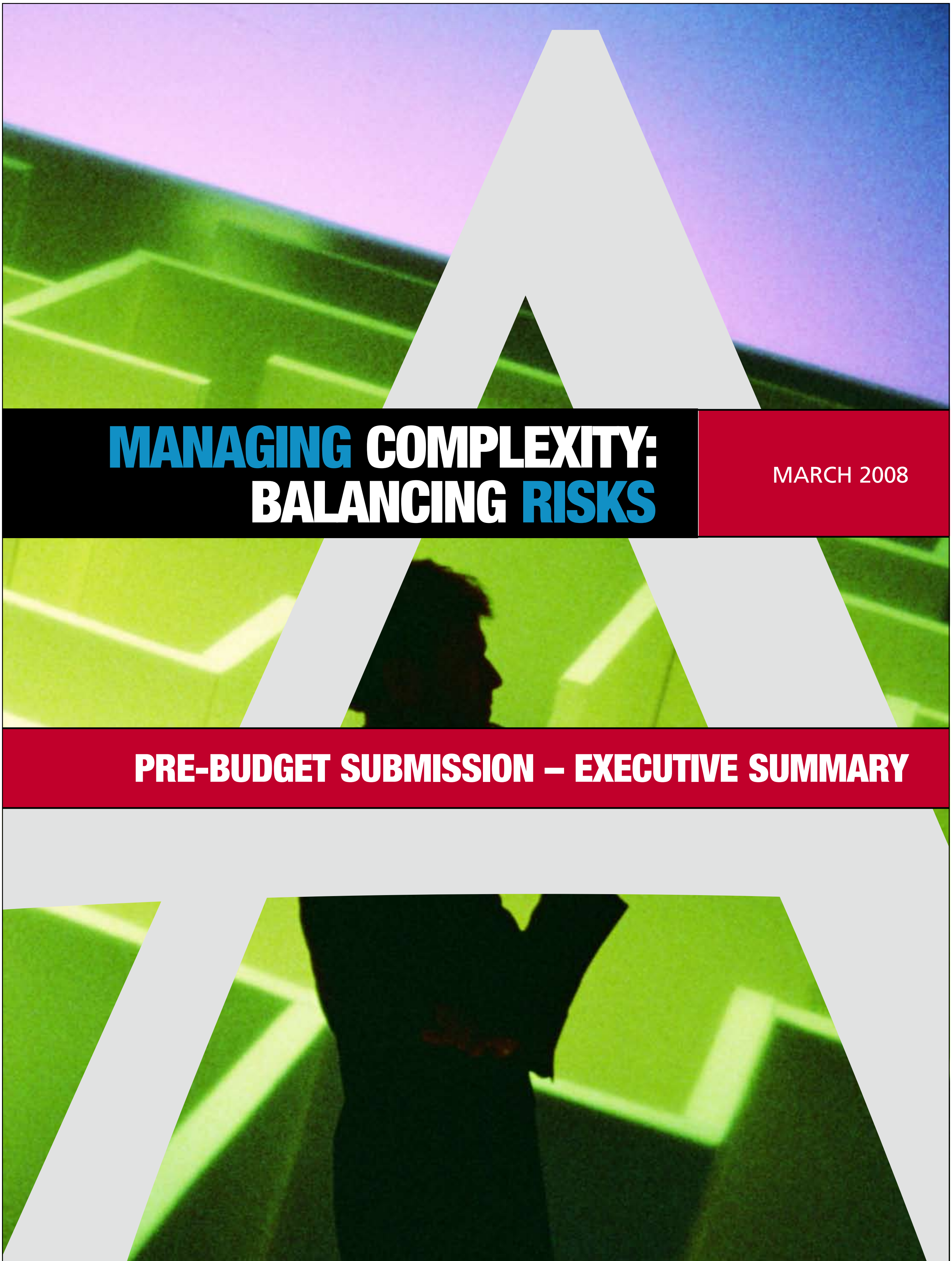

MANAGING COMPLEXITY: BALANCING RISKS

MARCH 2008

PRE-BUDGET SUBMISSION – EXECUTIVE SUMMARY

AUSTRALIAN INDUSTRY GROUP

MANAGING COMPLEXITY: BALANCING RISKS

Overview

Widespread concerns about underlying inflationary pressures in the Australian economy feature prominently in outlooks for 2008-09. These inflationary pressures stem from the combination of global price pressures, healthy domestic demand growth and short- and medium-term limits to domestic productive capacity.

This situation calls for something of a policy highwire act: balancing much-needed investment in capacity expansion with an overall fiscal stance that addresses inflationary forces and eases upward pressures on interest rates.

While considerable uncertainty surrounds the 2008-09 outlook due to the erosion of confidence in global financial markets, Ai Group's best estimate is for the inflationary pressures that have accumulated over the recent past to persist for much of the next financial year. We anticipate that domestic demand will display a degree of ongoing strength in excess of the immediate capacity to expand output despite the global financial nervousness. Accordingly the Australian Industry Group proposes a budget to:

- Build domestic productive capacity;
- Encourage and facilitate adjustment to the carbon constrained economy;
- Boost future retirement incomes of low-income earners; and
- Ensure domestic inflationary pressures are contained.

Building Domestic Productive Capacity

Ai Group's recent report *How Fast Can Australia Grow? Mark III* estimated that, in the absence of policy changes, our potential growth rate over the coming decade would struggle to reach 3% per year on average. This sobering estimate highlights the importance of taking measures to boost the pace of productivity improvement and to improve workforce participation.

Ai Group's priorities in expanding the capacity of the economy involve raising and refocusing investment in education and training; delivering on announced investments in infrastructure – particularly in transport and telecommunications; introducing promised personal income tax cuts in full to stimulate workforce participation; boosting Australia's business capabilities and its innovation performance and improving export facilitation programs.

Education and Training

The challenge for Australia over the next three years will be how quickly we can achieve and appropriately maintain a 'well educated and well trained' population.

This will involve increasing Australia's overall investment in education (5.9% of GDP) to match that of the OECD leaders (7-8%). In particular:

- The resource base for Vocational Education and Training will need to expand by a minimum of 5% over the next decade and the system needs to be overhauled to more effectively meet the needs of the existing workforce;
- Schooling will similarly need an additional boost to improve both school retention and attainment; and
- Higher education needs both structural and financial reform.

This task is significant. It must be underpinned by appropriate financial, policy and structural support, including both fixing Commonwealth and State relations and strengthening industry leadership.

Income Tax Cuts

Ai Group supports the delivery of the promised 2008-09 income tax cuts in full. In arguing for the tax cuts we are particularly conscious that the inflationary impacts have been considerably overstated and that insufficient notice has been taken of offsetting impacts.

- These tax reductions will impact most tellingly on low income earners many of whom will experience a reduction in their tax rate of 15 percentage points. This will significantly boost incentives for workforce participation - particularly for second income earners in families - and should be seen as a capacity expanding measure.

- The changes to taxation will also reduce pressure to increase pre-tax wages. Recent deliberations of the Fair Pay Commission have taken changes in income taxation into account and many submissions, including that of Ai Group, have called for a continuation of this practice in the current wage case. In Ai Group's experience, the impact of income tax changes on wage pressures goes beyond those affected by the minimum wage case and extends into a broader range of wage setting arrangements.

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Non-Budgetary Initiatives

These budgetary initiatives should be complemented by capacity-expanding non-budgetary policies that overhaul intergovernmental relations; accelerate the participation, competition policy and regulatory reforms under the National Reform Agenda; at least maintain current levels of net migration while removing unnecessary barriers to temporary migration; and implement the Infrastructure Australia proposal to improve planning, coordination and the development of transport, telecommunications, water and energy infrastructure.

Encourage and Facilitate Adjustment to the Carbon Constrained Economy

Imposing costs on emissions of greenhouse gases through an Emissions Trading Scheme (ETS) and other policies will shift relative prices and initiate a substantial process of adjustment in the Australian economy. Many businesses and their employees in trade-exposed industries in particular will find themselves operating at a disadvantage relative to competitors abroad.

To encourage and facilitate this process of adjustment, measures should be introduced in the 2008-09 Budget to ameliorate overall impacts without negating the intended shift in relative prices and incentives. Ai Group proposes:

- A phased reduction in the company tax rate so that by the year the ETS comes into operation (2010), the company tax rate has been reduced to 25%;
- A concerted campaign to disseminate to businesses and households information about reducing direct emissions and improving energy efficiency; and
- Acting now to boost the capacity of energy-efficiency and emissions-reduction advisory services.

Boosting Future Retirement Incomes of Low-Income Earners

Ai Group proposes directing new changes to superannuation towards lower and middle income earners to complement the changes to superannuation announced in the 2006-07 Budget. Consideration should be given to:

- Refunding into the superannuation accounts of low-income people an equivalent of the 15% tax on compulsory employer contributions;
- Adopting a similar measure that extends eligibility to middle income earners aged over 50; and
- Increasing the amounts available under the Superannuation Co-Contribution Scheme.

Reducing Domestic Inflationary Pressures

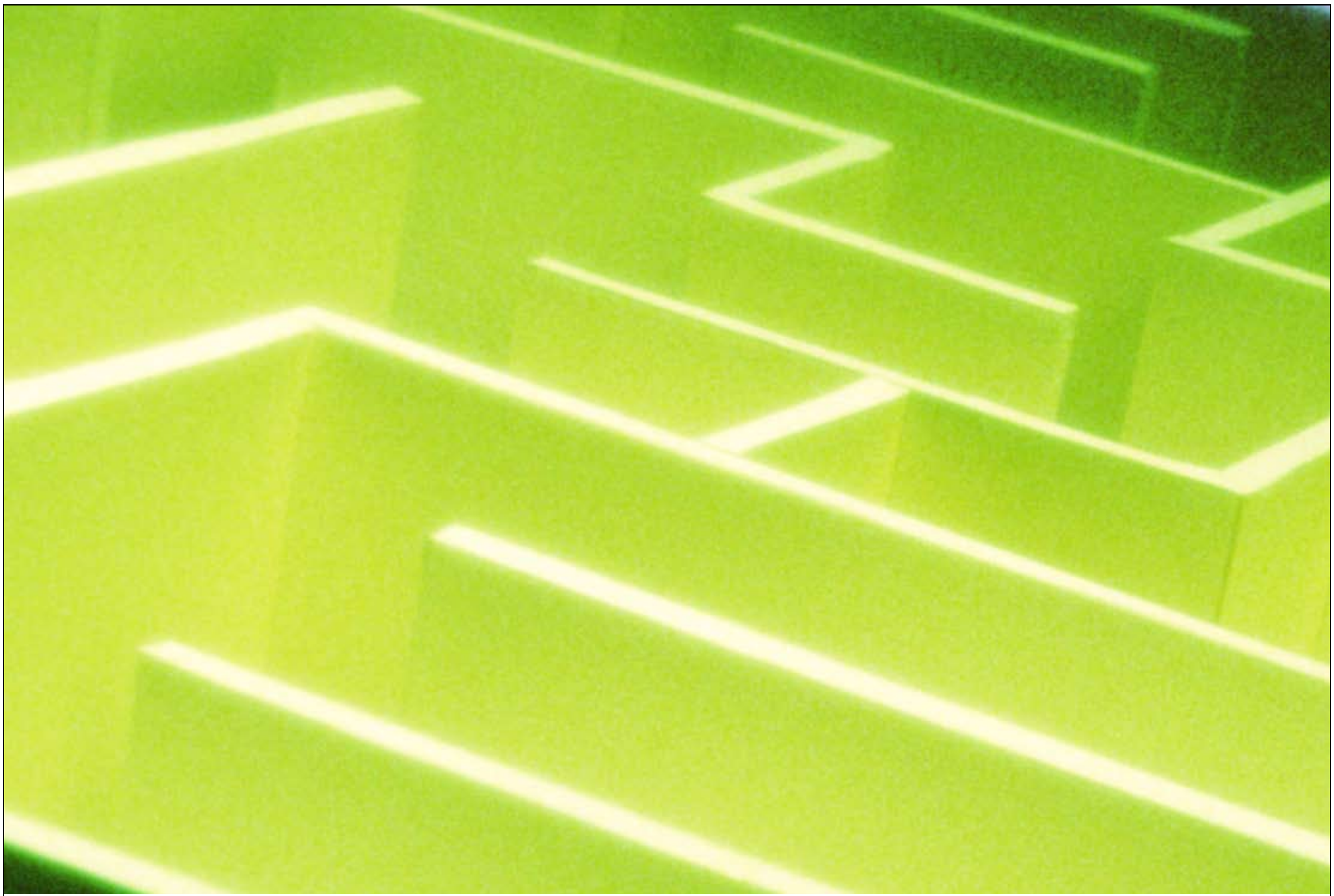
While the Budget needs to be framed with a close eye on inflationary impacts over the year ahead, this should not provide a reason to delay embarking on capacity-expanding measures. Rather, capacity-expanding measures should be accompanied by reductions in less productive expenditure. In this, care should be taken to discriminate by maintaining initiatives that add to productive capacity. In particular, earlier phases of fiscal pruning have often seen deep and ultimately counter-productive cuts to capital investment that would have added to capacity.

Ai Group proposes a two-pronged approach to reducing existing spending commitments. There should be a generalised reduction in expenditure based on concerted improvements in productivity across all portfolios and agencies and there should be a selective identification of unnecessary spending commitments.

In identifying specific areas of savings Ai Group proposes:

- Withdrawing funding allocated to undeserving commitments made for a wide variety of ad hoc projects, for example as identified by the Australian National Audit Office in relation to the former Regional Partnerships Program; and,
- Tightening eligibility for personal and family income transfers and entitlements to concentrate benefits on those with greater financial need.

Ai Group's Pre-Budget Submission is available at www.aigroup.asn.au.



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