29 March 2017

SUMMARY: Ai GROUP'S 2017-18 FEDERAL BUDGET PRIORITIES

The 2017-18 Budget is an opportunity to strengthen the outlook for the Australian community by giving it the underpinning of a competitive and diverse private sector that invests for the future; is globally competitive; and that generates challenging and well-paid jobs.

Australia's economy has a critical role to play in support of the community it serves. To play this role effectively in a competitive global economy, businesses and the public sector need to be competitive, flexible and productive. Making ourselves more competitive, more flexible and lifting our productivity implies continual adaption and in some cases transformation.

This does not occur without costs and disruption and change only makes sense when these costs are outweighed by benefits. And community buy-in and support for change will only be sustained if the distribution of these benefits is fair and is seen to be fair.

The challenge for the nation's political leaders is to press ahead with the directions that are necessary if we are to succeed as an active participant in the global economy while also building the more prosperous, richer and more cohesive communities that Australians aspire to - for themselves and for their children.

Economic Conditions

Australia's economy is rapidly chasing down the Dutch benchmark for a contemporary economy of 26 years of growth uninterrupted by recession. The achievement has spanned not just the Asian Financial Crisis; the dot-com boom and bust; and the Global Financial Crisis with its protracted aftermath, but also the global disruptions wrought by the rapid industrialisation of China; the domestic minerals and energy investment boom; the surge and subsequent retreat of commodity prices and the commensurate fluctuations of the local currency.

For all this success, we face significant challenges: our population is ageing; productivity growth has slowed; our education and training outcomes are falling short of where they should be; business investment remains low; we have clear infrastructure gaps; and the national budget position has not yet returned to a position of sustainability. At the same time, there are great opportunities on our horizons. A wide range of these arises from the very rapid growth in incomes in the regions to our north and north west as some of the world's most populous nations continue their journeys of development, industrialisation and urbanisation.

To meet these challenges and to take full advantage of these opportunities we need to shape up. We need to shape up not only in in lifting productivity and competitiveness but also in building an inclusive approach in which processes of adjustment are identified and smoothed and in which the opportunities and benefits of successful engagement in the global economy are broadly available for all Australians.

The current environment is also characterised by the rebalancing of the Australian economy. While this rebalancing appears to be moving onto a firmer footing at least at a national level, there remain clear vulnerabilities in the current outlook both in an economy-wide sense and in its more local and regional impacts.

2017-18 BUDGET PRIORITIES

These considerations lie behind Ai Group's priorities for the 2017-18 Budget. These priorities are set out in greater detail in Ai Group's Pre-Budget Submission[1] which includes the following highlights:

- Greater and smarter investment in the education and training of the current and future workforce;
- Active development of Australia's innovation and business capabilities;
- A clear trajectory to budget sustainability while facilitating new infrastructure investment;
- A first step in a more holistic reappraisal of our approach to taxation.

There are, in addition important non-budget policy priorities that should be pursued that are not addressed here. These include measures in the areas of workplace relations; energy and climate policy, the removal of unnecessary regulatory burdens and in the fundamental realm of intergovernmental finances.

Education and Training

Investing in education and training is critical to lifting the productivity and competitiveness of our economy; assisting the workforce and businesses adjust to change; and in ensuring the benefits of our participation in the global economy are broadly distributed across the Australian community.

Investing in Australia's VET System and Apprenticeships

Commonwealth funding for the delivery of Vocational Education and Training (VET) will fall by $500 million in 2017–18 given the end of the National Partnership Agreement on Skills Reform in mid-2017.[2] It is imperative that a new Partnership Agreement be developed through COAG to adequately fund the VET sector within a broader tertiary education context.

In this context, the major issue confronting apprenticeships and traineeships is a major downturn in activity. The latest NCVER data indicates there were 282,900 apprentices and trainees in training at the end of June 2016.[3] This is a decrease of 7.8 per cent from the previous year and represents the lowest level of participation for a decade. The percentage of Australian workers employed as an apprentice or trainee has declined from 3.3% to 2.7% during this period.[4] Commencements are the lowest for a decade and are currently half of what they were in June 2012. Trades commencements decreased by 17.3 per cent in the June quarter 2016 compared

[1] http://cdn.aigroup.com.au/Submissions/Budget/2017/AiGROUP_PRE-BUDGET_SUB.pdf
[2] Megan O'Connell and Kate Torii, Expenditure on education and training in Australia, December 2016, Mitchell Institute.
[3] Apprentices and trainees 2016 June Quarter, NCVER, Commonwealth of Australia.
[4] Apprentices and trainees 2014, NCVER, Commonwealth of Australia, 2015.

to the June quarter 2015. There is an urgent need to stimulate and support this vital training pathway. In the Ai Group survey of workforce development needs in 2016, only 11% of employers intended to increase apprentices and trainee numbers over the next twelve months.

For greater industry involvement in apprenticeship arrangements the current regime of employer incentives needs to be reviewed and rationalised. A focus on employer incentives for first time participants is required. European research indicates support of this kind is more effective in encouraging companies to start training than for companies already training. [5]

Further, a national body is needed to manage the implementation of these measures, to oversee national consistency and to ensure current and future workforce needs are met. Confronted with similar apprenticeship issues, the UK is establishing an independent employer-led body, the Institute for Apprenticeships, to regulate the quality of apprenticeships in the rapid expansion of the program.[6] It is timely for Australia to review the governance arrangements for apprenticeships to provide a genuinely national approach to arrest the decline in apprenticeships and the lack of balance compared to the significant increase in undergraduate degrees.

Developing Australia's Science, Technology, Engineering and Maths (STEM) capabilities

While some progress has occurred in the school sector, there are still gaps in the national approach to STEM skills and there is not a national strategy. In particular, there is little focus on measures to support and expand the STEM-qualified workforce and no reference to the importance of the VET sector in this policy area.

Ai Group's long-standing concerns about the state of STEM skills and the impact on the economy are well documented.[7] A major focus needs to be on growing the STEM workforce. Skilled technicians are often the most pressing area of shortage for companies rather than graduates as Ai Group workforce development surveys reveal. The latest data indicates a quarter of employers anticipated difficulties recruiting these workers. A renewed focus on apprenticeships and traineeships in STEM-related areas is required. Employer incentives could be targeted in these areas.

Support is also needed for existing workers to retrain in STEM areas and strategies are required to meet the needs of small and medium sized businesses. Government can support these companies via networks/clusters and engagement with group training companies. Support for sectoral and supply-chain companies working with larger companies also warrants consideration. The Industry Growth Centres initiative has significant potential to promote and implement STEM skills. All six of the Centres overlap with STEM skill areas. The centres are tasked with improving the management and workforce skills of key growth centres.[8]

The Ai Group supports the call for an overall national STEM skills strategy. The government can take a leadership role, for example through the Commonwealth Science Council and develop this

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[5] The effectiveness and cost-benefits of apprenticeships: results of the quantitative analysis, European Commission, September 2013.

[6] English Apprenticeships: Our 2020 Vision, Department for Business, Innovation and Skills, 2015.

[7] *Progressing STEM Skills in Australia*, Australian Industry Group, February 2015.

[8] www.business.gov.au/advice-and-support/IndustryGrowthCentres

strategy in conjunction with industry and others. A multi-pronged approach is needed to address school, university, VET and industry involvement. Sufficient resourcing is required to develop a co-ordinated and systemic response to the issue.

Developing Australia's Workplace Literacy and Numeracy Capabilities

Ai Group research confirms that the low levels of workplace literacy and numeracy are a major concern to employers. The most recent survey indicates that over 87 per cent of employers reported low levels of literacy and numeracy having an impact on their business.[9] This is detrimental to productivity improvement, labour mobility and the capacity of the economy to achieve the higher levels of skills needed for the increasingly knowledge-based economy. There remains an urgent need to address the language, literacy and numeracy needs of the Australian workforce.

The Ai Group has conducted a return on investment to employers' program with very positive results.[10] There is now a firm business case for employer investment in workforce literacy and numeracy. There needs to be program for them to invest in.

A national literacy and numeracy strategy needs support for workplaces. A key component is the development and implementation of a new co-contribution program specifically for workplaces. This would be based on tight outcomes for individual participants and employers. The use of the Australian Core Skills Framework could be mandatory to measure individual improvement and return on investment measures could be utilised for benefits to employers including direct linkages to productivity. The program could also be nationally accredited through the use of the Foundation Skills Training Package adapted to suit particular workplace needs. The Ai Group conducted a small pilot study with three workplaces during 2016 based on these approaches with significant success.[11] This combination of measures could be implemented through a larger national pilot program in concert with industry.

Innovation and Business Capabilities

Innovation and the development of business capabilities are central to the successful development of the Australian economy; its ability to generate well-paid and challenging jobs; and to create the dynamic and competitive industries that are necessary underpinnings to us building strong, resilient and cohesive communities.

Business-Research Collaboration and the Research & Development Tax Incentive

In recent years, there has been a recognition of the important gains that could come from a lift in business-research collaboration towards levels that occur in other developed countries. Ai Group has long urged this recognition and, while momentum needs to continue to build, fully supports the initiatives that have been taken to date.

We, along with many others in the business community, remain concerned about the contradiction between this direction and the experience over the last decade of successive cuts to and

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[9] Workforce Development Needs Survey Report, December 2016, Ai Group, page 16.
[10] *Investing in Workforce Literacy Pays*, Australian Industry Group, August 2015.
[11] Forthcoming Ai Group publication.

reshaping of the Research & Development Tax Incentive. There has been a succession of ill-conceived proposals, changes and clarifications that have deterred business investment in R&D and undermined a program that had been an outstanding success. While some of the proposals floated in the Government's recent review make sense and could improve the working and integrity of the tax incentive, others are simply poorly-designed, cost-cutting measures that will stifle other efforts by the Government to lift the pace of domestic innovation. The Budget should not cut back on the overall level of backing for business R&D.

The Entrepreneurs' Programme

The Entrepreneurs' Programme (EP) is a highly effective initiative that, through a national network of more than 100 experienced private sector Advisers and Facilitators, provides businesses with access to tailored advice and support to improve their productivity and competitiveness and to improve the frequency and quality of collaboration between business and researchers. EP has made a very valuable contribution to the strengthening of SME performance and, despite excessive tinkering and rebranding, continues to build significant recognition. The Government should continue to scale up EP in 2017-18 and beyond in line with business demand and economic opportunity.

Building Defence Industry Capabilities

The 2016 Defence White Paper, 2016 Defence Industry Policy Statement and 2016 Integrated Investment Program underpins the Federal Government's plan to invest $195 billion over the next decade on replacing or upgrading some 85 per cent of all equipment and systems currently operated by the Australian Defence Force. The program includes expenditure of $1.6 billion through to 2026 on innovation and science essential for maintaining a capability edge in an increasingly uncertain strategic environment in our region.

To ensure these initiatives generate broad benefit for the domestic economy and the Australian community, Ai Group proposes: the development of a systematic approach to the training and skilling of Australia's workforce to manage the ramp up of defence industry involvement in this major capital investment program; and initiatives to engage with domestic industry including by further improving export opportunities for defence-related equipment and services over the coming decade and beyond.

Budget Position, Debt and Public Sector Investment

Putting the Federal budget on a sustainable footing remains an outstanding policy priority and with the fiscal balance for the 2016-17 year estimated in the Mid-Year Economic and Fiscal Outlook (MYEFO) to be in deficit by over $40 billion (or 2.4 per cent of GDP) we are clearly well short of this objective.

With the economy continuing to grow at below-trend rates on a year on year basis; with labour underutilisation remaining high; and with business investment still falling, there are clear risks to moving too rapidly on fiscal consolidation in the 2017-18 year. Aggressive cuts to aggregate spending and/or raising taxes beyond current projections in the attempt to more rapidly improve the budget bottom line could further slow the economy to the detriment of growth, employment, private sector demand and tax collections.

While at the time of the MYEFO Ai Group did not favour a more rapid approach to the consolidation of budgetary aggregates than proposed in MYEFO, we strongly supported further efforts to remove waste and inefficiencies in Commonwealth programs and we proposed that such savings should be reallocated to the priorities listed above for their favourable impacts on expanding economic and social opportunities.

With the subsequent release of December quarter national accounts data, it appears that at the mid-point of 2016-17, the terms of trade and nominal GDP are on track to exceed MYEFO forecasts and if maintained, the 2016-17 budget position could well be better than expected in MYEFO. We believe this source of improvement in the budget position being essentially related to improved commodity prices (and therefore "temporary") should be allocated to improving the budget bottom line (and therefore reducing debt) rather than substituting for removing waste and inefficiencies in Commonwealth programs.

In relation to the end point of fiscal consolidation, Ai Group does not have a firm adherence either to running a cash surplus or to a position of zero net debt. We certainly support a highly disciplined approach to spending and taxation and to ensuring that recurrent spending is comfortably covered by recurrent revenue over the course of the business cycle. We also support rebuilding a fiscal buffer that could be deployed in the event of another crisis that posed a substantial threat to aggregate demand.

However, we do not see the advantage in denying the scope for governments to borrow to finance investments that would generate a return sufficient to cover borrowing costs, maintenance and depreciation. While in many cases such investments will be better financed by the private sector, in other cases – such as where there are highly dispersed benefits that cannot be adequately captured with user-charges – public investment and ownership can be the most efficient approach.

Where publicly-owned assets can be better managed under private-sector ownership, such as in electricity generation and transmission, we strongly support asset sales or long-term lease arrangements coupled with appropriate regulatory arrangements that effectively address market power and performance concerns. As demonstrated in a number of Australian jurisdictions, tapping into the private sector to realise the value of publicly-owned assets can be a fruitful way to finance new investment or to reduce the stock of public-sector debt. We strongly support further consideration by the Commonwealth of potential asset sales and any encouragement it can provide to the states and territories.

Towards Tax Reform

Substantial national benefits can be generated by improving our federal, state and territory tax arrangements.

A strong foundation for a range of positive directions was set out in Australia's Future Tax System Review (the Henry Review). While not without political challenges, this agenda is too important to be left languishing. Australia places considerable demands on taxation revenue including in making very significant and growing contributions to our health, education and training, disability support, welfare, infrastructure, and national security needs. Our tax system needs to be able to raise the revenue required to meet these demands in ways that are consistent with a competitive economy and a fair society and that do not burden taxpayers with excessive red tape.

In the context of our support for a whole-of-system reorganisation of taxation arrangements, Ai Group strongly supports the need for the Government's Enterprise Tax Plan (ETP). While we support the ETP we also recognise the political impasse surrounding it and we have put forward a proposal under which the following initial measures be prioritised:

- Lifting the small business entity threshold from aggregated turnover of $2 million per annum to aggregated turnover of $10 million per annum;
- Increasing the tax discount for unincorporated small businesses entities from its current level of 5 per cent to 8 per cent effective from the 2016-17 year;
- Phasing in the 27.5 per cent company tax rate for companies with turnovers below $100 million by the start of the 2019-20 year.

We have also suggested that the case to extend the 27.5 per cent rate to larger companies and to reduce the company tax rate to 25 per cent be re-prosecuted by the Government and others ahead of the next election (together with commensurate further changes to the tax discount for unincorporated small business entities). If successful at the next election, the Government could re-present the remainder of the Enterprise Tax Plan to the new Parliament. This could be achieved without changing the schedule of the ETP.