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A COMMENTARY ON THE 1988-89 FEDERAL BUDGET

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A COMMENTARY ON THE 1988-89 FEDERAL BUDGET

ADDRESS TO THE AUSTRALIAN SOCIETY OF ACCOUNTANTS, ROCKHAMPTON BRANCH

THURSDAY 25 AUGUST, 1988

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"While the balance of payments deficit is Australia's **number one economic problem, inflation** remains Australia's **number one economic disease**".

This is the **premise** upon which Paul Keating **predicated** the 1988-89 Budget Strategy.

The seriousness of preventing any worsening of Australia's trading performance dictates that domestic prices (the rate of inflation) must be **kept down to approximate the inflation rates being experienced by Australia's main trading partners.**

It also dictates, according to the Treasurer, the need for stringent wage and price restraint, and the withholding of major tax concessions, as well as the need to curtail public sector borrowing, which includes all three tiers of government and federal and state government statutory authorities and agencies.

Deficit containment or **winding back the deficit** was insufficient to restore the confidence of the international financial community in the ability of the Australian economy to claw its way back from the brink of a major economic catastrophe. It was necessary to arrest the growth of public sector expenditure and produce a learner more efficient public sector in order to generate a substantial Budget Surplus of $5.5 bn. This is no mean achievement following on last year's surplus of $2 bn.

This will permit the Government to pay off another instalment on Australia's foreign debt bill which peaked in the region of **$120 bn** in early 1987.

It is indeed a stark realisation, that with an overall debt liability (internal and external) of approximately **$320 bn** just two years ago, that is $20,000 for every Australian, this country's economy was not rated as being all that sound by the international trading community.

It was necessary to adopt a policy of unprecedented fiscal thriftiness. With a faltering dollar, terms of trade that had worsened dramatically over the past decade, and a manufacturing sector that lacked a competitive cutting edge as well as being out of kilter with international demand trends, the responsible economic option was a unpopular one requiring many explicit and implicit trade-offs and forfeitures but, fortunately it seems to be working. There is no doubt that the overall thrust of this Budget is what is required under the present circumstances. The basic Budget Strategy, like those of the two previous Budgets, was framed in an environment of severe economic constraints with the main pressure being applied through international financial markets. There was very little room for manoeuvre.

The target set for inflation in this Budget is a rate of 3 - 4 % by 1990. This, if achieved, will bring the Australian rate into line with those of our trading partners. It will assist in the sale of our traditional primary commodities and help gain access to new markets for manufactured goods. It will accelerate the benefit flow from the continuing re-structuring of the Australian economy.

An improved balance of payments will take pressure away from the Australian dollar whose present high trading level is partly attributable to the weakening of the U.S. dollar.

A stable dollar will make room for a reduction in interest rates which will provide a incentive for new business investment.

Of the modest 3.5% economic growth estimated for 1988-89, business investment is expected to make a major contribution with an anticipated growth of 12% over the financial year. So business investment will make up the shortfall created by reducing the size of the government sector. This is a reversal of the displacement or "crowding out" effect.

In withholding the long-promised PAYE tax concessions until 1st July 1989, the Government has not made any rash promises. Any tax relief is dependant on wage restraint and the striking of a wage/tax trade-off with the ACTU. This is certainly a hedged option, but we can be certain that unless something drastic happens on the wages front, the Treasurer will announce tax cuts for low and middle income earners in the May Economic Statement next year. I would not be too optimistic of immediate top bracket cuts, although not bringing the top rate down to approximate or equal the Company Tax rate will cause some distortions and anomalies with franked dividend imputation.

Withholding income tax reductions has helped the Treasurer in bringing down a "Budget of historic proportions" with an unprecedented surplus of $5.5 bn., that is, $2.2 bn. higher than promised in the May Economic Statement.

You will remember that a major initiative in the May Economic Statement was the reduction in the Company Tax rate by 20c in the dollar, from 49c to 39c.

Despite the fact that this realignment of the Australian Company Tax with prevailing rates in the U.K. and the U.S. was necessary to plug a weakness in the Balance of Payments Capital Account, it was a measure that also provided encouragement for those businessmen (if any) who are actually paying 49c in the dollar, (for many, due to a wide range of concessions the effective company tax rate would have been lower), to undertake new investments. It was accompanied by the abolition of a range of concessions which could mean that many companies will not gain very much from the overall exercise. It will be interesting to see to what extent the yield from Company Tax will decline over the coming fiscal year.

The other major new tax initiative in the May Economic Statement (which is part of the Budget) was the introduction of a 15% tax on the investment earnings of superannuation funds accompanied by bringing this fund into the full imputation system.

A third major initiative in the May Economic Statement was the across the board reduction in tariff levels, presumable to force some of our import competing industries to either become competitive or to phase themselves out, but risking a surge of imports which would have a damaging effect on our precarious balance of payments situation.

So some "heavy artillery" was used in the May Economic Statement and Australian's primary producers probably fall into the category that probably will not gain much from the Company Tax reductions and will more than likely be adversely affected by both the Superannuation Investment Tax and the tariff reductions.

Little wonder then that they do not get a mention in the Treasurer's Budget Speech.

One thing that I find particularly interesting about Paul Keating's recent Budget is that his new revenue raising measures cut in quickly, if not immediately, whereas increased social service payments are generally deferred to some future date. Promised income tax relief is now deferred to 1 July 1989, and even then it is surrounded by provisos. This helps generate the surplus, much of which derives from the revenue side, and a high proportion of which is attributable to "bracket creep". Paul Keating has made an art form out of the manipulation of "fiscal drag". I suspect the government is concerned that there may be a political backlash from what John Howard terms "middle Australia" to the long-drawn-out promises of income tax relief.

Given the commitment to clamp down on inflation, it may be worth while trying to pick out measures that will tend to either reduce inflation from the present rate, or, prevent any worsening of that rate.

The first prong in the governments anti-inflationary strategy is to the reduction in indirect taxes estimated to cost in the region of $400 m in 1988-89. Apart from the immediate effect on the Consumer Price Index, the loss in revenue to the government would be offset by the increased purchasing power in the hands of consumers if tax reductions are passed on in full, as price reductions. There would be a rise in real incomes for those who purchase the commodities affected.

The second prong in the strategy is a bit tenuous. It is contingent on an agreement between the government and the ACTU on a wage tax trade-off - presumably, aimed at providing significant reductions in the income tax rate for low and middle income earners in return for further wage restraint. This could mean little or no change in real incomes. One may justifiably ask why the Treasurer feels obliged to promise this somewhat illusory benefit, which is no more than the desired outcome of a bargaining process that has not yet taken place. It does suggest that the electorate is indeed gullible if it can be that easily placated.

How can the Treasurer follow-up these announcements with the following assertion?

"These arrangements will underpin the wage decision recently handed down by the Arbitration Commission and open the way for both higher real incomes and lower real labour costs".

As I have already indicated, any real wage improvement that may arise from the Treasurer's anti-inflation package will tend to be marginal. Neither is it clear that the adoption of this package will push the present inflation rate of 7% down to 3 - 4 % in 1990. When in 1990? What of all the other factors that can influence the inflation rate? This is all a bit too nebulous. It has an air of spurious precision as well as a strong element of wishful thinking. Then the Treasurer has to 'predict' a low inflation rate if he expects to maintain wage restraint. Despite the success of the Accord, the Government has not been very successful in bringing down the inflation rate.

You will remember that the Fraser/Howard Government, adopting the Monetarist school of economic thought, pursued a policy of trying to control inflation at the expense of rising unemployment, in that Government's view, the lesser of the twin evils.

The Hawke Labor Government was elected to office in March 1983 on a policy of fighting inflation and unemployment simultaneously.

Both employment and inflation rates were brought below the critical 10% "stagflation" threshold but both rates have averaged around 8% over the past five years. The most successful year was 1984/85 when the rate was consistently below 6.5% and actually touched 5% in December 1985. Significantly, however, the OECD rate fell from 4.5% to 2 % between June 1985 and September 1986 where as the Australian rate rose from 6.5% to 9% over this period. This wide disparity between our inflation rate and that experienced by the OECD countries contributed significantly to the worsening of our balance of payments and the rapid rise in our overseas indebtedness. Worse still, our major trading partners maintained lower inflation rates than the OECD average.

Coupled with this, our productivity growth was well below that of our major trading partners.

There is no escaping the fact that we have not made a great deal of progress yet in getting what it is now fashionable to call "the fundamentals" of an economy right, that is, becoming as dynamic, flexible and competitive as our trading partners, which means increasing productivity and trading our way back to the position of an economic equal within the OECD. But a severe economic collapse has been averted for the time being, at least.

This Budget introduced the JET programme to provide jobs, education and training for 12,000 sole parents. It provides the New Start Programme towards the retraining of 25,000 of the long-term adult unemployed. It provides 40,000 new university places over the next three years.

All three initiatives will make some inroads into the unemployment statistics but where are the job creation projects to absorb these better trained people into the workforce? The Budget is silent on this. If the projected increase in business investment materialises, then some additional new job opportunities will be created. There is no commitment to reduce unemployment to 6% or 5%. In fact the OECD and most reputable forecasters expect unemployment to rise over the next fiscal year.

This Budget is predicated on the maintenance of a steady 3.5% economic growth rate per annum - a growth rate which is heavily reliant on the estimated 12% increase in real business investment. Last year the expected contribution of net exports to economic growth was not realised. With consumer expenditure in check and little expectation of net exports making any contribution in economic growth in the near future, and with the containment of government expenditure, private investment is the only remaining feasible source of real economic growth. It is difficult to identify the basis of the Treasurer's confidence in such a major resurgence in private business investment.

The increased funding for Health and for Aboriginal and Torres Strait Islanders, coupled with the initiatives to reduce the number of registered unemployed, could well be viewed as an attempt to regain some of the lost ground among traditional Labor voters. Behind this apparent concern with creating goodwill for the 1989 Federal Election are the less publicised elements of the Accord - the ACTU trade-off to hold down wage pressure in return for sweeping social reforms when the state of the economy will permit their inplementation.

It can also be viewed as the success of the powerful welfare and aboriginal lobbies in obtaining real improvements in living standards despite the cut-backs and wage restraint policy.

An interesting monetary measure announced with the Budget is the discarding of the 7% Statutory Reserve Deposit requirement and thus increasing the lending capability of banks which is expected to generate a 5 - 10% increase in profits. Importantly, this measure is expected to lead to a slight reduction in interest rates. If interest rates do fall this will contribute to the encouragement of business investment and will also cause some reduction in the inflation rate.

The Overall Budget Strategy then, is a fairly brittle one. The immediate problem arises from our Balance of Payments performance and our high levels of overseas debt as the Treasurer correctly acknowledges. Short term juggling can provide temporary budget surpluses but improving our trading performance requires more than a substantial reduction in the domestic inflation rate. It requires greater productivity and vastly improved management and international marketing skills. It requires the re-assessing of export commodity markets from which we have been eased out and the breaking into new markets particularly those lucrative ones associated with innovative products.

The overseas constraint is a severe one. Our relative size in the world of international trade makes it difficult to use any bargaining muscle. Our economy is hyper-sensitive to fluctuations in world commodity prices. We will be fortunate if the recent recovery of the Australian economy is sustained. This is necessary to be assured of a significant improvement in our Balance of Payments in the short term and it too must be sustained. The uncertainties are beyond our control.

The present strategy has convinced the international financial and trading communities of the seriousness of the Governments commitment to re-structure the Australian economy and to attempt to slowly and deliberately put our house in order.

Two of the taxation changes in this Budget deserve special mention, the reduction in the sales tax on beer and the Graduate Tax now cleverly re-named the Higher Education Contribution Scheme.

The beer tax reduction, and the differentiation between full-strength and low-alcohol beer, is a very clever move. It has little significance from the public finance standpoint but it was aimed to generate goodwill among the average worker and at the same time pander to the beer barons and the hotel lobbies. The possible anti-inflationary effect is a bonus.

The attempt to diffuse the opposition to the Graduate Tax is also clever. It all sounds so reasonable - making the privileged pay 20% of the cost of their tertiary education and giving many more Australians access to our tertiary institutions. In the meantime the tax becomes increasingly complex. One gets the impression that the government is now on the retreat and is concerned at the threatened loss of the student vote in the next election. The impact of the tax is being diffused; its intent is being blurred; its yield is being played down.

It appears to penalise excellence at a time when high-level expertise is what we desperately need if we are to compete with those of our more enlightened trading partners who have left us on the starting blocks in both innovative enterprise and international marketing expertise.

This government puts a lot of effort into marketing its policies. It maintains the tough economic restraint pitch while tinkering with various taxes and expenditures on the periphery.

Will the reduction in the tax on female cosmetics win female votes? Will the reduced tax on beer win back traditional Labor votes? Will the income tax concessions on 1 July 1989 win back the support of middle income Australians? Why raise the tax on thickshakes? Has the Treasurer got something against fat kids?

One thing is certain, the main thrust of this Budget is determined by economic considerations. The trimmings on the periphery are pitched towards re-gaining political popularity. The expenditure cuts are well spread to minimise their impact and where real gains can be identified the influence of powerful lobbyists is evident. The clever fiscal craftmanships evident throughout.

The orchestrated leak has now become standard practice so there are no major shocks associated with the handing down of budgets. The market had already absorbed the news before this Budget was handed down.

An interesting feature of Tuesday night's Budget Speech was the quiet atmosphere surrounding the Treasurer's speech. Whether this was due to the aura of the new Parliament House or the fact that the content of the Budget was virtually known beforehand is hard to say. It was certainly a tame affair with very subdued "Hear! Hears!" and no noisy opposition outbreaks of protest.

The general reaction to this Budget appears to be relief - relief that the economy is showing some signs of recovery and that no further significant "belt-tightening" measures were introduced. Under the prevailing economic circumstances it would be difficult to find major faults with the Budget Strategy but the Budget Speech itself does contain some persuasive assertions that are not supported by in-depth economic analysis.

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