THE GLOBAL AND AUSTRALIAN ECONOMIES – SEARCHING FOR GROWTH

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by

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Global risks

The world economy is experiencing its first synchronized upswing in growth since the rebound from the 'Great Recession' induced by the financial crisis of a decade ago. Growth forecasts have been revised upwards since about this time last year. And central banks have begun, in some cases, or in others are thinking about when to begin, unwinding the extraordinary policy settings put in place to deal with the challenges of that period, and its last consequences.

There are obviously some risks associated with the drawing to a close of the 'era of free money' – although thus far it is really only in the US, among the major 'advanced' economies, that money is now no longer 'free', and it would seem that the beginning of the return to more 'normal' monetary policy settings in the euro area is still at least a year away, and in Japan even longer than that.

Just as many of the risks which many critics suggested would be posed by the unorthodox monetary policy strategies pursued in response to and after the financial crisis – in particular, massive currency depreciations and runaway inflation – failed to eventuate, I suspect some of the fears associated with the return to more 'normal' monetary policy settings will turn out to have been exaggerated.

Central banks appear to acknowledge that, while they don't know precisely what 'normal' monetary policy settings will look like in the post-crisis world, they do know that they will entail lower interest rates than were considered 'normal' before the crisis; and they seem committed to a very gradual, open-minded and data-dependent trajectory back to whatever 'normal' turns out to be.

Hence the possibility of another 2008-style financial crisis is not top of my list of things to worry about – although I do accept that a steady upward trend in global interest rates may at some point affect share-market valuations, and cause problems in some emerging markets.

A greater concern, with regard to interest rates, is the possible consequences for US monetary policy settings of the spectacularly ill-timed, from a cyclical perspective, fiscal stimulus which has been implemented in the United States.

IMF estimates suggest that the US structural budget balance will widen by 2 pc points of GDP between 2017 and 2019, at a time when the US economy will be operating at a bigger margin above its 'potential', and the US unemployment rate will be further below its 'full employment' level, than at any time since the late 1960s. History suggests the chance of this ending well are not high.

But this is not the only way in which the recklessness of the US Administration and Congress threatens to derail the current upswing in the global economy which has taken so long to bring to fruition.

The Trump Administration seems determined to undermine the rules-based system under which the global economy has operated since the end of World War II – a system which has by no means been perfect, but which has unambiguously served the people of the world much better than anything which preceded it.

A modelling exercise by Australia's Productivity Commission, published in June last year, suggests that a scenario in which all countries raised tariffs by 15 percentage points would result in the volume of world trade falling by 22%, and world GDP by 3%, relative to a 'no change' baseline. And Australia would not be immune. Our exports would fall by 15%, and our national income by 1½%. And around 100,000 jobs would be lost.

The Productivity Commission regarded this as a 'worst case' scenario. But it doesn't seem too far removed from what the Trump Administration is now contemplating for the US – and to which other countries seem bound to retaliate, even at some cost to themselves.

More generally, the Trump Administration's evident enthusiasm for autocrats and dictators, and its disdain for the democratically elected leaders of its ostensible allies, threatens to undermine the synchronized improvement in business confidence on which the current upswing in global economic activity is partly based.

The Australian economy

We are all of course well aware that Australia has avoided many of the difficulties encountered by other 'advanced' economies over the past 25 years. We haven't had a recession, in the most widely-used sense of that term, since the early 1990s. We haven't had a financial crisis. We've absorbed the various 'shocks' that have emanated from elsewhere in the world economy. We haven't seen increases in inequality, at least in the distribution of income, that most other 'advanced' economies (and many 'emerging') ones have experienced over the past three decades. All of that reflects well on the way economic policy has been formulated and implemented during this period, and on our most important economic and social frameworks and institutions.

But we have also been lucky, at least up until now. In particular, we've benefited, probably to a greater extent than any other 'advanced' economy, from the rapid growth, urbanization and industrialization which China has undergone beginning in the late 1970s.

And two things in particular have helped to obscure what, in their absence, would have been a rather less praiseworthy economic performance.

First, almost two-thirds of our economic growth over the past decade has been the direct result of population growth – and only one-third the result of growth in real per capita GDP (which is a much truer, albeit still imperfect, measure of improvements in people's material living standards). That's the reverse of the pattern over the preceding decade (when only one-third of our overall economic growth was attributable to population growth). Australia's real per capita GDP growth rate over the past five years has actually been lower than that of the US, Canada, New Zealand, the UK and even the euro area and Japan.

Let me be clear that I am *not* an advocate of cutting our immigration intake. But I do acknowledge that our rapid population growth has entailed costs – including most obviously those associated with increasing congestion and deteriorating housing affordability – which are not captured by measures such as real GDP.

Second, one of the principal ways in which we have sustained our below-average rate of per capita GDP growth has been through (yet another) episode of rapidly rising residential property prices, fuelled by rapid growth in household debt – the third, arguably, in the past 25 years or so.

As a result Australia now has some of the most expensive urban residential real estate in the world. But we also have, according to the Bank for International Settlements, the second highest level of household debt, as a proportion of GDP, in the 'developed' world. And we also now have, according to the most recent Census, the lowest rate of home ownership since the Census of 1954.

Again let me be clear that I do not interpret from any of this that Australia's housing market is a crisis waiting to happen, as many foreign observers have repeatedly (but so far wrongly) warned since at least the early 2000s.

The experience of countries such as the US, Ireland and Spain tells us that for there to be a housing 'crash' of those orders of magnitude, you need to have a large number of 'forced' sellers – that is, property owners who have to sell, at whatever prices buyers are willing to pay – into an oversupplied market.

Provided that Australian interest rates don't rise rapidly – and the RBA is being very clear that they don't envisage that happening – there is unlikely to be a material number of Australian property owners becoming 'forced sellers'. Occasional well-publicized anecdotes notwithstanding, there simply hasn't been enough 'dodgy lending' in Australia for that to become a widespread problem, absent a sharp rise in interest rates.

And although there are clearly pockets of 'over-supply' emerging in some segments – for example, inner-city apartments in Brisbane and Melbourne – there is no reason to think that we are going to witness a more general 'over-supply' of housing in Australia – particularly in the market for 'detached' dwellings which still make up over 70% of our total housing stock.

Nonetheless, it seems pretty clear that the most recent episode of growth fuelled by rising house prices and rising household debt has come to an end, and that in order to fulfil our expectations of continued growth in economic activity and employment, we are going to have to look elsewhere.

As it happens, we are seeing stronger contributions to economic growth from some other sources – including resources exports, infrastructure investment, other areas of business investment, and on-going growth in areas such as health, aged and disability care. The second and fourth of these are of course heavily dependent on government spending; and the third, the upturn in non-mining business investment, is at least partly dependent on the improvement in global business confidence which as I noted earlier is potentially threatened by the deteriorating geo-political climate.

We are also of course now experiencing the same persistently low growth in wage and salary earnings which has been a characteristic of most other 'advanced' economies for at least a decade (or longer in the US), and from which we were initially sheltered by the 'mining boom'.

There are a number of reasons for this, including the effects of globalization and technology, and changes in the legislative or institutional arrangements within which pay and conditions of employment are determined – but another important factor appears to have been the sustained slowdown in productivity growth which has occurred in most 'advanced' economies since, if not since before, the financial crisis.

The experience of other 'advanced' economies which now have much lower unemployment rates than we do suggests that the unemployment rate needs to be much lower, and for longer, than during previous business cycles before wages growth begins to accelerate. And the Reserve Bank (among others) is also telling us that any pick-up in wages growth in Australia is going to be very gradual.

In combination with the high levels of debt which many Australian households now have, this means it is difficult to envisage a pick-up in household spending acting as a significant driver of faster, sustained economic growth.

Tax cuts as a spur to stronger sustained economic growth

The Turnbull Government's strategy appears to focus on spurring faster sustained economic growth through a combination of higher infrastructure spending and personal and company income tax cuts.

I'm generally supportive of higher levels of infrastructure spending in Australia's current circumstances, even if that entails higher levels of public debt, as long as the infrastructure projects are themselves well-chosen and managed, and that the interest payments on the debt and the depreciation associated with the new assets can be accommodated without incurring 'operating deficits'.

I am not sure that the first of these criteria has been universally satisfied, and I have some concerns about the visibility of the way in which the Federal Government is financing an increasing proportion of the infrastructure spending which it is undertaking or facilitating. But that's a topic for another day.

I'm less convinced about the merits of tax cuts as a spur to economic growth. I think there is a reasonable case for personal income tax cuts directed towards low- and middle-income earners, who are have had to contend with very sluggish growth in their pre-tax incomes in recent years yet are now paying a higher proportion of those incomes in tax than at any time since 2006. But I think the case which the Government has made for cutting corporate tax rates is quite weak. And I haven't found the case which the Government has been trying to make for the third tranche of its Personal Income Tax Plan – in terms of nurturing 'aspirations' – especially persuasive either.

By way of explaining what I mean, it's perhaps worth going back to the last occasion on which a Government consciously sought to change the tax system with a view, so it said, to encouraging aspirational behaviour. I'm referring here to the changes that were instituted by the Howard Government in response to the Ralph Review of Business Taxation in 1999. Among those changes were the last comprehensive reduction in the company tax rate – from 36% to 30% - and the change to the capital gains tax regime, whereby nominal capital gains became taxable at half the rate payable on other types of income (instead of real capital gains being taxed at full marginal rates, as had been the case since 1985).

The Ralph Review thought that these reforms would turn Australia into a nation of shareholders and entrepreneurs. They didn't.

The proportion of Australia's adult population who are shareholders (directly or indirectly) has fallen from a peak of 54% in 1999 to 37% in 2017. The proportion of the workforce who are owners or managers of businesses has fallen from a peak of 20% in 2002 to less than 17% so far in 2018.

Instead, we have become, if anything, even more of a nation of property speculators than we were before. Almost 21% of taxpaying individuals are now property investors, up from 15% in 1999. And 62% of those are 'negatively geared' – that is, financing their investments in such a way as to reduce their taxable income – compared with 51% in 1999. When interest rates were at their most recent peak, just before the onset of the financial crisis, more than 70% of taxpaying property investors were 'negatively geared'. Almost one-third of the increase in household debt, and nearly one-quarter of the increase in total private sector debt, since the beginning of this century has been for the purchase of investment properties.

And while defenders of 'negative gearing' are wont to say that it is simply 'Mums and Dads trying to get ahead', the implication being that they are entitled to preferential tax treatment in support of that aim, the question which we should be asking in response to that is, 'ahead of whom?'. And the answer is, increasingly, their own children, or their children's peers – as a growing number of people are beginning to recognize, as their adult children remain in the family home much longer than expected, or want to draw on the 'Bank of Mum and Dad' in order to become home owners themselves.

As advocates of cutting Australia corporate tax rate are fond of pointing out, lots of other countries are doing it. What is far less commonly noted is that there's very little evidence from the experience of those countries which have cut their corporate tax rates that it has done anything to lift business investment, employment or real wages to higher levels than would otherwise have been attained.

It certainly hasn't been borne out in Canada, which in many respects is more like Australia than any other country in the world; nor does the UK's experience provide any empirical support for the arguments typically advanced in Australia for a cut in the corporate tax rate. And while it's too soon to make definitive conclusions about the recent US tax changes, the only part of them which is widely expected to result in a (temporary) lift in business investment is something which *isn't* on offer in Australia – or, at least, not from the government – namely, a universal 'instant asset write-off' (as we would call it here).

Nor is there any evidence *at all* to support the one part of the Government's corporate tax package which has enjoyed almost universal support across the political spectrum – the idea that preferentially taxing small businesses will do something to boost employment, or innovation.

This seems to be grounded in an almost religious, or at least romantic, belief in the inherent nobility of 'small business'. It's the 'engine-room of the economy', we are repeatedly told.

Well, actually, it isn't. Small businesses (that is, those with 20 or fewer employers) did employ just under 44% of the private sector workforce in 2016-17, according to ABS statistics. But a decade ago they employed more than 52%. Over the past two financial years, since small businesses have been paying a lower company tax rate than large ones (and operators of unincorporated businesses have been getting a 'discount' on the personal income tax they would otherwise pay), employment in small businesses has fallen by 0.5% - while employment at large businesses (those with 200 or more employers) has risen by 2.5%.

Likewise, ABS statistics show that small businesses are, in general, less likely to engage in any form of business innovation than medium-sized or large businesses.

A much more sensible strategy, if you believe that preferentially taxing any type of business is a good way to boost employment, investment or innovation, is to preference *new* businesses, rather than small ones. There's a lot of evidence, mainly from overseas, to suggest that *new* businesses actually are much more likely to create jobs, and to engage in innovation. Indeed, it's often precisely for the second of these reasons that new businesses are started.

Moreover, since there are a lot fewer new businesses than there are small ones, the revenue foregone by taxing them at a lower rate – or giving them some other kind of preference or concession - is much less than that resulting from preferentially taxing small businesses. And there are no perverse incentive effects – a new business can't *not* get older (other than by going out of business), whereas we know that small businesses can and do choose to stay below whatever threshold entitles them to preferential treatment.

Put differently, if we are going to use the tax system to induce changes in personal or business decisions and behaviour that we think will improve our overall economic performance, wouldn't it be better if we rewarded people or businesses for doing something, rather than for being something – which seems to be the current approach?

Can't we think of anything else except tax cuts?

In my view, it will require more than tax cuts – even much better-designed ones than those currently on offer – to induce a sustained improvement in Australia's economic performance.

In particular, we need to remedy the shortcomings in our education system – as evidenced by, among other things, the steady decline in Australia's PISA scores since 2000, the increasing and potentially unsustainable reliance of our universities on international students, and the inability of our TAFE and VET systems to deliver the skills required by employers.

These don't necessarily require spending more, in aggregate, on education than we currently do – as opposed to spending what we do spend more effectively, and more equitably. The Productivity Commission's *Shifting the Dial* Report released last August devotes one of its six chapters to things that could and should be done to that end.

That same report includes a welter of other suggestions and recommendations in areas such as health, planning and land use policies, housing, energy, road funding, copyright laws, and inter-governmental relations which would help to boost productivity.

I would also strongly endorse the Productivity Commission's recommendation in its most recent *Trade and Assistance Review* that there should be a periodic review of the costs imposed by 'national security' measures, "by an agency without active involvement in security policy". I have absolutely no doubt that our collective inability to calibrate risks rationally and sensibly, and to weigh up the costs associated with the pursuit of 'security' against the purported benefits, has contributed to the slowdown in productivity growth this century. However, I'm not holding my breath waiting for that recommendation to be taken up.

The importance of 'inclusive growth'

The brief for this session concludes with a nod to the importance of ensuring 'inclusive growth in a technological era'. This is an important consideration. It's now widely accepted, at least by international agencies such as the OECD and the IMF, as well as by the World Economic Forum, that rising inequality and social exclusion are inimical to sustained economic growth – not least because they provide fertile breeding grounds for the populist sentiments that are now becoming more widespread across 'advanced' democracies, and which are informing policy shifts – particularly in the United States – that are likely to detract from the prospects for sustained economic growth in individual nations and the world as a whole.

It ought to be crystal clear that the 'reform agenda' that has been pursued by political elites in most Western democracies, with the support of most of the business community, has paid insufficient attention to distributional questions, and has been too ready to assume that "a rising tide lifts all boats".

Australia has managed to avoid a widening in the inequality of the distribution of income across income quintiles as has occurred in most other 'advanced' economies since the turn of the century, or earlier. That's partly a by-product of not having had a recession (since recessions have their greatest impact on people at the bottom end of the income distribution); but it also attests to the effectiveness of our tax-transfer system. However, we have experienced an increase in income inequality between age groups (the old have gained at the expense of the young) and between regions (people living in cities have gained at the expense of those living outside the major metropolitan areas). And there has also been a significant increase in inequality in the distribution of wealth, largely as a by-product of the housing boom.

There also seems to be an ongoing increase in inequality in the distribution of educational opportunities and outcomes, and possibly also in employment opportunities.

Reform advocates therefore need to factor these considerations into their thinking about what needs to be done, what policies need to be changed, and how.

For my part I am *not* in favour of raising tax *rates* – on anyone.

But I have long been an advocate for curtailing or eliminating various forms of preferential treatment which the Australian tax system confers on particular categories of income or expenditure, particular saving or investment vehicles, particular forms of business organization, or particular groups of taxpayers, preferences which more often than not work disproportionately to the benefit of higher income taxpayers (or people who would otherwise be higher income taxpayers).

But fostering 'inclusive growth' requires more than merely tinkering with the tax system. It requires repairing the holes in our social safety net – for example, the level of NewStart Allowance paid to unemployed people. It calls for more effective and equitably distributed spending on school education, and on trade and vocational training. It involves more effective constraints on the use of 'market power', in both product and labour markets. It entails greater provision of affordable housing, including 'social housing', so that people can afford to live in reasonable proximity to where the jobs are (or are likely to be).

In other words, once we recognize the importance of ensuring that growth is truly 'inclusive', there's a lot more to it than there used to be.