A new reform agenda for Australia

kpmg.com.au

Reform is achievable

We at KPMG have been thinking about a new reform agenda for Australia. In doing so, we are mindful of the situation in Canberra. Australia's 45th Parliament is finely balanced: the Liberal-National Coalition holds a one-seat majority in the House of Representatives and 30 of the 76 Senate positions. If the Australian Labor Party and the Australian Greens opposed a bill, the Government would require the support of almost all the crossbenchers of diverse political philosophies and backgrounds for it to pass.

For the 45th Parliament to implement a new reform agenda, the reforms would need to be grounded in what Prime Minister Malcolm Turnbull describes as "the sensible centre", capable of attracting the support of the major political parties.

An insight into what such a reform agenda might look like was offered by the National Reform Summit of August 2015, supported and hosted by KPMG. Summit participants represented a broad cross-section of the community – business groups, trade unions and civil society organisations – who, in a spirit of cooperation, sought to find common ground on public policy principles and priorities.

KPMG is realistic but also optimistic that, building on the success of the National Reform Summit, a new reform program can be formulated and legislated by the current Parliament.

The sensible centre

A practical reform agenda could include:

1

Budget repair – a combination of agreed further savings and revenue measures, involving changes that grow over time.

2

Mending the social safety net – supporting society's most vulnerable members, including through an increase in the Newstart Allowance.

3

A sharp lift in productivity-raising infrastructure investment – involving building new infrastructure and upgrading existing infrastructure, based on priorities identified by Infrastructure Australia and endorsed by Parliament.

4

Further education reform – a better-connected education from early childhood development through schooling, vocational education, higher education and lifelong learning to equip Australians for future jobs in the digital age.

5

Modernising the industrial relations system – agreed changes to the enterprise bargaining framework and reductions in the regulatory burden on small business.

6

Making a start on reforming the tax and retirement income systems – a new investment allowance and public inquiries into the tax and retirement income systems.

7

More effective action on climate change – using the existing regulatory framework for emissions reductions and implementing an emissions-intensity scheme for the electricity generation industry.

8

Indigenous economic empowerment – supporting and promoting entrepreneurship in Indigenous Australia.

Other reform proposals for which bipartisan support is forthcoming could also be considered, such as agreed recommendations of the Competition Policy Review.

A reconvened national reform summit?

Achieving bipartisan support for a new reform agenda would be much easier if it enjoyed the backing of key stakeholders. KPMG proposes that the National Reform Summit of 2015 be reconvened in the first part of 2017 in an effort to find common ground on a set of reforms. KPMG's proposed eight-item reform agenda would be one input into such a summit. The other summit participants – business groups, the trade union movement and civil society organisations – would have their own ideas to bring to the table.

Building on the 2015 Summit Statement, a reconvened National Reform Summit would endeavour to agree upon a new statement on reform priorities capable of being implemented by the 45th Parliament.

The case for change

Australia has achieved an impressive 25 years of recession-free economic growth. Consumer sentiment is positive and the outlook for economic growth is encouraging.

But government and household debt are very high and non-mining private investment is flat. Despite ongoing economic growth, average Australian incomes have declined every year since the end of the mining boom. Productivity growth, which has accounted for more than four fifths of the improvement in our living standards over the past four decades, is in the doldrums. And our population is ageing – a social positive but also a handbrake on growth.

Without appropriate policy responses, the ageing of the population will cause a transfer of wealth from future generations to the present through the accumulation of public debt and the exclusion of many aspiring first homebuyers from the market. In the absence of further reform, living standards, when they do recover, will grow slowly by Australia's historical standards. Moreover, Australia will be highly vulnerable to external economic crises and to a prolonged period of slow global growth – something which seems increasingly likely.

Australia's transition from the end of the mining boom is slow

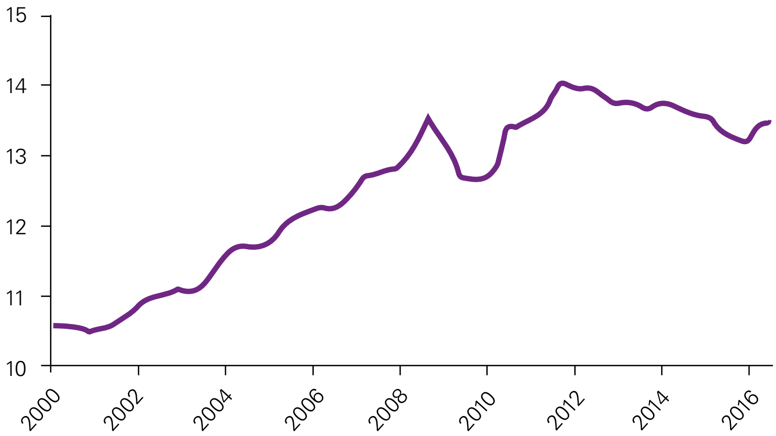
Australia is making the transition from the end of the largest mining boom in its history as China reclaims the position it held until 500 years ago as one of the world's two largest economies. In 2011, China began changing its economic model from one based on exports of manufactured products to a consumption-based economy with growing service industries. This reorientation of the Chinese economy, combined with a strong global production and investment response to exceptionally high iron ore and coal prices in the early part of the present decade, has ended Australia's mining boom.

Yet since the end of the mining boom, Australia's economic output has continued to expand quite strongly, with real Gross Domestic Product (GDP) growing by an average annual rate of 2.8 percent.

However, the falling prices of our mineral exports and the high levels of foreign ownership of our major mineral exporters have limited the incomes accruing to Australians from these exports.

In fact, Australians have experienced declining material living standards since 2011; real net national disposable income per person is lower now than it was then (Chart 1). Encouragingly, there has been a recent pickup. Yet, on average, Australians remain more than $550 a year worse off than they were at the mining boom's peak in 2011.

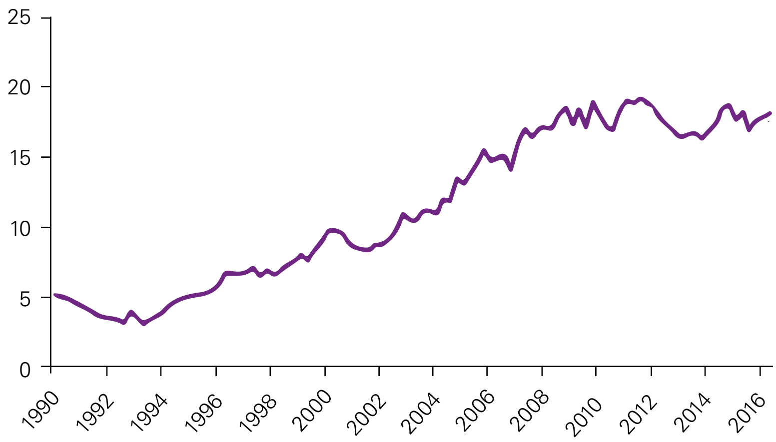
Chart 1: Real net disposable income per person 2000-2016 ($000)



Source: KPMG Economics, ABS.

Australian material living standards are on average more than $550 per person lower now than they were in 2011.

Chart 2: Non-mining capital expenditure 1990-2016 ($ billion)

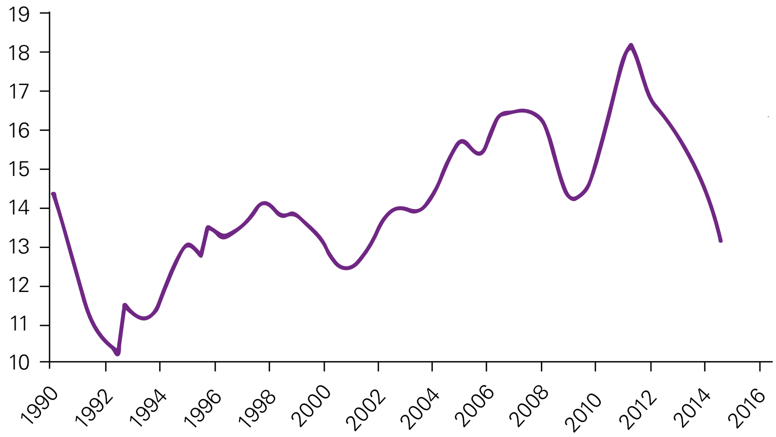


Source: KPMG Economics, ABS.

A successful transition from the mining boom to sustained economic and income growth requires new investment in non-mining industries, which has not been occurring (Chart 2).

Non-mining business investment is flat.

Chart 3: Business investment as a share of GDP 1990-2016 (percent)



Source: KPMG Economics, ABS.

A combination of falling mining investment and flat non-mining investment is producing a sharp fall in total private investment as a share of the economy (Chart 3).

The Australian economy is vulnerable to external shocks

The global recovery from the 2009 recession is the weakest recovery on record. As reported in KPMG's analysis of the global economy,[1] the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD) and the World Bank have revised down their global growth forecasts every year since the recession's end.

Among the possible sources of an external economic crisis are asset price bubbles coupled with high levels of indebtedness, geo-political events, terrorism, political turbulence in the United States and mismanagement of China's economic transition.

US President-elect Donald Trump has made a set of promises to increase government spending and cut taxes, including a large infrastructure renewal program and a cut in the company tax rate from 35 percent to 15 percent. The net effect of these policies would be a significant increase in US government debt. The likely disposition of Republicans in Congress will be to support tax cuts but oppose spending increases.

If such a large fiscal expansion was to materialise, the Federal Reserve could well respond with contractionary monetary policy by raising interest rates. Since there is great uncertainty about how much of this taxation and spending program will be approved by Congress, it is difficult to assess its impact on the US and global economies.

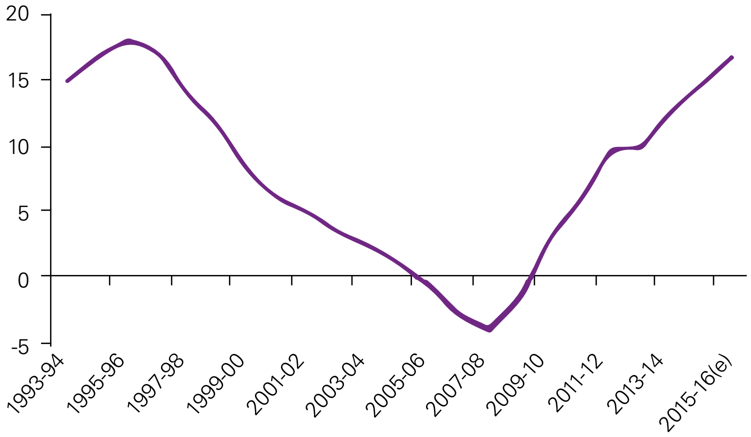
A second possible source of external shock from a Trump presidency is his trade policies. Trump has promised to impose a 45 percent tariff on Chinese imports, apply a 35 percent tariff to imports from Mexico and to renegotiate the North American Free Trade Agreement and bilateral trade agreements.

While economic advisers will brief the President on the consequences for the US of an all-out trade war, the promised tariff increases are a signature of his candidacy and may not be easily abandoned. The President needs little or no Congressional approval to proceed with his protectionist policies, further increasing the likelihood of their implementation in some form or another.

Ongoing large budget deficits and rising debt are making Australia more vulnerable to external crises than it has been in decades (Chart 4). While Australia's net government debt remains low by international standards, it is approaching the median of AAA-rated countries and, unlike the debt of those countries, is heading higher. The international ratings agencies have warned about the possibility of Australia losing its AAA credit rating. Getting it back would take a decade of tight fiscal discipline.

1. KPMG (2016b), *The global economy – is this as good as it gets?*, May, p. 3.

Chart 4: Australian Government net debt as a proportion of GDP 1993-2016 (percent)

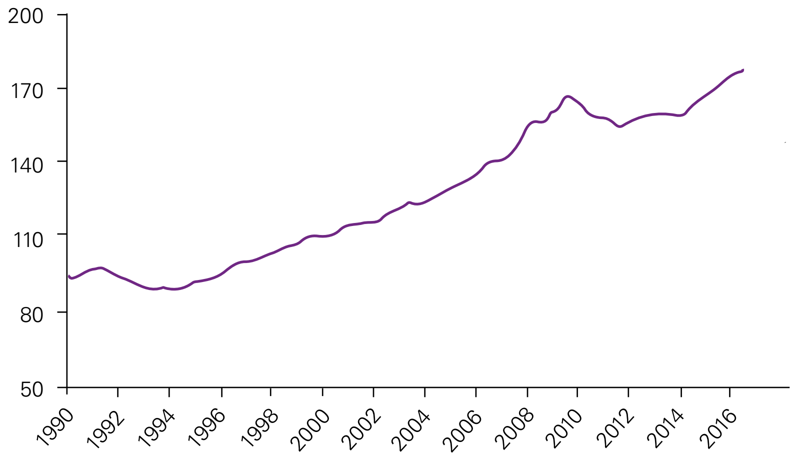


Source: KPMG Economics, ABS.

Interest paid on Australian Government debt is expected to reach almost $16 billion in 2016, rising to more than $18 billion by the end of the decade. This is a large intergenerational transfer – an obligation on future generations to foot the bill to maintain the living standards of the present generation.

Not only is government debt rising, but so too is private debt. In Australia, credit as a proportion of GDP is rising to alarming levels (Chart 5), increasing the economy's vulnerability to external crises.

Chart 5: Australia: credit as a proportion of GDP 1990-2016 (percent)



Source: KPMG Economics, ABS, RBA.

In its warning about unprecedentedly high global debt, the IMF explains that many countries have reduced their private debt levels but that, in Australia's case: "… private debt has continued to accumulate at a fast pace".[2]

Our economy is also vulnerable to global economic stagnation

An external economic crisis is not the only risk facing the Australian economy. As a small, open economy, Australia is reliant on a growing global economy and on flourishing international trade. Yet the OECD has described the global economy as being "stuck in a low-growth trap" – stagnating incomes for workers feeding into weak consumer spending, which is reducing expected returns from new business investment, stifling productivity growth in turn.[3]

Four global and domestic forces are at play, which are inimical to Australia's growth prospects:

1. Rising international protectionism
2. Population ageing
3. Weak productivity growth
4. A loss of full-time jobs.

These forces are discussed in Appendix A. They call for a new reform agenda if Australia is to continue its record-breaking era of recession-free economic growth.

The IMF's most recent report on Australia summarises these forces and is consistent with KPMG's assessment of the state of the Australian economy:

"Wage and price pressures are weak, underemployment has risen, and non-mining investment is yet to fully recover. Ensuring the return to full employment under weak global conditions will need continued accommodative monetary policy and quality infrastructure spending, which will also boost long-term growth potential."[4]

2. IMF (2016a), *Fiscal monitor*, Washington, DC, October, p. 3.
3. OECD (2016), *Economic Outlook No 99*, Paris, June, p. 3.
4. IMF (2016b), *Australia: IMF Staff Concluding Statement of the 2016 Article Mission*, November 15.

A new reform agenda

The statement issued by the National Reform Summit[5] committed participants to a comprehensive program of economic and social reform to enable governments and businesses to invest in the long-term prosperity of the nation, protect the social safety net, protect Australia in the face of economic shocks and ensure sufficient funding for quality services including health and education.

Summit participants agreed that reform was urgent as the nation's economic and social position was slipping. They wanted Australia to take action immediately so that any challenges were met earlier rather than later – before the problems became critical. They agreed that too much of the current debate was consumed by special-interest lobbying and single-issue politics at the expense of the broader community interest and called on the major political parties to reach a bipartisan view on the big challenges confronting the nation.

While the National Reform Summit has laid the groundwork, it is appropriate now to identify reforms that could be implemented – or at least initiated – on a bipartisan basis during the term of the 45th Parliament. A viable reform agenda comprising eight items is set out below. This list is not exhaustive. For example, the major parties agreed on a majority of the recommendations of the Competition Policy Review released in March 2015,[6] and many other policy matters will be brought before the 45th Parliament. But it would constitute a valuable contribution towards meeting economic, social and environmental challenges.

1. Budget repair

The Government and the Opposition have agreed on a set of savings measures that constitute a $6.3 billion down payment on reducing the structural fiscal deficit. Further savings and revenue measures will be needed to return the budget to surplus. KPMG has identified 30 measures that could improve the budget position on a long-term basis by about $10 billion per annum.[7]

Participants in the National Reform Summit agreed to consider using an initial 2-year period to set out a plan for returning the budget to structural balance, followed by an 8-year transition period. This did not preclude initiatives consistent with the Summit Statement from being implemented within the initial 2-year planning period.

The participants agreed that in respect of expenditure, the focus should be on redesign of the major programs, including health, to improve equity, access, effectiveness and efficiency of services. They agreed that this should focus on the effectiveness of spending, making small changes that grow over time, and targeting the fastest-growing programs. On the revenue side, the participants agreed that reforms should include a focus on tax concessions that are no longer fit for purpose.

Any review of major programs such as health, education and income support should involve consultation with key stakeholders, such as the summit participants, rather than being conducted behind closed doors.

5. See National Reform Summit Statement at *http://www.acoss.org.au/wp-content/uploads/2015/08/National-Reform-Statement-full.pdf.*
6. Harper, I., Anderson, P., McClusky, S. and O'Bryan, M. (2015), *Competition Policy Review Final Report*, March.
7. KPMG (2016a), *Solving the structural deficit*, April.

2. Mending the social safety net

Although Australia is recognised as having one of the most effective social safety nets in the developed world, it contains a number of holes, the largest of which is the inadequacy of Newstart. At just $40.85 per day,[8] the Business Council of Australia has described Newstart as "a barrier to employment" that "risks entrenching poverty".[9] The OECD has expressed concern about the effectiveness of Newstart in "enabling someone to look for a suitable job".[10] While identifying potential savings to help remove the structural deficit, KPMG has advocated a $50 per week increase in Newstart.[11]

Although the inadequacy of Newstart is probably the largest failing of the social safety net, problems exist for other types of households such as age pensioners renting privately.

As Australia's population continues to age and the nation's tax base changes, ongoing scrutiny of services across these areas will be required to help reduce the structural fiscal deficit while maintaining and improving access to timely, affordable, high-quality health, housing and human services.

The Productivity Commission has identified opportunities for reform across health, education and community services, including in disability, aged care, social housing and job services.[12] The Commission specifically notes that governments have made progress in introducing reforms to support increased user choice in the provision of health and human services, such as through the National Disability Insurance Scheme. However, there is significant variation between jurisdictions with regard to the efficiency and effectiveness of the delivery of such services.

Where service delivery frameworks and future planning activities are inadequate, there are real costs to the economy – both at a system level in terms of reduced productivity and increased cost of service provision, and at an individual level whereby poorer health outcomes affect people's quality of life and their ability to perform rewarding work.

Despite the efforts of successive governments to improve incentives to move from welfare to work, some groups continue to face high effective marginal tax rates (EMTRs) from the interaction of income support taper rates and the personal tax system. Low-income earners and women who are secondary income earners in a household are especially responsive to high EMTRs.[13] A single parent with two children considering increasing her working hours from 3 to 4 days a week faces an EMTR of more than 100 percent by the time she takes account of her marginal rate of personal tax, the withdrawal of child care assistance and the loss of family payments.[14] Priority should be given to reducing high EMTRs for women and those seeking to make the transition from welfare to work.

In repairing the social safety net, the full range of services that affect the daily lives of Australians should be considered. The public and private sectors and civil society organisations led by the Australian Council of Social Service (ACOSS) could work together on a program for repairing the social safety net at the same time as measures to repair the budget are considered.

3. Infrastructure investment

It is widely acknowledged that Australia would benefit from new and upgraded infrastructure.[15] Investing in the right

8. As at September 2016, the rate of Newstart for jobseekers with children was $40.85 per day and for those without children it was $37.76 per day. The Newstart rate is indexed in accordance with the Consumer Price Index.
9. Business Council of Australia (2012), *Submission to the Senate Education, Employment and Workplace Relations References Committee Inquiry into the Adequacy of the Allowance Payment System for Jobseekers and Others*, August.
10. OECD (2010) Economic Surveys: Australia, Paris, October pp. 127-128.
11. KPMG (2016a) *op. cit.*, pp. 14-15 and p. 24.
12. Productivity Commission (2016b), Introducing competition and informed user choice into human services, identifying sectors for reform, Canberra, September.
13. Stewart, M., Moore, A., Whiteford, P. and Grafton, Q.R. (2015), *A stocktake of the tax system and directions for reform: five years after the Henry Review*, Tax and Transfer Policy Institute, The Australian National University, Canberra, February, p. 44.
14. See Productivity Commission (2014) *Final Report: Childcare and Early Childhood Learning*, Commonwealth of Australia, Canberra, December, (Corresponds to Cameo 1, Box E.3, Appendix E), reproduced as Chart 4.7 in Stewart et al, op. cit., p. 45.
15. See, for example, Infrastructure Australia (2016), *Infrastructure Priority List*, October 7.

infrastructure projects can make an important contribution to lifting Australia's productivity growth by, for example, reducing travel times and costs. But what is the right infrastructure and how can debt-laden governments fund it?

Interest rates are at historically low levels and are expected to remain low for the foreseeable future. Low borrowing costs provide an ideal opportunity to invest in productivity-raising infrastructure. But as public debt continues to rise, the federal government has been reluctant to engage in large-scale borrowing for infrastructure and state governments lack the balance sheet strength to enable them to do so.
This reluctance is being fuelled by a debate over which side of politics is better at managing the economy, a key public test of which has become each party's ability to rein in debt.

There are two circumstances under which a large-scale infrastructure investment program would be politically feasible and economically justifiable. One is where the Australian economy is hit by a new external shock of the magnitude of the Global Financial Crisis. The other is where global economic growth is slower for longer, where, to use the OECD's language, it is "stuck in a low-growth trap".

A new external crisis

In the event of a new global economic crisis, a fiscal stimulus could be deployed, modelled on the Rudd Government's 2008 cash payments to households.
The imperative would be to get the cash out quickly to help avert a recession. An alternative to cash payments to households, that could also deliver quick stimulus while creating and maintaining assets for the future, would be to invest in public housing and accelerate pre-existing works on road maintenance and widening

A weak global economy

In circumstances where the global economy continued to struggle, the Australian economy might require support through public infrastructure investment. Projects would be evaluated in advance for their net economic and social benefits and a priority list would be developed. Where possible, necessary approvals would be obtained as well.

Projects for consideration would include upgrading the stock of existing infrastructure though the application of advanced technology. Improvements such as better scheduling and signalling could lift the productivity of existing infrastructure at a relatively low cost.

An independent infrastructure authority

To maximise the chance of projects in the infrastructure pipeline offering clear net benefits to Australia, an independent authority would be given responsibility for conducting cost-benefit analyses and developing the priority list.[16] This authority already exists in the form of Infrastructure Australia, which works with relevant state government agencies in arriving at a priority list. Under this proposal, Federal Parliament would endorse Infrastructure Australia's priority list, ensuring it had bipartisan support.

Parliamentary oversight and accountability

Parliament would also agree that the government of the day could not substitute politically appealing infrastructure projects that had not been subjected to rigorous cost-benefit analysis for projects on Infrastructure Australia's priority list. While this would help avoid poor project selection, as has occurred in the past,[17] it is no guarantee that priority projects would actually deliver the net benefits claimed for them. Infrastructure Australia would therefore be required to report to Parliament on the realised net benefits of priority projects compared with the predicted net benefits outlined in prior cost-benefit analyses.

4. Reforming the education system

As the world journeys through the digital age, the nature of work will undergo a profound change. Computers and robots possessing artificial intelligence will progressively displace routine jobs, both unskilled and skilled, including labouring,

A more sustained, multi-year increase in spending on efficient infrastructure… at the Commonwealth level would be desirable, considering that Australia has infrastructure needs and fiscal space, the funding environment is favorable, and that the expected return to full employment is gradual (IMF 2016b).

16. *Ibid.*
17. See Terrill, M., Emslie, O. and Coates, B. (2016), *Roads to riches: Better transport investment*, Grattan Institute, April.

factory work, basic accounting and legal positions. Non-routine jobs at the high end, such as managerial positions that organise robotics and artificial intelligence, will be highly remunerated. Non-routine personal services are likely to continue to expand as a flow-on from population ageing and the rising demand for home services by affluent but time-poor households.[18]

Lifting Australia's educational performance at all levels, from early childhood through to higher education, will be vital to ensuring all Australians are capable of performing rewarding work and contributing to society in the digital age. A system offering quality education and training, coupled with lifelong learning, will be required for the jobs of the future.

Yet recent reforms and significantly increased funding are not translating into educational improvements. Australia's school performance has stagnated and is falling behind internationally, there have been major concerns with the quality and standards of vocational education and training, and the higher education sector has struggled to deliver innovative teaching and learning in an ongoing environment of funding and policy instability.

Major identified problems in the schooling system include:[19]

- The reading and mathematical literacy levels of Australian 15-year-olds have declined since at least the turn of the century.
- There are growing disparities between Australia's schools, with those disparities increasingly associated with socioeconomic background.
- Large numbers of Australian students are falling behind at school and are not meeting minimum standards.
- On starting school, one in five Australian children is developmentally vulnerable and at risk of being locked into a trajectory of long-term low achievement.
- Teaching is becoming a less attractive career option for more able school leavers.

Growing disparities between Australia's schools
Differences between schools accounted for 28 percent of the variance in Australian students' performance in the Programme for International Student Assessment (PISA) in 2012, up from 20 percent in 2000.

Large numbers of students are falling behind
Based on performance in PISA, the OECD estimates that 40,000 Australian 15-year-olds, comprising 14 percent of students, lack basic reading skills. Further, 57,000 Australian 15-year-olds, amounting to 20 percent of students, fail to meet the international minimum standard in mathematics.

Many school starters are developmentally vulnerable
Australia has 60,000 developmentally vulnerable children in their first year of school, representing 22 percent of all school starters. This ratio is a staggering 42 percent for Indigenous children and 33 percent for children from low socioeconomic backgrounds.[20]

Teaching is becoming a less attractive profession
Almost 60 percent of school leavers being offered a place in teacher education courses have an Australian Tertiary Admission Rank (ATAR) below 70 and this proportion is rising. In school systems in, for instance, Singapore, Hong Kong, Korea and Finland, teachers are drawn from the top 10-30 percent of school leavers.

Australia has faced a long period of education policy instability at the federal level and in many states and territories. Reform needs to focus on how to join up the different education systems to provide genuine lifelong learning and to support all individuals to develop the broad range of skills required for the future. These skills

18. For a more comprehensive discussion, see KPMG (2016b), *op. cit.*

19. Masters, G. (2016), *Five challenges in Australian school education*, Australian Council for Educational Research Policy Insights, Issue No. 5, May.

20. Department of Education and Training (2016), *Australian early development census national report*, Canberra, p.15 and p.33.

include collaboration, resilience and creative problem solving, as well as skills in science, technology, engineering and mathematics (STEM).

We need our education systems to be well connected to facilitate smooth transitions from early childhood education and care through to school education, providing a pathway to further education and training. Recent reform agendas in education have delivered increased participation, particularly in tertiary education, where large increases in engagement from low socioeconomic status cohorts have been achieved. This is an important step in improving equity, not only in the workforce but also, more broadly, in Australian society.

The federal government and states and territories need to work together on building cohesive policy settings that support students to stay engaged and build the skills they need as they move between the various stages of their educational journey. Reform in all aspects of education must put students and their learning needs at the centre, focusing on what works in terms of delivering skills and knowledge to students.

In 2013, the Australian Parliament enacted a new, needs-based school-funding model based on recommendations of an expert panel chaired by David Gonski, AC. The Gillard Government made a commitment that no school would be worse off, greatly increasing the cost of the new system. The large increases in funding were scheduled for 2018-19 and 2019-20.

In the 2014 Budget, the Abbott Government removed the big funding increases to disadvantaged schools. In the 2016 Budget, the Turnbull Government slightly lifted the rate of funding increases and promised a new deal to be settled in 2017. The Labor Opposition promised ahead of the 2016 federal election to reinstate the original growth funding profile. Parliament will need to agree in 2017 on the magnitude of future needs-based school funding.

5. Modernising the industrial relations system

For most of the period since Federation, Australia had a highly centralised system of industrial relations, with bargaining at the enterprise level introduced only in the early 1990s. Further changes were made to the enterprise bargaining system from the mid-1990s to the mid-2000s, including the introduction of statutory individual contracts known as Australian Workplace Agreements (AWAs). Following the 2004 election, when the Howard Government gained control of the Senate, it introduced WorkChoices. Among the major changes included in WorkChoices was the removal of the no-disadvantage test, which had required that no individual worker be worse off from any changes to wages and that working conditions be compared with the provisions of the relevant safety-net award. After numerous cases of workers being made worse off were brought to light, the Howard Government reinstated the no-disadvantage test towards the end of its term in office.

The Rudd Government abolished AWAs and expanded the number of matters over which bargaining could occur. Large numbers of enterprise agreements have been reached under the Rudd Government's legislation, which remains in place to this day. Recently, however, the Fair Work Commission decided on a number of occasions that some enterprise agreements negotiated between unions and large employers were invalid owing to flexibility trade-offs made concerning overtime and penalty rates.

Notwithstanding substantial increases in expenditure on education over the past decade, national and international assessments of student achievement in Australia show little improvement and in some areas standards have dropped (Productivity Commission 2016a, p. 23).

If, as seems likely, the Fair Work Commission continues to strike down enterprise agreements containing such flexible provisions, then, under the existing legislation, employers and employees will need to rely on industry-wide safety net awards. But that would place many more employees on higher penalty rates than those provided for in their enterprise agreements, and this at a time when employer organisations are arguing for reductions in some penalty rates. Employers might well need to rely on awards and make over-award payments where they consider it appropriate to do so.

KPMG Australia Partner Paul Howes, Head of Wealth Management Advisory, has called for a less adversarial approach to industrial relations.[21] Pointing out that the World Economic Forum ranks Australia 103rd in the world for cooperation in industrial relations, Howes describes the existing approach to industrial relations as "destructive, irrational and unsustainable for our future prosperity". He proposes a Grand Compact "in which business, unions and government all work out a deal that we all agree to live with for the long haul". The Compact would enable long-term planning, establish investing in a workforce as a virtue not a cost, and recognise that productivity is a shared responsibility.

Whatever the outcome of ongoing legal proceedings relating to enterprise bargaining, it is likely that changes to the existing legislation will be required. This will be further driven by the changing nature of work, as more Australians are engaged in casual and part-time work.

Given the history of WorkChoices, any progress on industrial relations reform would need to begin with an agreement among business organisations representing small, medium and large businesses and the trade union movement. Another area of early progress could be in the small business arena, in which union membership is low but where a large number of strict regulations apply.

6. Making a start on reform of the tax and retirement incomes systems

In the present Parliament, where the major political parties and the crossbenchers have sharply differing attitudes towards lowering the company tax rate, the goods and services tax (GST), and even the appropriate overall level of taxation, comprehensive reform of the tax system is impractical. Further, the Prime Minister has ruled out any additional changes to the superannuation system during the current parliamentary term.

In circumstances where there are ongoing budget deficits and pressure on future budgets from the ageing of the population, it will be impossible to formulate tax reform proposals that do not involve some segments of society losing while others gain. In designing *A New Tax System for a New Century*, the Howard Government was able to compensate income groups for the effects of the GST by dipping into projected surpluses. In the 1985 tax reform, the Hawke Government repaired the income tax base by introducing a fringe benefits tax, a capital gains tax and motor vehicle substantiation rules, using the proceeds to reduce the higher marginal rates of income tax and the company tax rate.

In the 2016 Budget, the Turnbull Government announced phased reductions in the company tax rate, starting with small and medium-sized companies, with gradual reductions in the rate for large corporations beginning in 2022. The Labor Party is opposing the proposed tax rate reductions for large corporations, as are most of the Senate crossbenchers.

KPMG has been a consistent contributor to the tax reform debate, undertaking economic modelling for the Australia's Future Tax System Review (the Henry Review) and making a major submission to Treasury in 2015, wherein KPMG Australia National Managing Partner, Tax, David Linke and Partner Grant Wardell-Johnson, Leader of KPMG's Australian Tax Centre, made 60 recommendations for comprehensive reform. [22]

21. Howes, P. (2014), Address to the National Press Club, Canberra, February 5.
22. KPMG (2015), *Tax reform: KPMG's submission to Treasury*, July.

KPMG supported the proposed gradual reduction in the company income tax rate to 25 percent. Since the company tax rate cut for large corporations is unlikely to gain the support of the Senate, it might be realistic to consider a reform to the company tax system that is potentially capable of attracting bipartisan support.

The stated objective of the proposed company tax rate cut for large corporations is to increase foreign investment. Since under the dividend imputation system company tax is effectively a pre-payment of personal tax for Australian residents, reducing the company tax rate for Australian shareholders increases their personal tax liabilities. For foreign investors – who are not covered by the imputation system – a reduction in the company tax rate on income streams from future investments can increase investment incentives.

A possible reform that would have a similar effect on investment incentives to a company tax rate cut is an investment allowance for new investments. The Government could allow investors to claim an extra, upfront deduction of, say, 20 percent on new capital expenditure. Or it could accelerate existing depreciation allowances, or do both. Investment allowances were used from time to time during the Hawke-Keating era.

The investment allowance could start in 6 months' time, much sooner than 2022 when the Government proposes to begin phasing in the company tax rate cut for foreign investors. It could remain in place for as long as investment remained weak. Moreover, it could be replaced by a general company tax cut if, and when, the budget could afford it.

As for more comprehensive tax reform, the lessons of history are instructive. In 1972, the McMahon Government established the Asprey Taxation Review Committee, which released its report 3 years later, in the final year of the Whitlam Government. For the best part of a decade, successive governments effectively ignored the Asprey Report. Yet, over the 25 years from the report's release, almost all its main recommendations have been implemented.

A committee chaired by Ken Henry produced a new roadmap for reform, *Australia's Future Tax System*, which the Rudd Government released in 2010. Like the Asprey Report, the Henry Review could heavily influence future tax reform. KPMG has prepared its own tax reform proposals to help inform the debate.

If major representative organisations such as the participants in the National Reform Summit could find common ground on elements of tax reform and superannuation reform, the task would be made much easier for governments.

7. More effective action on climate change

Reducing carbon emissions continues to be a heavily contested area of public policy. The Howard Government announced, but did not implement, a market-based emissions trading scheme. The Rudd Government announced an emissions trading scheme – the Carbon Pollution Reduction Scheme – with the carbon price fixed for 1 year, but could not get it through the Senate. The Gillard Government developed an emissions trading scheme with the carbon price fixed for the first 3 years and succeeded in legislating the scheme. The Abbott Government abolished the emissions trading scheme and replaced it with Direct Action – a system of cash incentive payments for selected businesses to reduce their carbon emissions. The Turnbull Government has continued the Direct Action scheme and has reaffirmed the Abbott Government's commitment to a 26-28 percent reduction in emissions on 2005 levels by 2030, made in the 2015 Paris Agreement of the United Nations Framework Convention on Climate Change. During the 2016 federal election campaign, Labor committed to a 45 percent emissions reduction on 2005 levels by 2030.

In reality, the Paris Agreement will require Australia to do better than its 26-28 percent emissions reduction undertaking, since the Agreement commits nations to keep temperatures well below 2 degrees centigrade above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5 degrees centigrade. Under the Agreement, targets will be reviewed every 5 years and countries will be expected to ratchet up their commitments each time.

A compromise between the major political parties could modify Direct Action to include features of an emissions trading scheme as favoured by business organisations such as the Business Council of Australia and the Australian Industry Group. Although Direct Action is a government subsidy scheme, its architecture would enable it to take on features of an emissions trading scheme. Direct Action provides for penalties for emitters that exceed prescribed limits so as to prevent other companies increasing their emissions, while the government pays selected companies to reduce theirs. However, under this safeguard mechanism, the allowable emissions levels are based on a facility's highest carbon emissions over the period 2009-10 to 2013-14.

Some companies are already exceeding their baselines. If the baseline emissions were tightened, they would become a binding constraint, obliging emitters to reduce their emissions consistent with Australia's obligations. The Coalition Government has left open the possibility of non-complying businesses purchasing emissions permits from abroad to meet their commitments but has not allowed trading in permits among Australian emitters. If the Government reduced baseline emissions over time and allowed domestic trading of permits, it would effectively have evolved the Direct Action plan into an emissions trading scheme.

In addition, industry specific schemes are possible. One such proposal, by the Climate Institute, is for an emissions-intensity scheme for electricity generators.[23] The Government would calculate the electricity industry's average carbon emissions per megawatt hour. To avoid facing penalties, electricity generators whose emissions exceeded the industry's average intensity would be required to purchase credits from producers with below-average emissions intensity to offset their excess emissions. They would not have access to international credits, obliging Australian emissions-intensive power stations to reduce their emissions. In practice, power stations using brown coal would be required to buy permits from those using gas or renewable energy. Over time, the Government would reduce the allowable emissions intensity of the electricity-generating industry, consistent with its Paris commitments.

Rather than totally redesigning the existing scheme, a convergence of the major political parties' schemes, similar to the Climate Institute proposal, could be attained that achieves effective emissions reductions and predictability for business.

8. Indigenous economic empowerment

Discussions of ways to improve the lives of Australia's first people have traditionally been around how to 'fix' Indigenous Australia. Thankfully, this is now changing. A generation of Indigenous leaders has argued passive welfare is destructive to dignity, and that long-term economic empowerment must be built through employment and entrepreneurial activity.

KPMG has released a report designed to contribute to this momentum.[24] It is not about what government or business can do 'for' Indigenous Australia. Instead, the report brings together prominent Indigenous thinkers and combines them with KPMG specialists to provide tangible recommendations focused on economic development. In all, the report contains 24 recommendations. However, it is not a blueprint. Others will have their own ideas. But it would be a travesty if the 45th Parliament were to make no further progress on Indigenous economic empowerment.

Indigenous economic empowerment could form an important agenda item for the Council of Australian Governments during the current term of Parliament. It is likely to attract bipartisan support since the major political parties support the Closing the Gap initiative, as well as sharing the philosophy of Indigenous economic development through entrepreneurship and affording Indigenous Australians the dignity of rewarding work.

23. Climate Change Authority (2016), *Towards a climate policy toolkit: special review on Australia's climate goals and policies*, Canberra, August.

24. KPMG (2016c), *Collaborative ideas for igniting the Indigenous economy*, October.

A way forward

In the tightly balanced 45th Parliament, none of the reforms outlined are likely to be feasible in the absence of support from key stakeholders. It is proposed that the parties to the National Reform Summit reconvene to consider these reforms and any others they might want to bring to the table. If they were able to find common ground, the chances of the Federal Parliament also doing so would be substantially increased. Australia's future as a prosperous, fair and environmentally sustainable country depends on it.

References

Australian Government Treasury (2015), *Intergenerational Report 2015: Australia in 2055*, Canberra, March, at http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/2015%20Intergenerational%20Report/Downloads/PDF/2015_IGR.ashx

Brynjolfsson, E. and McAfee, A. (2014), *The Second Machine Age*, W.W. Norton & Company Inc., New York.

Business Council of Australia (2012), *Submission to the Senate Education, Employment and Workplace Relations References Committee Inquiry into the Adequacy of the Allowance Payment System for Jobseekers and Others*, August, at http://www.bca.com.au/publications/submission-to-the-senate-inquiry-into-the-adequacy-of-the-allowance-payment-system-for-jobseekers-and-others

Case, A. and Deaton, A. (2015), "Rising morbidity and mortality in midlife among white non-Hispanic Americans in the 21st century", *Proceedings of the National Academy of Sciences of the United States of America*, December 8, 112 (49), pp. 15078–83, at http://www.pnas.org/content/112/49/15078.full

Climate Change Authority (2016), *Towards a climate policy toolkit: special review on Australia's climate goals and policies*, Canberra, August, at http://climatechangeauthority.gov.au/sites/prod.climatechangeauthority.gov.au/files/files/Special%20review%20Report%203/Climate%20Change%20Authority%20Special%20Review%20Report%20Three.pdf

Department of Education and Training (2016), *Australian early development census national report,* Canberra, at https://www.aedc.gov.au/resources/detail/2015-aedc-national-report

Goss, P., Hunter, J., Romanes, D. and Parsonage, H. (2015), *Targeted teaching: How better use of data can improve student learning*, Grattan Institute, at http://grattan.edu.au/wp-content/uploads/2015/07/827-Targeted-Teaching.pdf

Terrill, M., Emslie, O. and Coates, B. (2016), *Roads to riches: Better transport investment*, Grattan Institute, April 16, at http://grattan.edu.au/wp-content/uploads/2016/04/869-Roads-to-Riches.pdf

Daley, J., Duckett, S., Goss, P., Minifie, J., Norton, A., Terrill, M. and Wood, T., (2016) *Orange Book 2016 – Priorities for the next Commonwealth Government*, Grattan Institute, June, at http://grattan.edu.au/wp-content/uploads/2016/06/873-Orange-Book-2016.pdf

Harper, I., Anderson, P., McClusky, S. and O'Bryan, M. (2015), *Competition Policy Review Final Report*, March, at http://competitionpolicyreview.gov.au/files/2015/03/Competition-policy-review-report_online.pdf

Howes, P. (2014), Address to the National Press Club, Canberra, February 5.

IMF (2016a), *Fiscal monitor*, Washington, DC, October, at https://www.imf.org/external/pubs/ft/fm/2016/02/pdf/fm1602.pdf

IMF (2016b), *Australia: IMF Staff Concluding Statement of the 2016 Article Mission*, November 15, at http://www.imf.org/en/News/Articles/2016/11/15/MS111516-Australia-IMF-Staff-Concluding-Statement-of-the-2016-Article-IV-Mission

Infrastructure Australia (2016), *Infrastructure Priority List*, October 7, at http://infrastructureaustralia.gov.au/projects/files/IPL_161007.pdf

Katic, P. and Leigh, A. (2016), "Top wealth shares in Australia 1915-2012", *Review of Income and Wealth*, series 62, no. 2, June.

KPMG (2015), *Tax reform: KPMG's submission to Treasury*, July, at https://assets.kpmg.com/content/dam/kpmg/pdf/2015/07/tax-reform-kpmg-submission-to-treasury-july-2015.pdf

KPMG (2016a), *Solving the structural deficit*, April, at https://assets.kpmg.com/content/dam/kpmg/pdf/2016/04/solving-structural-deficit-australia-april-2016.pdf

KPMG (2016b), *The global economy – is this as good as it gets?*, May, at https://assets.kpmg.com/content/dam/kpmg/pdf/2016/05/global-economy-may-2016.pdf

KPMG (2016c), *Collaborative ideas for igniting the Indigenous economy*, October, at https://assets.kpmg.com/content/dam/kpmg/au/pdf/2016/igniting-indigenous-economy-australia.pdf

Krugman, P. (2014), "The wages of men", New York Times, March 16, at http://krugman.blogs.nytimes.com/2014/03/16/the-wages-of-men/

Masters, G. (2016), *Five challenges in Australian school education*, Australian Council for Educational Research Policy Insights, Issue No. 5, May, at http://research.acer.edu.au/cgi/viewcontent.cgi?article=1004&context=policyinsights

New York Times (2016), "Drug overdoses propel rise in mortality rates of young whites", January 16, at http://www.nytimes.com/2016/01/17/science/drug-overdoses-propel-rise-in-mortality-rates-of-young-whites.html

Noonan, P., Burke, G., Wade, A. and Pilcher, S. (2015), *Expenditure on education and training in Australia*, Mitchell Institute, Policy Paper 08/15, August, at http://www.mitchellinstitute.org.au/wp-content/uploads/2015/08/Expenditure_on_education_and_training_in_Australia_2015_Update_and_analysis.pdf

OECD (2010) Economic Surveys: Australia, Paris, October, at http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-surveys-australia-2010_eco_surveys-aus-2010-en#page129

OECD (2014), *PISA 2012 Results: What Students Know and Can Do: student performance in mathematics, reading and science*, Paris, vol 1, February, at https://www.oecd.org/pisa/keyfindings/pisa-2012-results-volume-I.pdf

OECD (2016), *Economic Outlook No 99*, Paris, June, at http://www.oecd.org/eco/outlook/OECD-Economic-Outlook-June-2016-handout.pdf

Peterson Institute for International Economics (2016), Assessing Trade Agendas in the US Presidential Campaign, PIIE briefing 16-6, September, at https://piie.com/system/files/documents/piieb16-6.pdf

Plunkett, D. (2016), "Malice or misunderstanding: Government's carbon price under-compensation?" Tax and Transfer Policy Institute, Crawford School of Public Policy, Australian National University, June 8, at http://www.austaxpolicy.com/malice-or-misunderstanding-governments-carbon-price-under-compensation/

Productivity Commission (2013), *An Ageing Australia: Preparing for the Future*, November, at http://www.pc.gov.au/research/completed/ageing-australia/ageing-australia.pdf

Productivity Commission (2014) *Final Report: Childcare and Early Childhood Learning*, Commonwealth of Australia, Canberra, December.

Productivity Commission (2016a), *National education evidence base, draft report*, Canberra, September, at http://www.pc.gov.au/inquiries/current/education-evidence/draft/education-evidence-draft.pdf

Productivity Commission (2016b), Introducing competition and informed user choice into human services, identifying sectors for reform, Canberra, September, at http://www.pc.gov.au/inquiries/current/human-services/identifying-reform/preliminary-findings/human-services-identifying-reform-preliminary-findings.pdf

Productivity Commission (2016c), *Increasing Australia's future prosperity*, Productivity Commission Discussion Paper, Canberra, November, at http://www.pc.gov.au/inquiries/current/productivity-review/discussion/productivity-review-discussion.pdf

Saez, E. (2016), *Striking it richer: the evolution of top incomes in the United States*, at http://eml.berkeley.edu/~saez/saez-UStopincomes-2015.pdf

Stewart, M., Moore, A., Whiteford, P. and Grafton, Q.R. (2015), *A stocktake of the tax system and directions for reform: five years after the Henry Review,* Tax and Transfer Policy Institute, The Australian National University, Canberra, February, at https://taxpolicy.crawford.anu.edu.au/files/uploads/taxstudies_crawford_anu_edu_au/2015-03/stocktake_report_27_feb_2015_final_web_version.pdf

Wilkins, R. (2016), *The Household, Income and Labour Dynamics in Australia Survey: Selected Findings from Waves 1 to 14*, Melbourne Institute for Applied Economic and Social Research, at http://www.melbourneinstitute.com/downloads/hilda/Stat_Report/statreport_2016.pdf

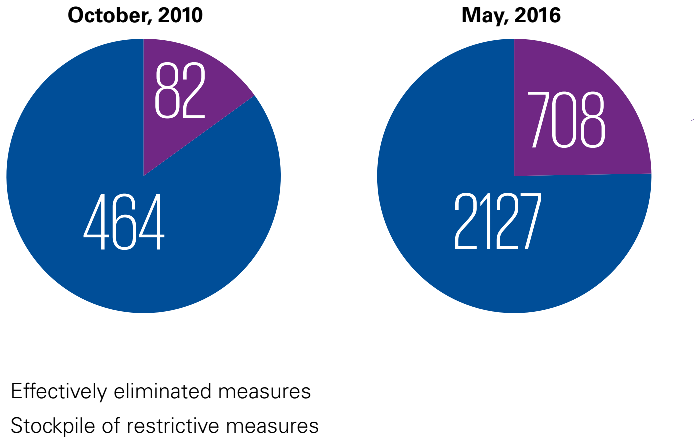
World Trade Organization (2016), *Report to the TPRB from the director-general on trade-related developments*, Geneva, July 4.

Appendix A

Four forces pushing against future growth

1. Rising international protectionism
In the most recent period for which statistics are available – to May 2016 – WTO members applied an average of 22 new trade-restrictive measures per month, the highest since 2011.[25] Worse, the stockpile of trade-restrictive measures has increased exponentially from 464 in 2010 to 2,835 in 2016 (Chart A1).

Chart A1: Stockpile of world trade-restrictive measures 2010 and 2016



Source: KPMG Economics, WTO.

The OECD expects global trade growth to be less than 3 percent over the period 2015-2017, down from more than 4 percent over 2011-2014 and almost 7 percent during the pre-crisis decade.[26]

2. Australia's population is ageing
Australian life expectancy at birth is 91.5 years for men and 93.6 years for women, and is projected to increase in the next 40 years to 95.1 years for men and 96.6 years for women.[27] These are positive developments, a sign of a successful society, placing Australia in the top seven countries in the world for life expectancy.

However, the ageing of the population creates its own economic challenges. The proportion of Australia's population that is over the age of 65 is projected to more than double over the next 40 years, leaving far fewer Australians of traditional working age for every person over the age of 65. Whereas in the mid-1970s there were 7.3 Australians aged between 15 and 64 for every person over the age of 65, that ratio had fallen to 4.5 in 2015 and is projected to fall to just 2.7 by 2055.[28]

25. World Trade Organization (2016), *Report to the TPRB from the director-general on trade-related developments*, Geneva, July 4, p.4.
26. OECD (2016), *op.cit.*, p. 6.
27. Australian Government Treasury (2015), *Intergenerational Report 2015: Australia in 2055*, Canberra, March, p. vii.
28. *Ibid.*, p. viii.

From the 1960s, women began entering the workforce in large numbers. This positive social development was also economically positive: the rise in female workforce participation boosted Australia's overall participation rate. Some extra gains are possible from further increases in female workforce participation but the biggest gains have already been achieved.

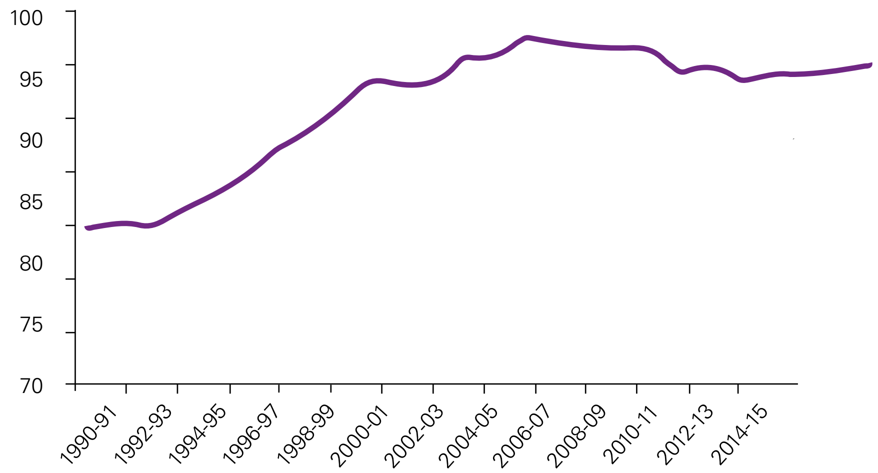
Immigration continues to freshen up the age profile of the Australian population since migrants, on average, are younger than the resident population. However, immigration alone is far from sufficient to counter the ageing of the Australian population.

While labour force participation by older age groups will rise in coming decades as healthier older people take on part-time work instead of full-time retirement, it will be well below that of the prime-age cohort. Overall labour force participation is therefore expected to fall as Australia's population continues to age.

3. Weak productivity growth

As Australia seeks to make the transition from the end of the mining boom to a more diversified, innovative economy, it will need to improve its productivity performance. Multifactor productivity (MFP) measures how well inputs of capital and labour are combined to produce a unit of output. MFP reflects technological progress and improvements in managerial expertise. Australia's measured MFP suggests the economy is less productive than it was in 2004 (Chart 5).[29]

Chart A2: Multifactor productivity in Australia 1990-2015 (Index 2013-14 = 100)



Source: KPMG Economics, ABS.

Measurement issues might be concealing improvements in MFP. Unpriced innovations such as free text messaging and electronic encyclopaedias, street directories and classified advertisements do not show up in productivity statistics. The rising volume of digital goods produced each year that do not have a price will exacerbate the understatement of improvements in living standards.[30] However, measurement issues are unlikely to explain all the slowdown in productivity growth in Australia and the rest of the developed world since the early 2000s.

A combination of falling labour force participation associated with population ageing, a return of Australia's terms of trade towards pre-boom levels and a continuation of the mediocre productivity growth rates achieved since the turn of the century would result in per capita incomes growing at less than half the rate enjoyed during the mining boom (Chart 6).[31]

29. See also Productivity Commission (2016c), *Increasing Australia's future prosperity*, Productivity Commission Discussion Paper, Canberra, November.
30. Brynjolfsson, E. and McAfee, A. (2014), *The Second Machine Age*, W.W. Norton & Company Inc., New York, p.111.
31. Productivity Commission (2013), *An Ageing Australia: Preparing for the Future*, November, p. 10.

Chart A3: A major slowdown in income growth is impending 1987-2067 (percentage change)

Source: KPMG Economics, ABS.

Without good luck or a sharp lift in productivity growth, the incomes of Australians are expected to grow at only 1 percent per annum, sharply down from the 2.7 percent achieved during the mining boom.

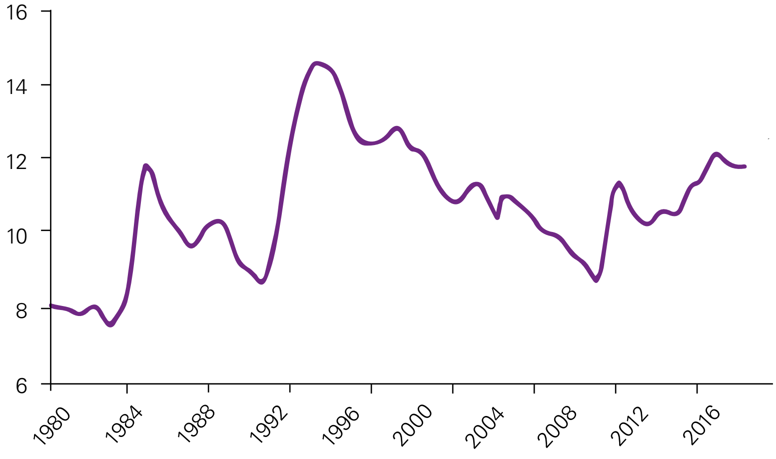
4. The future of work

Jobs are being lost in the minerals and energy sector and in industries servicing them such as procurement and construction contracting. The lost jobs are being replaced by lower-paid, casual and part-time jobs in household services industries and in retailing and wholesaling, keeping the overall unemployment rate below 6 percent.

When account is taken of employees who want to work more hours and those who have dropped out of the workforce altogether, underemployment and hidden unemployment – reflected in the underutilisation of labour – have been rising (Chart A4).

Hidden unemployment and underemployment have been rising since the end of the mining boom.

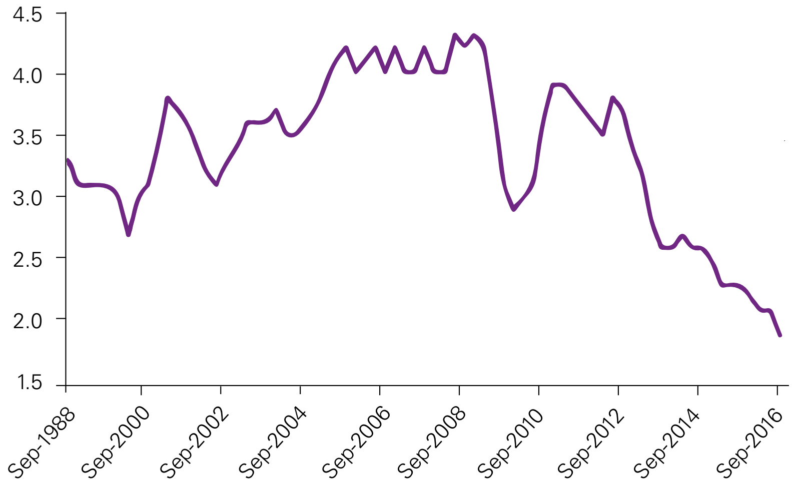
Chart A3: A major slowdown in income growth is impending 1987-2067 (percentage change)



Source: KPMG Economics, ABS.

Wages growth has been at its slowest since records were first kept in 1998 (Chart A5). This helps explain why householders report that they are under cost-of-living pressure when Australia is actually experiencing negligible inflation. While inflation is low, wages growth is also low, and many workers have moved into lower-paying jobs following the end of the mining boom.

Chart A5: Wage price index growth 1998-2016 (percentage change)



Source: KPMG Economics, ABS.

Contact us

KPMG Australia

John Somerville
National Managing Partner, Advisory
T: +61 3 9288 5074
E: jsomerville@kpmg.com.au

Craig Emerson
Economics Consultant to KPMG
T: +61 2 9455 9714
E: cemerson@kpmg.com.au

kpmg.com.au

December 2016. QLDN14895ADV.