Fit for the future
Challenges for the next generation of Australians
About Saul Eslake

Saul Eslake worked as an economist in the Australian financial markets for 25 years, including as Chief Economist at McIntosh Securities (a stockbroking firm) in the late 1980s, Chief Economist (International) at National Mutual Funds Management in the early 1990s, and as Chief Economist at the Australia & New Zealand Banking Group (ANZ) from 1995 to 2009.

Since leaving ANZ in August 2009 Saul has had a part-time role as Director of the Productivity Growth Program at the Grattan Institute, a non-aligned policy ‘think tank’ affiliated with Melbourne University, and more recently also as an Advisor in PricewaterhouseCoopers’ economics practice.

He has a first class honours degree in Economics from the University of Tasmania, and a Graduate Diploma in Applied Finance and Investment from the Financial and Securities Institute of Australia. He has also completed the Senior Executive Program at Columbia University’s Graduate School of Business in New York.

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Fit for the future: Challenges for the next generation of Australians

First edition

Fit for the future: Challenges for the next generation of Australians
Foreword

The Institute of Chartered Accountants in Australia (the Institute’s) thought leadership papers to date have rightly focused on forward looking, thought provoking public policy debates on traditional accounting topics.

I truly believe that it is the Institute’s role and responsibility to also produce thought leadership papers that directly impact broader business issues and include valuable economic commentary relevant to all Australians.

In this regard the Institute’s latest thought leadership paper entitled, *Fit for the future: Challenges for the next generation of Australians* provides valuable insights into the six biggest issues that Australia’s future leaders will confront in the next decade.

I specifically encourage business leaders to utilise this paper and to closely evaluate the core components identified in order to gain a greater understanding of how to ensure Australia remains fit for the future. Today’s decision-makers will leave to the youth of Australia and future generations a world where traditional thinking regarding housing, public debt, infrastructure, resources and work incentives seem redundant in comparison to the new concepts and ideas presented in this thought leadership paper.

The Institute is extremely pleased to have worked with one of Australia’s leading economists Saul Eslake, to produce this paper and trust that you will find the issues presented in it both interesting and thought provoking. The challenge for Australia’s future generations is to capitalise on the opportunities and manage the risks that we as a nation are likely to face in the future.

Michael Spinks
President
Institute of Chartered Accountants in Australia
**Executive summary**

Peter Cosgrove announced in his 2010 Australia Day speech, ‘Australia is a nation of good fortune and a good future’, this statement certainly rings true when viewed in the context of Australia’s modern history. Australia has continued modest growth in terms of GDP, population and national wealth. And globally has remained relatively unscathed from the recessions and downturns of the last 70 years.

Presently, Australia is in a situation to fully appreciate its unique position on a global scale. This paper identifies six issues which are integral to future growth and are required to be managed and addressed in order for Australia to continue to reap the benefits of its distinctive position.

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<th>Resource boom</th>
<th>Infrastructure requirements</th>
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<td>Australia must draw on foreign capital if it is to fully realise all the opportunities created by the rapid growth and industrialisation of emerging Asian nations. The challenge is recognising alternate capital sources (such as superannuation) as the traditional capital sources are drying up.</td>
<td>It is imperative that Australia’s investment in infrastructure is funded through clear economic and social reasons, rather than through short-termism and politically motivated public private partnerships.</td>
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<th>Level of public debt</th>
<th>Human resources</th>
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<td>It is to Australia’s detriment that it doesn’t borrow enough. As Australia’s health, education and infrastructure problems escalate there is no reason why such capital expenditures and programs cannot be partially funded through an increase in borrowing from the Australian Government.</td>
<td>Australia can not afford to have too high a proportion of its human assets remaining abroad for long periods, or permanently. Public policy and legislation needs to play a role especially as demographic changes accentuate pressure on the available pool of skilled Australian workers.</td>
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<th>Home ownership and housing affordability</th>
<th>Governance structures</th>
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<td>The ideal of owning a home is no longer an aspiration for many young Australians. With that said Australia’s housing supply has failed to keep pace with the growth in housing demand as it is. This is a huge problem particularly as the willingness of younger Australians to live in rural/regional areas is in decline.</td>
<td>There will almost certainly be a requirement for Australia to commit to financial sector regulatory reforms as part of a global response to the failings exposed by the recent financial crisis. The requirement could include tighter regulation of the activities of financial institutions, including requirements that financial institutions hold more capital and liquid assets, and that the term structure of their liabilities be more closely aligned with that of their assets.</td>
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Introduction

The global financial system has experienced its most serious financial crisis, and the world economy its deepest recession, since the 1930s. And yet the Australian financial system and economy, which for much of the post-war period had appeared especially vulnerable to global shocks, has come through this episode remarkably well. Australia’s experience of the ‘global financial crisis’ reflects a combination of good fortune and good management, which, if it can be sustained, augurs well for Australia’s prospects over the next two decades.

In particular, Australia seems well placed to derive substantial benefits from the rapid economic growth which is widely expected to occur in China, India and other developing economies in Asia over the next few decades. Australia stands to attract more migrants and more foreign capital, to enjoy faster rates of economic growth, and to provide greater advances in our citizens’ standard of living, than many of the countries with which we have typically compared ourselves in the past, if we are able to make the most of these opportunities.

Yet in order to make the most of those opportunities, and to deal with the challenges which will also be posed by our increasing economic engagement with Asia, and other challenges which we will inevitably confront during the next two or three decades, the political, business, professional and social leaders of tomorrow will need to be visionary and courageous.

This paper seeks to provide a perspective on how future leaders of Australia can contribute to public debate about the best means of capitalising on the opportunities and managing the challenges which Australia is likely to face over the next few decades.

Australia’s ‘terms of trade’

The ‘terms of trade’ is the ratio of the prices Australia receives for its exports to the prices it pays for its imports. Australia’s terms of trade are recovering from their GFC-induced slump and seem likely to remain at a high level by historical standards for an extended period, generating significant additional income for the Australian economy.

Source: Australian Bureau of Statistics.
Making the most of the ongoing resources boom

The rapid growth and industrialisation of China and India has led to a substantial increase in demand for minerals and energy over the past decade, and in particular, for coal, iron ore and natural gas, commodities with which Australia is well-endowed. This surge in demand appears to have been interrupted only briefly by the global financial crisis. Such is the growth potential of China and India that demand for these and other commodities could continue increasing for somewhat longer than the 15 or so years which has been typical of previous resources booms in Australia’s experience.1

This continuing demand for Australian resources is likely to keep the prices of those commodities at elevated levels (by historical standards) for some years to come, and will ideally also be reflected in significant increases in the volume of Australian commodity exports. Both effects will add substantially to Australia’s national income.

This prospect might seem like an unmitigated blessing. Yet Australia’s previous experience of resources booms suggests that without careful management, we may fail to maximise the benefits for current and future generations from what is a ‘one-time’ event in the grand sweep of human history (there are no more countries as large as China and India to come after these two giants have passed through their present phase of economic development).

The present resources boom, like its predecessors, is also likely to create economic and social strains and tensions associated with financing the level of investment required to enable substantially higher volumes of commodity exports; with the redirection of labour and capital towards the resources sector, towards those regions of Australia where resources are located, and away from other sectors and other regions of Australia; and with some of the broader risks associated with an extended period of economic prosperity, including inflation and financial instability.

Previous economic reforms will allow Australia to manage some of these strains more effectively than during previous resources booms. For example, Australia’s floating exchange rate provides something of a ‘shock absorber’ that did not exist at the time of the last major surge in commodity prices in the mid-1970s. Also the appreciation of the Australian dollar which has occurred since the present boom began has lessened the likelihood of competition between the resources sector and other parts of the economy for labour and capital leading to a surge in inflation as it did on that earlier occasion.2 The credibility of Australia’s central bank in keeping inflation low and stable, combined with our more decentralised wage-fixing arrangements, is another important point of difference between the current boom and earlier similar episodes in our history.

However the likelihood of the Australian dollar remaining at elevated levels by the standards of the past 25 years will be discomfiting for sectors of the Australian economy such as manufacturing, agriculture, tourism and education, all of which compete internationally and are thus sensitive to movements in the exchange rate but which derive none of the benefits flowing to the mining sector from high commodity prices. These sectors are likely to decline as a proportion of GDP over the next decade, and may even decline in absolute terms unless they are able to substantially improve their productivity performance and thereby maintain their output levels and competitiveness in the face of greater pressure on the availability of capital and skilled labour, and a more challenging external environment.

Australia has never been able to finance major resources developments wholly from its own domestic savings and is unlikely to be able to do so during the current resources boom. Australia will thus need to draw on foreign capital if it is to fully realise all the opportunities created by rapid growth and industrialisation in Asia. And the changing structure of the world economy inevitably implies that less of this capital will come from traditional sources in advanced economies such as those of Europe, North America and Japan, and more of it from east Asia (including China and India) and the Middle East.

That in turn implies that Australia will need to come to terms with the vehicles through which capital from these sources is likely to be available, such as state-owned enterprises and sovereign wealth funds. Both of these potentially carry political or strategic implications that have not usually been associated with more traditional sources of foreign capital. Australia will need to develop clear, transparently administered rules for determining the conditions under which investment from these sources may occur.

It will also be important to consider arrangements for ensuring that current and future generations of Australians derive an appropriate share of the benefits accruing from the exploitation of resources which nominally ‘belong’ to them. Traditionally, Australian governments have received returns from resources developments through royalties and company tax collections, as well as more generally through the revenue generated by increased employment and economic activity.

1. Ric Batellino (Deputy Governor, Reserve Bank of Australia), ‘Mining Booms and the Australian Economy’, Address to the Sydney Institute, 23 February 2010, p. 8.
2. See David Gruen (then Chief Advisor (Domestic), Macroeconomic Group, Australian Treasury), ‘A Tale of Two Terms-of-Trade Booms’, Address to Australian Industry Group Economy 2006 Forum, Melbourne, 1 March 2006.
However, the mineral royalties collected by state governments are typically based on production volumes and thus, could be argued, do not necessarily allow the broader community to receive a share of the unusually high prices now being, and for some time likely to be, received for minerals and energy commodities. Income taxes paid to the Australian Government on mining company profits do reflect higher commodity prices as well as increased production, but even so there may be room for argument as to whether the revenue thereby generated represents an appropriate sharing of the financial returns from the exploitation of Australia’s resources.

In the context of some offshore petroleum projects, successive Australian governments have concluded that it does not, and accordingly have imposed a higher ‘resource rent tax’ on the economic profits generated by those projects. The same approach could be taken to other highly profitable resource projects, although it would be important that any such arrangements are designed with Australia’s international competitiveness firmly in mind, and are not so onerous as to dissuade companies from proceeding with otherwise profitable projects, or to divert investment to other countries. Revenue from a ‘resource rent tax’ could be used to reduce other taxes, including the statutory rate of company tax (which might provide some relief to businesses under pressure from a strong A$, for example).

A related question is the extent to which the additional revenues which flow to government as a result of the resources boom (however collected) are shared between the current and future generations of taxpayers. Prior to the onset of the financial crisis, both the Howard Government and (in its first budget) the Rudd Government targeted a budget surplus of 1 per cent of GDP, with the result that any revenue in excess of that required to meet that target was either spent or used to pay for income tax cuts. This meant, in effect, that the vast majority of the broader community’s share of the revenue derived from the resources boom (and from on-going economic growth more broadly) was directed towards current taxpayers, and only a small proportion of it ‘saved’ for future generations.

An alternative approach, which has been taken up in many other commodity-exporting nations or regions (including Alaska in the United States and Alberta and Newfoundland in Canada, as well as Norway, Chile, Trinidad and Tobago, Malaysia, Brunei and many oil-exporting nations in the Middle East and the former Soviet Union) has been to establish a ‘sovereign wealth fund’ to accumulate some proportion of the commodity-related revenue accruing to governments (either the profits of state owned oil or mining companies, or revenue from taxes on public and privately owned resources companies) and invest it for the benefit of future generations. Some other countries that are not commodity exporters but have nonetheless found themselves running large budget surpluses or accumulating large foreign exchange reserves at their central banks (such as China, Singapore, Taiwan and Korea) have also established similar funds.

The Australian Government currently expects to be running budget deficits until the 2015/16 financial year, and has committed itself to applying any unforeseen revenue gains towards deficit reduction. This is a prudent strategy. And once the budget returns to surplus, the Government may well choose to apply those surpluses to paying off the debt incurred during the financial crisis more rapidly than currently envisaged. Sooner or later, however, the question of what to do with recurring budget surpluses is likely to re-emerge.

Transferring revenues from any newly introduced resource-related taxes, or from future budget surpluses, would provide a means of ensuring that future generations derived at least some benefit from the sale of Australian resources to China, India and other economies during their period of rapid growth and industrialisation.

It could also provide a more politically acceptable way of running tighter fiscal policy as the economy approaches full employment of labour and capital (that is more acceptable than simply piling up cash at the Reserve Bank) and thus of reducing the burden that would otherwise fall to monetary policy to contain inflationary pressures.

An Australian sovereign wealth fund could be readily administered by the Future Fund, established by former Treasurer Peter Costello to accumulate assets in order to meet future public service pension liabilities. An Australian sovereign wealth fund could also help to ameliorate public disquiet about equity investment in Australian resources projects by foreign state-owned enterprises or sovereign wealth funds, either by taking stakes in overseas enterprises or even (under clear and rigorous guidelines) taking stakes in Australian resource projects.
**Sovereign wealth funds**

Many commodity-exporting economies have established sovereign wealth funds as a way of saving a proportion of the income generated from resources exports. Australia’s Future Fund was established out of previous Budget surpluses to pay future public service pension liabilities, but could also be used to administer an Australian sovereign wealth fund.

![Bar chart showing sovereign wealth funds by country.](chart.png)

**Source:** Sovereign Wealth Fund Institute.
The appropriate level of public debt

The Commonwealth and most state government budgets swung into deficit during the financial crisis, reflecting both the impact of the economic downturn (and especially the sharp reversal of the earlier upward trend in mineral and energy commodity prices) on government revenues, and the decisions which governments took to lessen the impact of the financial crisis and the ensuing global recession on the Australian economy. As a result, the Australian public sector is once again a net debtor, and returning budgets to a sustainable position will of necessity be a major priority for the medium term – although this is a much less onerous requirement for Australia than for most other industrialised nations, which are confronting levels of public debt that as proportions of their national incomes are substantially higher than Australia’s.

It is important to have an appropriate sense of perspective about budget deficits and public debt. There is no cardinal principle of economics or public finance which says that the optimal level of debt for a government is zero, any more than there is such a principle for a household or a business. The level of borrowing or debt which will be appropriate, or prudent, for a government will depend on, among other things, what the debt is used for, the context in which it is incurred, and the adequacy of the government’s revenues to service it.

In general, government ‘operating expenses’ – the running costs of the public service and other agencies (including the defence forces, schools, and hospitals), pensions and other social security payments, grants and subsidies to industries and the like – should be covered by revenues from taxes and user charges, rather than by borrowing.

However there is no reason why capital expenditures – expenditures which result in the creation of long-lived assets such as schools, hospitals, roads, railways and port facilities – cannot be partly funded by borrowing, as opposed to wholly out of current revenues.

Indeed, there are at least two good reasons why part of the cost of providing public infrastructure and other long-lived facilities should be met by borrowing. First, borrowing provides a way of ensuring that future generations of taxpayers who will derive some benefit from the provision of such facilities contribute to their cost, by servicing and ultimately repaying those borrowings. Secondly, it is unlikely to be politically possible for governments to run sufficiently large ‘operating surpluses’ (that is, to generate revenues in excess of their ongoing expenses by a sufficiently wide margin) to fund a level of public infrastructure investment appropriate to the needs of a rapidly-growing population. Hence an unwillingness to borrow, even within prudent limits, for infrastructure spending is likely to lead to inadequate infrastructure provision, as the experience of many Australian state governments over the past two decades bears out.

Where a government is responsible for macro-economic policy (which in our federal system is the responsibility of the Australian Government), it may be appropriate to depart from general principle that ‘operating expenses’ should be fully covered by taxation and other current revenues in the face of a major economic downturn. In those circumstances, to seek to maintain ‘operating expenses’ in line with revenues would necessitate cuts in spending or increases in taxes that would in turn exacerbate the downturn in private sector economic activity. Indeed, most mainstream economists accept that it is reasonable, in the face of a significant downturn in private sector activity, for governments to do more than merely accommodate the impact of the downturn on tax collections, they should also seek to lessen the severity of the downturn and bring forward the eventual recovery, through measures that are timely, temporary and well-targeted (towards those objectives).

Such measures will usually entail some level of government borrowing. But provided that borrowing can be undertaken without putting the governments finances on an unsustainable path, and there are reasonable grounds for confidence that ‘operating expenses’ and revenues will again converge, there is no basis for considering such – borrowings to be imprudent. These conditions will usually be satisfied if governments credibly commit to running budget surpluses during favourable economic circumstances, giving them the leeway to run deficits during less propitious times.

Australian governments have generally done so during the past 25 years or so, with the result that the large deficits they have incurred following the onset of the global financial crisis in 2007-08 have not been widely regarded as unsustainable. Indeed, both the IMF and the OECD see Australia as having among the lowest levels of both gross and net public debt in our peer group of advanced economies, and needing little or no ‘fiscal adjustment’ (tax increases or reductions in government spending) over the medium term to ensure that they remain on a sustainable footing. This is in marked contrast to the fiscal situation confronting most other western economies.

The capacity for Australian Governments to ensure adequate and appropriate provision of public infrastructure, and to mitigate the impact of sharp swings in the business cycle, would be enhanced by a broadly-shared understanding of what represents appropriate and prudent upper and lower limits for the level of public debt.

At the Commonwealth level, it would also be enhanced by the presentation of the annual budget in terms which more clearly separated operating expenditures from capital expenditures – as has been the case for state governments since the late 1990s – rather than focusing primarily on cash flows.
Budget deficits and public debt in advanced economies, 2010

By comparison with most other Western economies, Australia does not have a significant public debt problem.

Source: OECD Economic Outlook No 85 (December 2009); projections are for 2010.
Home ownership and housing affordability

Successive generations of Australians have aspired to, and generally attained, a high rate of home ownership. Home ownership caters to the need, which most people feel, to have a place they can call their own. Typically, it provides a source of stability and security for families when they are raising children, and for people in retirement. It provides the means by which many people accumulate the majority of such wealth as they have. For some, it provides the financial base from which a small business can be built. Arguably, home ownership also provides broader social benefits such as stable communities in which people feel they have a tangible stake, and to which they are willing to contribute.

Yet the ‘great Australian dream’ of a ‘home of one’s own’ is becoming an increasingly remote prospect for growing numbers of younger Australian adults. Since the early 1990s, the home ownership rate has actually dropped in every age group except the over 65s; the only reason the overall home ownership rate has remained fairly steady at 70 and 72 per cent is that of the proportion of the population aged 45 or over, among whom home ownership rates have always been significantly higher than among younger age groups has increased. The home ownership rate among people aged 25 – 29 dropped from 51 to 43 per cent between the 1986 and 2006 Censuses; that for 30 – 34 year olds dropped from 65 to 57 per cent over the same interval; and that for 35 – 39 year olds fell from 71 to 65 per cent.

To some extent the decline in home ownership rates among younger adults stems from the (wholly desirable) increase in the proportion of young people acquiring tertiary qualifications, and thus commencing employment later in life; from the fact that younger workers, in common with all employees, are now required to contribute to superannuation; and from the fact that people generally are forming families at a later stage of their lives than was common in the first few decades after World War II.

However, it increasingly also reflects the fact that home ownership has become less and less affordable for a growing proportion of younger Australians – even though mortgage interest rates have for the past 15 years been significantly lower than they were during the 1970s and 1980s, and despite the billions of dollars in assistance which governments have provided to first-time buyers through cash grants and stamp duty concessions. Whatever effect these might have had in making home ownership more affordable has been more than offset by the almost unending upward march of house prices. As a result, a growing number of young adults are continuing to live with their parents, or in shared accommodation, rather than buying or renting their own dwellings at the same ages at which previous generations have done. This has in turn prompted an end to the decades-long downward trend in the average number of people per dwelling.

The United States has, unintentionally and at enormous cost, ‘solved’ its housing affordability problem as a result of the sharp decline in house prices which helped bring on the recent financial crisis. American housing is now more ‘affordable’ than it has been in almost forty years, provided that a would-be buyer can get a mortgage (which is more difficult than it used to be as a result of the financial crisis). The same is true to a lesser extent in a number of other countries.

In Australia, by contrast, house prices barely declined at all during 2008 or 2009, and, while the sharp decline in mortgage interest rates provided home-buyers with some temporary respite, the decline is now in the throes of being at least partially reversed.

The fundamental cause of Australia’s housing affordability problem is that the supply of housing has failed to keep pace with growth in the underlying demand for it, so that increases in the capacity of buyers to pay for housing (as a result of rising incomes, lower interest rates or government financial assistance) have instead been ‘capitalised’ into higher house prices.

Since the turn of the century, Australia’s population has grown by more than 200,000 per annum, rising to more than 400,000 per annum in 2008-09. Yet the number of dwelling completions has averaged just 150,000 per annum, little changed from the average of the preceding three decades. Over the past decade, around 520 new dwellings have been completed for every 1000 increase in Australia’s population; compared with an average of 670 over the preceding three decades. And around 15 per cent of dwelling completions over the past decade have entailed the demolition of an existing dwelling, compared with around 10 per cent in previous decades.

The reasons for the failure of housing supply to keep pace with the growth in ‘underlying’ housing demand are complex, but they include a diminishing supply of land available for ‘broadacre’ housing development; the increasing use by local governments and other agencies of ‘up front’ charges on developers to pay for suburban infrastructure (which have in turn prompted developers to build a smaller number of more expensive dwellings); and growing opposition within many urban communities towards high-density residential development.3

3. See the National Housing Supply Council State of Supply Report 2010 (forthcoming) for a more thorough analysis of factors affecting housing supply.

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There are no simple or easy solutions to Australia’s housing affordability problem. Providing cash assistance to home-buyers (in the form of grants or stamp duty concessions) has clearly failed: all it has done to further inflate the prices of existing housing. Ideally, this assistance should be redirected towards measures which will facilitate increases in the supply of housing, including by tackling the constraints on housing supply noted earlier.

If effective solutions to Australia’s housing affordability problem are not found, many of the assumptions on which previous generations of Australians have built their lives will no longer be valid.

**Australian home ownership rates**

Australia’s overall home ownership rate has been remarkably stable for five decades – but more recently, despite declining home ownership among younger age groups. Home ownership rates could decline sharply over the next 20 years if affordability is not improved.

### Overall home ownership rate

![Graph showing home ownership rate over time](image)

### Home ownership rate by age group

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Meeting Australia’s infrastructure requirements

Infrastructure – the physical structures and equipment which allow people, goods, services and information to be transported or transmitted from one place to another, which create, store and distribute water and energy, and which allow people and businesses to communicate and interact with one another – is the backbone of any modern economy. Infrastructure is especially important in Australia because of the way in which our relatively small population is distributed over such a vast land mass.

As the Productivity Commission has noted, ‘the timely provision of efficient economic infrastructure plays a key role in supporting innovation activity and Australia’s productivity performance’.  

Australian investment in infrastructure peaked as a proportion of GDP in the mid-1960s and declined steadily to less than 3 per cent of GDP in the 1990s and early years of the 2000s. Since then, infrastructure investment has increased to around 5 per cent of GDP, driven largely by increased private sector investment associated with the resources boom and in transport infrastructure under public-private partnerships (PPPs) and similar arrangements, although there has also more recently been some increase in public sector infrastructure investment, including as part of governments’ economic stimulus programs in response to the global financial crisis. However, Australian public sector infrastructure investment as a proportion of GDP remains at the lower end of the spectrum of advanced economies, and the average age of Australia’s public infrastructure has been rising more rapidly than that of the business sector’s stock of fixed capital.

Of course, the adequacy or otherwise of any country’s infrastructure depends not only on the level of investment in it but also on the quality of that investment and the efficiency with which the capital is used. Some countries which have invested considerably higher proportions of GDP than Australia have done so to little obvious benefit in the form of faster economic growth (Japan being the standout example). And there are numerous examples in Australia’s experience of infrastructure investments which have been funded by governments for reasons other than clear economic or social return.

Nonetheless, the World Economic Forum last year ranked Australia 21st (out of 134 countries) for the overall adequacy of its infrastructure, compared with (for example) 12th for the quality of our institutions; Australia’s port infrastructure and road infrastructure were particularly poorly ranked (at 41st and 31st, respectively). The adverse consequences of shortfalls in the quality and quantity of Australia’s economic infrastructure are likely to become more apparent over the coming decade, during which the Australian economy is likely to be operating with smaller margins of ‘spare capacity’ than it has done for most of the past 35 years.

The recently released *State of Australian Cities 2010* report identified ‘increased inefficiencies and productivity losses arising from an infrastructure backlog, transport congestion, and increased costs associated with the movement of freight, and the provision of services such as water, power and sewerage’ as factors detracting from the economic performance of Australia’s major cities over the past decade. It cited Bureau of Infrastructure, Transport and Regional Economics projections that the cost of urban road congestion was likely to rise from $9.4bn in 2005 to $20.4bn by 2020. As the report quite rightly observed, urban road congestion also has a social cost through, for example, reducing the amount of time available for families to spend together.

It thus seems reasonable to assert that Australia’s economic performance and the quality of life of its citizens will be enhanced by a program of rigorously evaluated, appropriately regulated and rationally priced infrastructure investment. Not all of this investment needs to be undertaken or financed by governments. The financial crisis has not undermined the proposition that, in many instances, the private sector can construct and operate infrastructure assets in a more timely fashion and at lower cost than governments. The financial crisis has, for the time being at least, increased the interest rate premium paid by private sector borrowers relative to governments, and rendered less viable some of the structures commonly used to facilitate private sector involvement in the construction and operation of major infrastructure projects through PPPs and alliances. Even so, well-structured PPPs have been able to secure financing over the past year.

In any event, it would not be unreasonable for a share of the cost to governments of providing long-lived infrastructure assets to be met through borrowing, thereby ensuring that future generations which benefit from those assets also make some contribution towards their cost. As noted earlier, rational discussion of the appropriate level of borrowing for infrastructure investments by the Australian Government would be enhanced by a presentation of the budget which more clearly delineated ‘operating’ and capital expenditures.

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Financing of infrastructure investment might also be enhanced by tax reforms which create a more ‘level playing field’ between different forms of saving and investment instruments. The current Australian tax system imposes much higher effective rates of taxation (after taking account of the impact of inflation) on fixed-income type investments than it does on property or equities.

It is also crucial that major infrastructure investment proposals be subjected to rigorous cost-benefit analysis and that, where they involve elements of ‘natural monopoly’, they are subject to appropriate regulatory oversight to ensure access on prices and other terms which are reasonable to all parties.

**Australia’s ageing infrastructure**

Australia’s infrastructure assets are older than other components of the nation’s capital stock, and increasingly inadequate to service the requirements of a rapidly growing population and expanding export industries.

![Diagram showing the average age of infrastructure assets from 1960 to 2010](chart)

*Source:* Australian Bureau of Statistics.
Making the most of Australia’s human resources

Australia is likely to be a rewarding place in which to live and work during the coming decade. But it will not be the only one. Rapid growth and rising living standards in the so-called ‘emerging’ world, and particularly in Asia, will also create enormous new opportunities for Australians to work and do business outside their own country, in addition to those which Australians have long pursued in Europe or the United States.

Young Australian adults, in particular, will be no less enthusiastic than previous generations to experience the challenges and rewards of living and working in different countries and amid different cultures.

That they will do so is not only to their benefit but to the benefit of Australia as a whole, through the linkages and connections that they build with the countries where they work, and the knowledge, skills and experience which many of them will eventually bring back to Australia. Talented Australians working abroad should be viewed as an asset (in a balance sheet sense), not a loss (in an income statement sense).

Nonetheless, Australia can not afford to have too high a proportion of its human ‘assets’ remaining abroad for long periods, or permanently; nor can it assume that it will always be able to replace skills and talent which move overseas by drawing on the skills and talents of people from other countries. Demographic change will accentuate pressure on the available pool of skilled labour in Australia.

Australians of all ages move abroad for a variety of motives, of which the prospect of financial gain is but one – and often not the primary one. In particular, very few Australians determine where they wish to live and work solely on the basis of the amount of tax they will pay. They also consider factors such as the cost of housing and other essentials, other aspects of the ‘quality of life’, opportunities for career advancement and personal growth, and (where relevant) the impact of their choices on their children’s prospects. Often it is the last of these which prompts expatriate Australians to return home.

This broad spectrum of considerations needs to be borne in mind when considering how both public policy, and employment practices may affect Australia’s capacity to retain or attract the talent or ‘human capital’ required to make the most of the opportunities which lie before us in the coming decade.

Very high rates of personal income taxation, especially if they become payable at income levels much lower than those which attract high marginal rates in other countries, could deter people with readily mobile skills from remaining in or coming to Australia. However, moderate differences in tax rates, especially if transparently paralleled by higher quality public services, are unlikely to have much difference on people’s location decisions. Other factors affecting the cost of living and the quality of life, including the availability of affordable housing, travel times, the range of opportunities for entertainment and recreation, and the cost and quality of education for children, are likely to be of greater importance. Government decisions affecting the quality of urban life will be as important to attracting and retaining talent as decisions about the taxation system.

Bearing in mind that fiscal pressures associated with demographic change and the need to return the budget to surplus will limit the scope for significant reductions in the overall level of taxation over the medium term, efforts at tax reform will ideally focus on enhancing incentives to work and invest – by lowering rates of taxation and broadening the tax base; improving the efficiency of revenue collection mechanisms, and removing out-dated and distorting taxes which impose a significant compliance burden while contributing relatively little to total revenues.

For individual employers, employment practices such as recognition and rewards, flexible hours of work and forms of leave, opportunities for further training, and the scope for rapid advancement, are likely to be at least as important in attracting and retaining talent as monetary remuneration.

It is therefore important that government workplace relations policies allow the greatest possible flexibility for employers and employees in negotiating terms and conditions of employment, within agreed broad parameters established by legislation.
Australia’s role in international governance structures

Australia’s membership of the ‘G20’ group of advanced and developing economies has given Australia a voice in the international discussions and decision-making which will shape the evolution of the global economy and the international financial system over the coming decade and beyond. It is very much in Australia’s interests that this forum has supplanted the ‘G7’ group of the seven largest industrial nations as the key forum for co-ordinating international responses to global economic issues, not only because Australia is directly represented; but also because of the increasing alignment between Australia’s interests and those of emerging Asian economies, four of which are also represented in the ‘G20’ (compared with none in the ‘G7’).

Australia’s evolving economic engagement with Asia implies that our international interests may not always co-incide as fully with those of the United States and Europe as they have done in the past. Balancing our economic and trade interests with our long-standing strategic interests and democratic values will be an important and on-going challenge for Australian political and business leaders.

Our membership of the ‘G20’ is also likely to entail obligations as well as opportunities. Among the former will almost certainly be a requirement to commit to financial sector regulatory reforms as part of a global response to the failings exposed by the recent financial crisis. This response will include tighter regulation of the activities of financial institutions, including requirements that financial institutions hold more capital and liquid assets, and that the term structure of their liabilities be more closely aligned with that of their assets.

It may be tempting for Australia to argue that, given the resilience displayed by its financial system and institutions through the recent crisis, there is little need to make significant changes to existing framework for financial system regulation and supervision. However, as a significant capital importer, and with much of the capital Australia needs for its ongoing economic development likely to continue to be imported through the banking system, Australia’s financial system will need to conform to evolving international norms.

Some of these new requirements may prove challenging for Australian financial institutions, given the comparatively small size of the Australian Government bond market, the large proportion which (long-term) mortgages represent of their assets, and their still relatively high dependence on wholesale funding. It is likely that these requirements will, on net, add to financial institutions’ operating costs – although this need not result in higher borrowing costs for Australian businesses and households if the additional costs are taken into account by the central bank in calibrating the stance of monetary policy.
Conclusion

Australians can look to the future with a good measure of confidence. The Australian economy has come through a substantial, real-time ‘stress test’ in relatively good condition, without some of the major challenges in terms of large burdens of public debt, fragile banking systems and high unemployment faced by other countries to which we have traditionally looked as comparators or benchmarks. And we are comparatively well placed to benefit from some of the major changes underway in the world economy, in particular the rapid growth and industrialisation occurring in the Asian region.

Yet the future also brings challenges, which if not successfully met will mean, at best, that Australia will fail to make the most of the ways in which the world is changing and, at worst, will face significant economic and social adjustment pressures.

This paper has sought to lay out some of those challenges, focussing on those where future leaders of the accounting profession can make a contribution to public debate about the best options for Australia’s future.
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