of other key variables, 1997–98 to 2010–11

	1997–98 (per cent)	2010–11 (per cent)
Current account deficit as a ratio of GDP	3.9	0.4
Net external liabilities as a ratio of GDP	58.9	35.4
Commonwealth underlying budget surplus as a ratio of GDP	-0.7	1.5
Stock of Commonwealth debt as a ratio of GDP	19.3	0
Labour force as a proportion of population aged 15–64	74.4	77.9
Unemployment rate	8.6	4.5
Average hours worked per week	34	35.5
Company tax rate	36	3
Maximum marginal income tax rate	47	30
Maximum effective marginal tax rate for social security recipients	100	30