What if our luck runs out?

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Rotary Club of Melbourne

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Good afternoon to Rotarians and Guests.

Given the significance of the Angus Mitchell Oration and the leadership role which Rotary Clubs around the world play in communities, I had planned to focus my delivery today on Leadership within communities, from a corporate perspective

Given the events of the last week and a Wall Street Journal headline which says Australia tips into political crisis, it is worth a comment on what we as a community seek from our political leaders.

I am stating the obvious, but there are all kinds of communities – factories, mines, offices, volunteer organisations, government agencies, sporting teams, churches – the list is endless.

I do not think that anyone in this room will argue that we are held together by neighbourhoods, occupations and political affiliations. Each one of those communities is a human enterprise, a complex living system. In each case people come together to pursue a common purpose, to make a contribution and to create value for themselves and others.

All of these different communities have one thing in common – they need leaders. We need leaders who are community builders and we need leaders who understand why people need community.

Effective leaders know how to tap into the power of community.

And they know how to build communities by inspiring the commitment of others.

I see mature community leaders, in Churches, sporting organisations, volunteer organisations and business leaders who are building or have built healthy organisations who are concerned about others and have a deep appreciation for community life, the environment and the long term sustainability of society.

I have a filing cabinet full of marvellous case studies of leadership in action, but that does not give me much comfort when I look around the democratised world – here I struggle to find political leaders who understand the value of building healthy, socially responsible enterprises who interact with their constituencies.

The dearth of political leadership in this country is why I have changed tack and have decided to concentrate on a few themes which should be of concern to all of us as we tackle structural changes in the economy and lock in a long term strategy which allows us to reap the benefits of the growth of India and China who are demanding more and more of our scarce and non-renewable resources.

That can only happen if our political leaders set acceptable standards, create commitments to objectives and determine the values and principles that guide the country.

At the moment our leader-follower relationships are tense, cynical, confused and mistrustful.

That sort of environment only leads to dysfunctional relationships and of course a crisis of commitment.

The theme of my public speeches over the past few years has been that although Australia has been incredibly lucky, we cannot rely on luck for our future prosperity.

Instead, we need to make sure the country remains competitive in uncertain times and that our political leaders foster strong sustainable growth for the benefit of all Australians.

The source of Australia's so called luck is well known. We are positioned in a unique way to benefit from the shift in the globe's economic centre of gravity from the western world, to Asia. And we stand to benefit enormously from the emergence of the Chinese middle class over the next two decades.

Against that backdrop I want to structure my talk today around three issues where I believe we will need strong leadership to deliver quality outcomes.

We need to get these things right to ensure that the living standards of our children and grandchildren are at least as good – and hopefully better – than what we enjoy today, and we need to engage in outcome thinking to build that healthy community to which I referred earlier.

The three areas I want to focus on are productivity, management of our public finances and taxation.

As I have said before on previous occasions, I fear that in many cases our political leaders are opting for the most politically convenient outcomes, not those that are in the best interests of future generations; – all this selfish leadership debate is really quite exhausting and futile.

1) Productivity

Let me deal with the first of my concerns - productivity.

I am pleased that Australia's productivity has received more attention of late. This is not an academic issue. It is a crucial determinant of the living standards to be enjoyed by future generations of Australians.

Simply put, productivity is what a workplace, a business or government agency, an industry, a region or a nation gets by way of goods and services for what it "puts in", in terms of labour, capital and other factors of production.

Economists and others have long recognised that productivity growth (that is, increases in the level of productivity over time) is the only sustainable source of improvements in a community or a nation's material well being, which benefits its citizens in the long run.

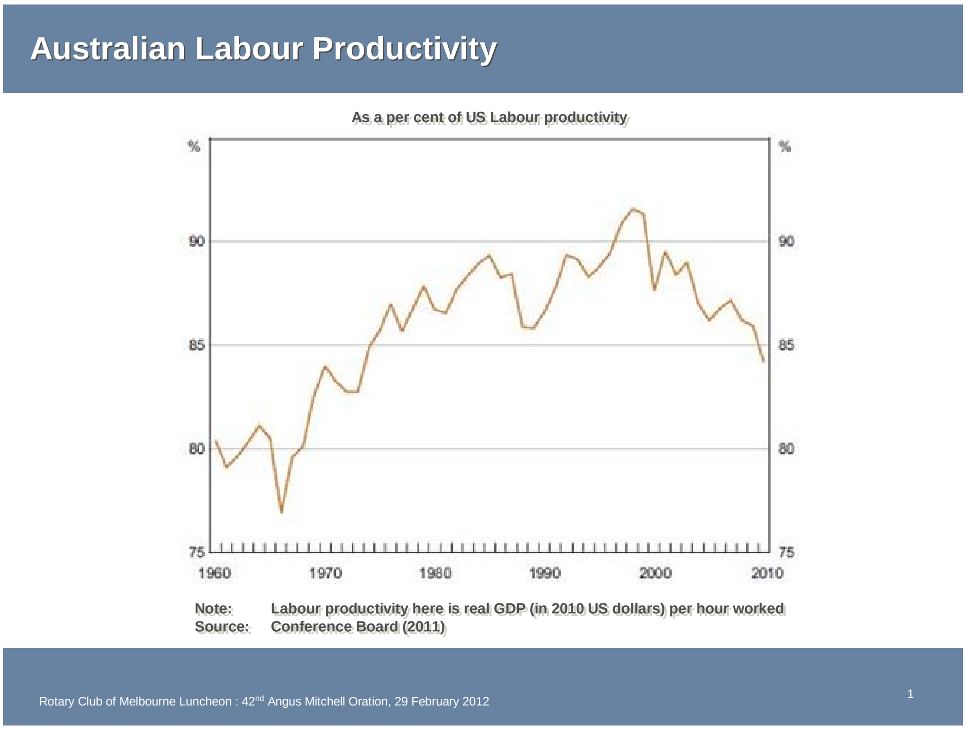
Most of you will have heard that Australia has experienced declining productivity growth for the last decade.

Even more worrying is the fact that our productivity has also been falling relative to other countries, which makes Australia less competitive even before factoring in the higher Australian dollar.

You can see how Australia's labour productivity has declined when compared to the US in this chart I sourced from work done by Bank of America Merrill Lynch's Australian chief economist, Saul Eslake.

The productivity of Australian workers relative to their US counterparts is back where is was in the late 1970s.

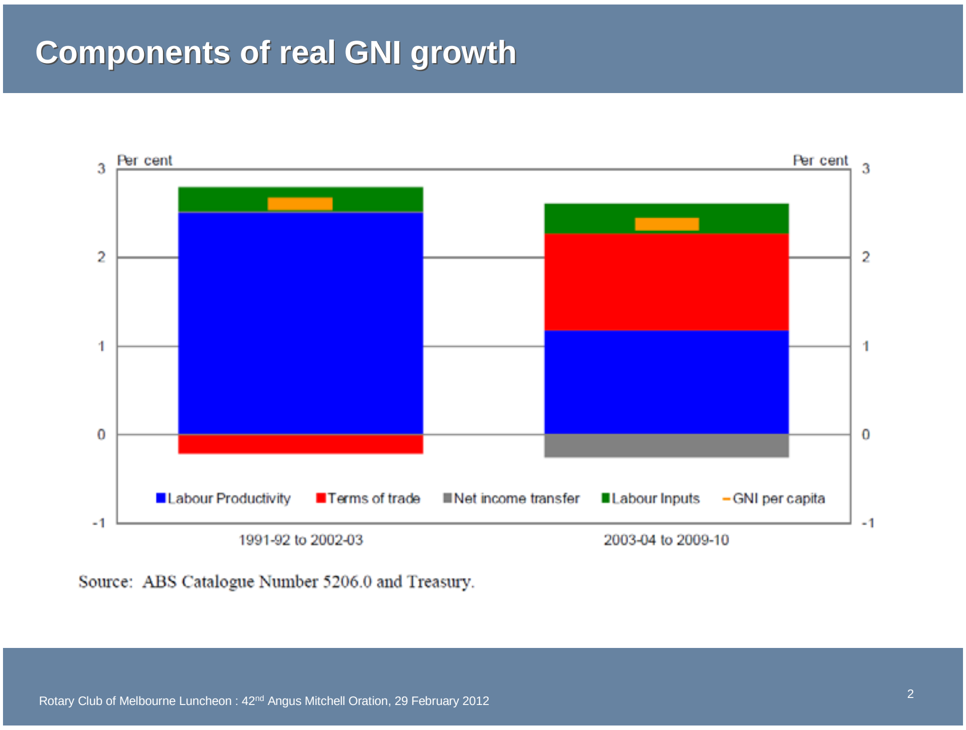
Put simply, over the past decade we have unwound the improvement in relative productivity that took 25 years to build between the late 1970s and the turn of the millenium.



Ordinarily falling productivity would mean that Australian living standards decline. But this is where Australia's luck comes in.

The deterioration in productivity growth has been masked by the unprecedented boost to the terms of trade that has occurred because of China's rapid economic development. This can be clearly seen in this next chart, which I have used before and borrowed from a speech given last year by Martin Parkinson.

It shows that the decline in Australian labour productivity growth – the blue bars – more than halved since the 1990s but this was largely offset by the boost in the terms of trade – the red bars – such that Gross National Income growth was little changed.



This chart very clearly highlights the risk of relying on the mining boom alone to boost living standards in this country. It is unlikely that Australia will see an improvement in the terms of trade of the magnitude we have witnessed in recent years. In fact many, including the RBA, think the peak in the terms of trade is now behind us.

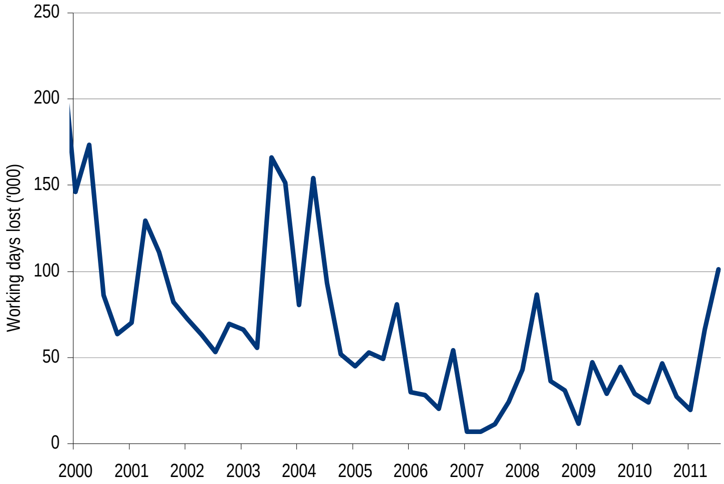
That means productivity growth must play a greater role in improving living standards.

I believe we have seen a major warning light for productivity in the disruption many businesses face from strikes and the rising power of unions.

This is one of the most concerning developments over the past few years that I can recall. This problem gained significant national attention after the high profile disruptions at Qantas and Patrick last year, but I want to emphasise that it is spreading well beyond these high profile cases.

The official data show we have a looming problem on our hands. This chart shows that working days lost in Australia because of industrial disputes picked up four-fold in the September quarter last year, to over 100 000 days. That was the highest number of working days lost in one quarter for seven years. I do not see this trend abating in the short term.

Working days lost to industrial disputes



Source: ABS

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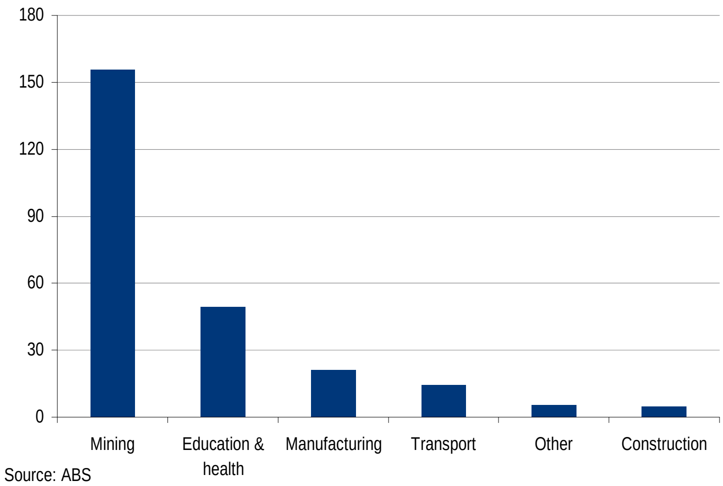
Lost productivity is regrettable for any business. But it is particulalry unfortunate that the mining sector has been very heavily affected by strikes, which you can see from this next chart. Mining jobs are highly valuable to the economy and we should be worried that the country's income is being lost to industrial disputes.

Working days lost in September quarter per 1000 employees



Source: ABS

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So how can we deal with our productivity malaise?

First and foremost, business leaders must be given the flexibility to shape their workforces and manage their balance sheets without threats of disruption from unions and harrassment from government.

This is imperative now because outside of the resources sector, much of Australia is going through a tough patch. The impact of the high Australian dollar, slowing global growth and fragile consumer confidence means that many businesses and households are doing it tough.

The tough decisions taken now will set the stage for future growth in Australian productivity although with the advent of a Carbon Tax, many business leaders are expressing pessimism here.

If we slow down or obstruct the natural adjustment process that businesses need to go through then we will harm the prospects for productivity for perhaps a decade to come.

Of course the Fair Work Act governs the interactions between workers, unions and businesses. It is a problem that we still face substantial uncertainty about how to interpret key provisions of this legislation.

If you accept the argument that we must continuously strive for improved efficiency to remain internationally competitive, we do need certainty in the application of our regulatory environment to ensure that potential artificial barriers do not again impede this competitiveness.

Labour market flexibility is perhaps the most important determinant of productivity and if we lose our focus on productivity objectives, the Australian economy will suffer, investment capital will go elsewhere and we will see a return to the dark days of the 70s, and our competitive and comparative advantage will be squandered.

The second way I think we can address our productivity malaise is to recognise that we have a public authority charged with addressing this issue, the aptly named Prodictivity Commission. One of the unfortunate things we have witnessed in recent years is that some of the Commission's recommendations are abandoned because they are politically unpalatable.

For example, a few year ago the Commission recommended the easing of restrictions on parallel importation of books. In plain language this change would have meant you and I could buy books more cheaply and Australian publishers would have to compete more vigorously. Unfortunately this proposal was abandoned as a result of intense lobbying by those with a vested interest in the existing arrangements.

It is also unfortunate that the Commission has not been given a central role in the assessment and debate of major policy initiatives. For example, the Productivity Commission was not asked for an assessment of the *Fair Work Act* as part of the Government's recent review, nor was it asked to assess the NBN. Both of these policies will play a very important role in determining Australia's productivity over the coming decade and it is bemusing that there will be no assessment from this impartial public body.

2) Management of our public finances

Before I address my second theme of our public finances, I want to make sure we appreciate the global backdrop against which Australia sits.

Most of you will know that much of the world is going through a lengthy period of deleveraging. This began in 2008 and followed a multi-year credit boom where debt funding was freely available and cheap.

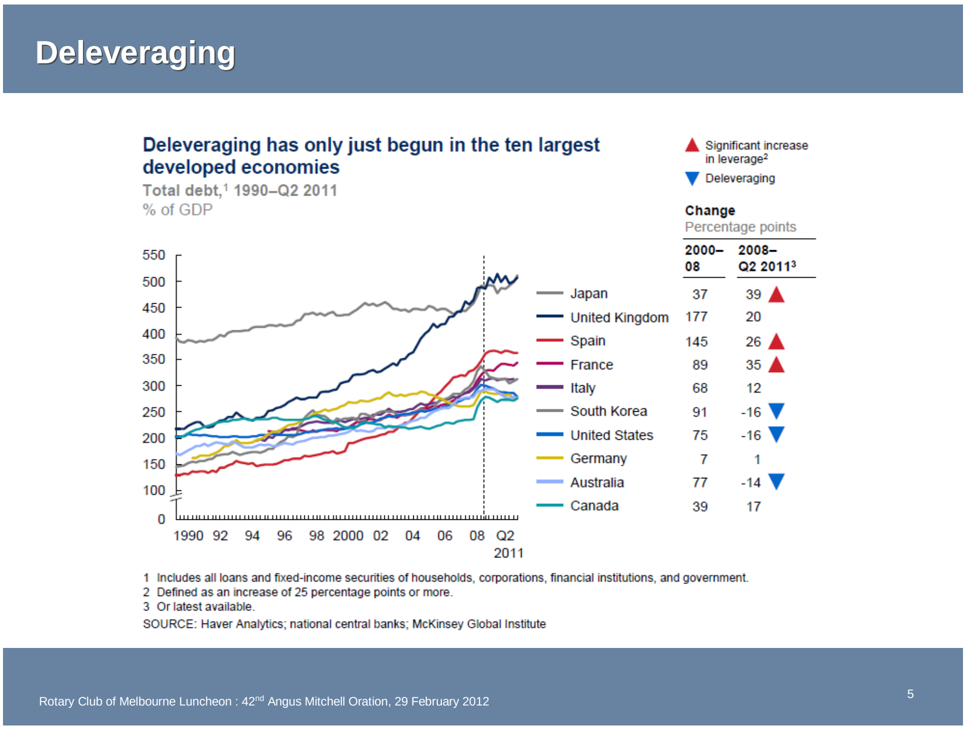
Investors are now more discerning about which debt securities they buy. Funding is more expensive and in some cases not available to countries unless it is intermediated through government or supranational bodies like the IMF.

We are fortunate that Australia's public finances were well managed in the past such that global investors are still happy to lend to us, although headlines like "Australia in Political Crisis" are not helpful.

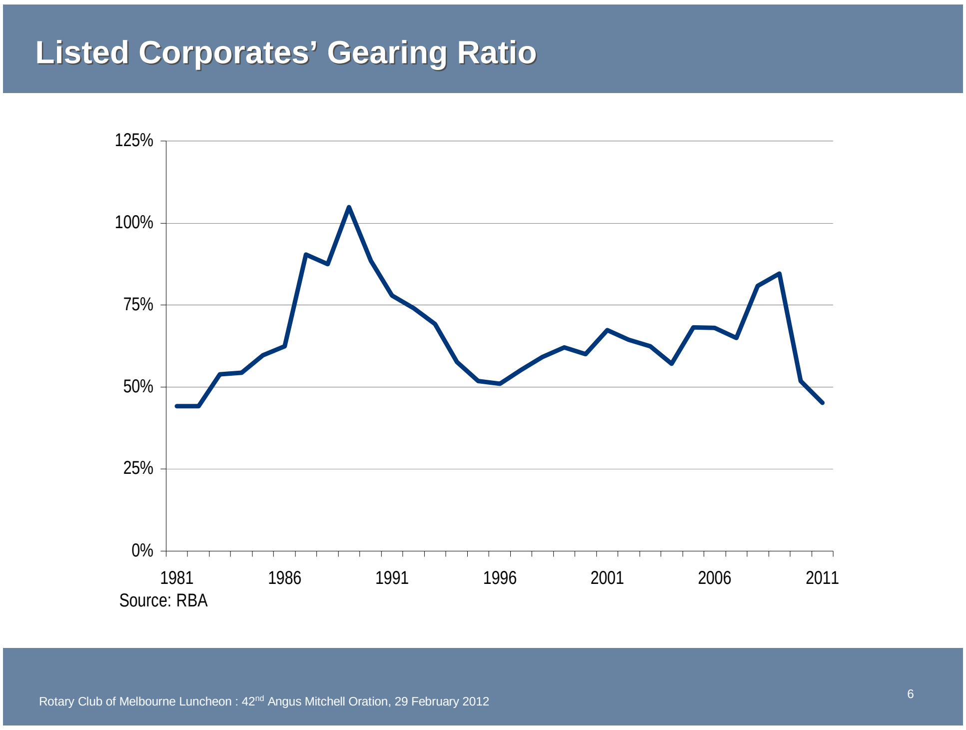
The McKinsey Global Institute recently provided an update on the progress of deleveraging globally. Their work is summarised in this graph which shows total debt-to-GDP ratios for large developed countries. Debt here is a comprehensive measure that includes government, business and household debt. You can very clearly see the two decade leverage boom that saw debt-to-GDP ratios rise very strongly.

On face value, the key takeaway from this graph is that only a handful of countries – including Australia – have started the deleveraging process..

One needs to be careful when analysing such graphs as a closer examination will reveal that this deleveraging is due to households and businesses – with Government debt around the globe still rising at a rapid rate.



This is certainly true in Australia's case where the reduction in debt has been entirely due to businesses deleveraging their balance sheets. The gearing ratio of listed companies is now the lowest it has been for three decades, which puts them in good shape to navigate a very uncertain period ahead.



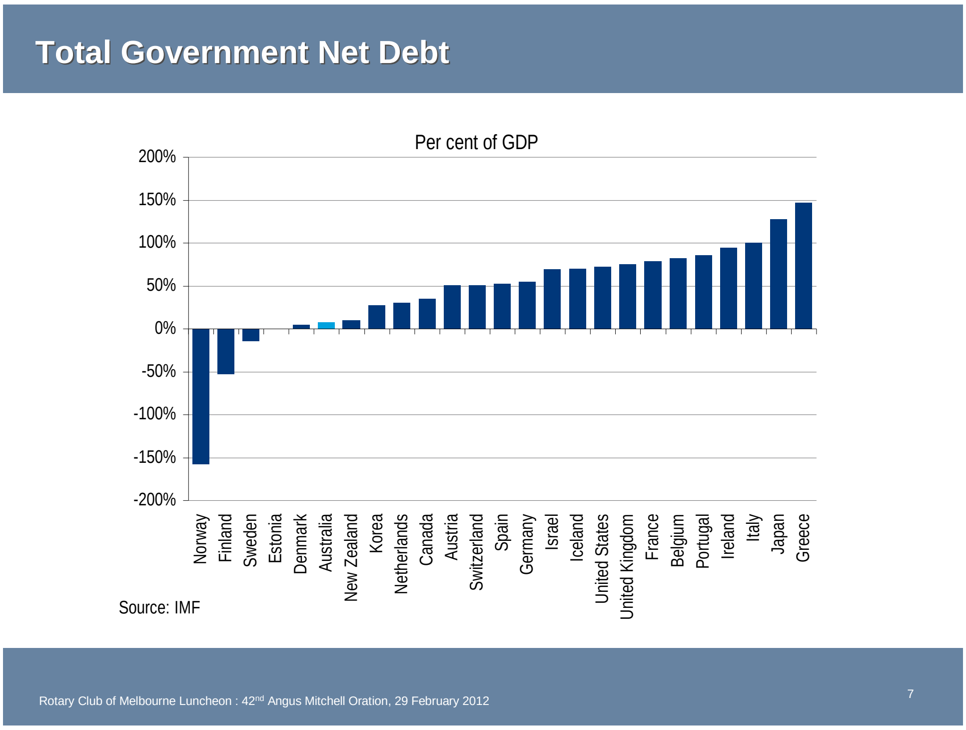
Australian households have also demonstrated leadership in this area by saving more and being more prudent with their finances. To this point debt has not declined much relative to income because, as you will appreciate from your own experience, it can take a long time to reduce debt when you have other financial commitments to meet.

As a consequence the deleveraging of household balance sheets is likely to take a long time and must be managed carefully by policy makers like the RBA.

There is also a very important role for politicians to lead the country through this challenging period in such a way that builds confidence among Australian households and businesses. I think Australians have become quite cynical about our political leadership and that is being borne out in some of the business confidence surveys and consumer inactivity.

If we turn our attention now to a closer evaluation of our public finances. It is true that in an international context our government finances are in pretty good shape, with graphs like this one often used to highlight this point. It shows total government net debt expressed as a percentage of a nation's GDP.

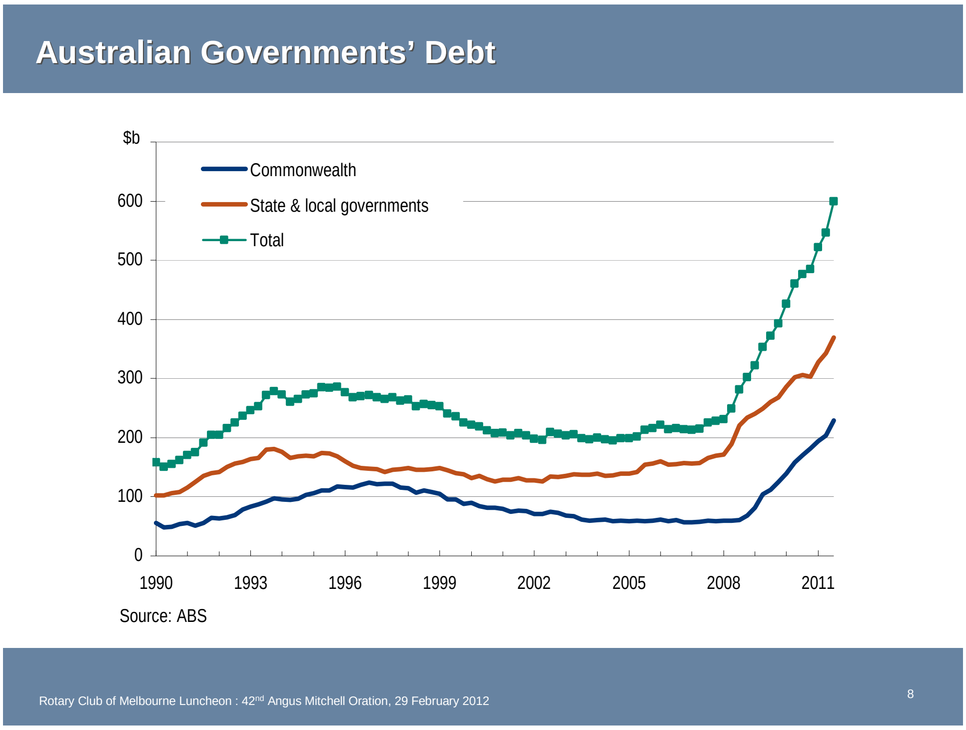
Net debt is total debt on issue less financial assets which the government owns.



We should be grateful for political leaders that diligently managed Australia's finances in years gone by because they have positioned us well to deal with unfortunate surprises that have come our way. These decisions included obvious ones like how taxes are raised and spent, but also encompassed reforms of the labour and financial markets in the 1980s, and the introduction of compulsory superannuation.

These were not easy reforms to make, but important reforms never are. They took political courage and an unyielding focus on what was in the long-term national interest. It took a long time to determine what the best policy design was, and even more time and hard work building community support.

Regretfully, my sense is that more recently our public finances have not been managed to the same standard. For some context on this point, this next graph shows the debt outstanding for all levels of government in Australia. Remember that this debt must ultimately be repaid by future generations of Australians and it is therefore imperative that we keep a watchful eye on our national balance sheet.



The rise in debt since 2009 is dramatic. Of course much of this was a consequence of action taken during the global financial crisis. Clearly some fiscal stimulus was needed but it is disappointing that we saw a sizeable amount of wasteful spending during that period. Governments were not as prudent and careful as they should have been which is evidenced by the fact that most of us could list a few instances where taxpayer money was wasted.

Some want us to evaluate the fiscal management of the Australian Government on their promise to achieve a small budget surplus in 2012/13 alone. But surely that is far from the ultimate criteria upon which we should evaluate the management of our public finances?

Putting wasteful spending aside for a moment, we must also evaluate the quality of any surplus if it is achieved. Financial analysts will tell you that the quality of a company's profit matters as much the quantity, and so it is with our public finances too. If a surplus is achieved by introducing poorly designed taxes and bringing expenditure forward to earlier years, then in my view the government has been far from prudent and responsible.

Before I move onto my final theme, I want to make the observation that the financial position of the states was actually deteriorating before the onset of the financial crisis, albeit modestly. This is disappointing because the economic conditions faced by the country during that period were very, very good and ultimately should have been used to strengthen governments financial position by repaying debt. Against that backdrop I think you'll agree that the finances of our state governments deserve greater scrutiny going forward.

3) Taxation

My third topic of concern is Taxation.

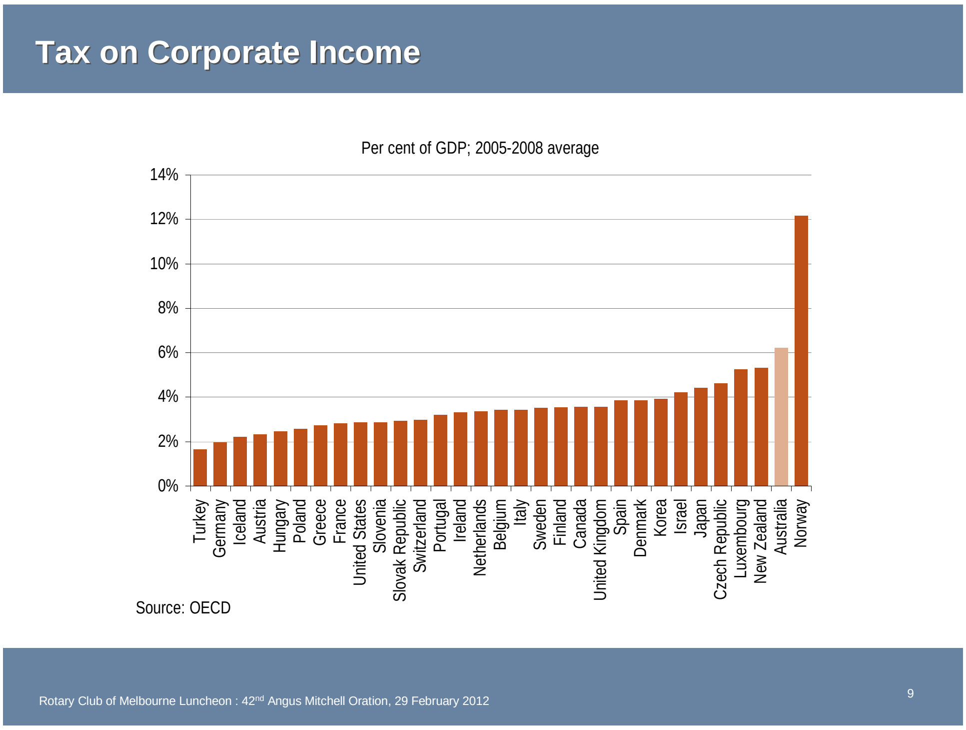
This is an emotive subject and periodically we go through an extensive exercise of a review.

As we have all observed, taxes can strongly influence the level of activity in a market economy. The actual impact that a tax has depends on its type and size. Proposed changes to existing systems can at face influence the future of Governments, as we saw with the poorly conceived Resource Super Profits Tax.

If the level of taxation is already at or above the optimal level where a country's competitiveness is deemed to be marginal for investment funds, further increases in taxes are not only bad for the country, but changes in the tax regime also undermine the investment community's perception of stability, raising the perceived risk of the country.

Projects that would otherwise be undertaken may not eventuate.

As you will see from this chart, Australia's corporate taxes are not low and if we continue to change the tax regime and add new taxes, some projects will be delayed or not undertaken at all.

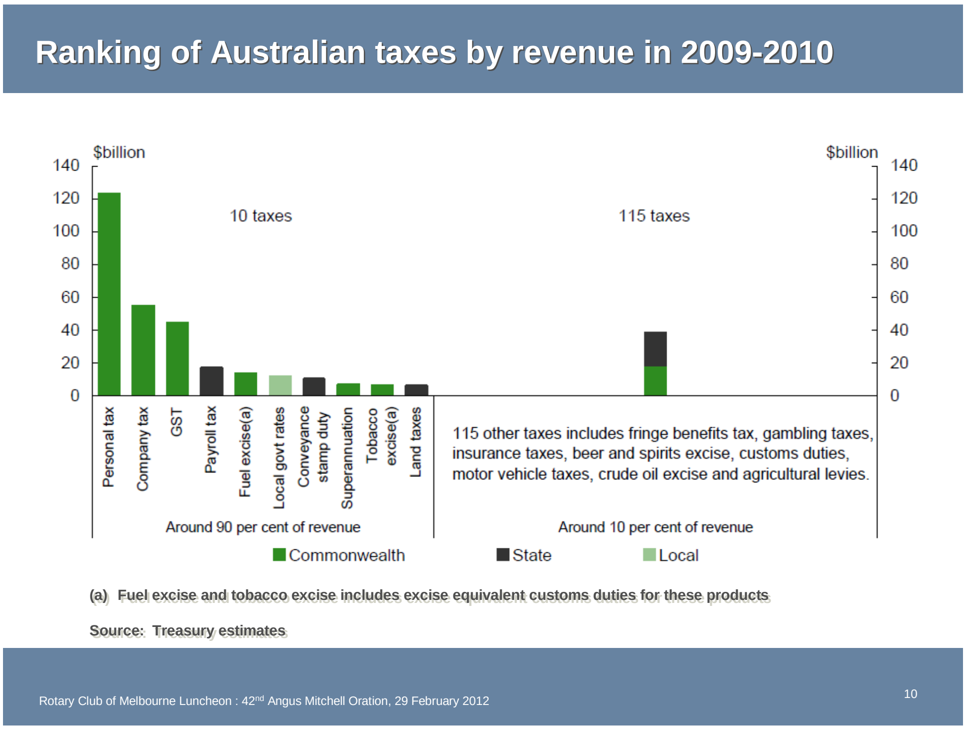


We should never forget that a higher tax rate on any product shifts revenue over time, from the more distant future to the present and near future.

This means that a tax increase is easier to justify if the interests of political parties are focussed largely on the present generation or even the current electoral cycle, which in Australia's case is relatively short term. But if the welfare of future generations are of concern, then the longer run negative effects of high corporate tax rates should be carefully considered.

It is also crucial that we **simplify the tax system**.

The need for simplification is very clear when I look at this chart. We have 10 main taxes which contribute around 90% of the revenue and 115 other taxes which collect around $40 billion.



This complexity costs businesses time and money – resources that could certainly be used more productively. If we included the costs of complying with our complex tax system in the corporate tax rate, then the tax burden on businesses would be much higher than what is implied by the statutory rate alone.

In my view it is these 115 other taxes that need simplifying most. But how one can exclude the GST from any reform agenda is beyond my comprehension. Any major reform in taxation should also not undermine the basis upon which long term investment decisions have already been made, nor compromise the principle of equitable treatment, irrespective of the needs of the Government of the day.

Let me make some observations about the carbon tax. Of course this tax has passed the parliament and will become effective from July this year.

Let me leave aside for the moment my deep reservations about Australia being a world leader in this area when it represents less than 2% of global CO2 emissions.

I will also put to one side my concerns about introducing the tax at this time. The decisions businesses and households must take are already extremely complicated at the moment because of the volatile global scene and governments would be well advised not to complicate these decisions further.

Instead I want to focus my comments on how politically expediant this legislation was. And because it was the product of political expedience we almost certainly know that a more carefully designed tax could achieve better outcomes with less cost for the economy.

For example, I was quite bemused that carbon capture storage has been excluded from the proposed $10 billion Clean Energy Finance Corporation. This is potentially a very worthwhile technology that is apparently being excluded on political grounds.

It also bemuses me that so much attention is being given to renewable energy sources without adequate consideration of other, less risky and more cost effective options. In a previous speech I outlined in some detail the advantages of natural gas, which of course is as abundant, more cost-effective than renewables and more likely to deliver reductions in emissions.

Trevor St Baker of the Australian company, ERM Power, argues that “gas power can deliver five times more greenhouse gas abatement than wind for the same dollar outlays. It can deliver 10 times more than solar – and 100 times more than the same money spent on a carbon tax or an emissions cap-and-trade scheme.”

The exclusion of carbon capture storage and limited focus on gas in our national debate shows how little alternatives were truly debated.

Simply put, because the carbon tax was the result of political expediency I am concerned that we have a badly designed, hurriedly implemented tax that imposes significant costs on the economy but that may not achieve its core aim of causing a change in behaviour that will lead to a meaningful reduction in carbon emmissions.

The final point I want to make here is that in selling the carbon tax our politicians have laboured the point that large businesses need to change their behaviour and households, in most cases, will actually be better off because of the tax. In fact if you log onto the government carbon tax website, as I did recently, the first thing I was confronted with was a big banner saying “How much will I get?” and “How much will my family get?”. It seems that actually reducing emissions is actually a secondary consideration. Shouldn’t we be giving greater prominence to how households can actually reduce their emissions?

Conclusion

Let me conclude. Australia has been a very lucky country over the past couple of decades. We escaped relatively unscathed from the financial crisis and are positioned in a unique way to benefit from the shift in the globe’s economic centre of gravity toward Asia. – And we stand to benefit enormously from the emergence of the Chinese middle class in ways that many cannot yet fathom.

To benefit from the Asian phenomenon we must have political and business leaders who understand the complexity of change. They must be the change agent that mobilises the community the leader must start by convincing the country or the organisation that there is an urgent need to change. Successful leaders that I have observed create a vision that is clear, compelling and shared by others and where the consequences of the change are clearly articulated and costed. Integrity and transparency are essential principles in generating trust so essential in executing any strategy.

The followers of successful leaders must then "step up to the plate" – understand the challenges and take responsibility for solving them. The leader must continually challenge the organisation to keep the momentum going.

We must use this opportunity wisely but can not rely on good fortune alone to secure Australia's future.

Decision making by our business leaders is quite transparent with the markets being a harsh judge of misadventure or poor judgement. I believe we need closer scrutiny of the decisions being taken by our political leaders – particularly decisions around productivity and management of our public finances.

In order for Australia to remain competitive and to improve the living standards of future generations, we need a greater focus on productivity than has existed for some time. This means ensuring that the labour market does not lose flexibility, which I fear is happening quickly.

We also need to hold our political leaders to account in the area of financial management. The quality of a government's financial management cannot only be judged by whether they achieve a small budget surplus. The quality of the financial bottom line matters as much as the quantity – maybe even more.

We all know the challenges we have to face. If we lose our competitive advantage then Australia will not benefit. And that's my message – let's debate the issues, assess them against what is in Australia's best interests, understand the cost/benefit of change and keep Australia competitive globally – for we will all then benefit from Australia's growth.

If we get this wrong, we might just find that our luck has run out.