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31 January 2020

Budget Policy Division
Department of the Treasury
Langton Crescent
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Pre-Budget Submission 2020-21

On behalf of the Australian Institute of Company Directors (**AICD**), I am pleased to provide this submission to Treasury ahead of the release of the 2020-21 Federal Budget.

The AICD has a membership of more than 45,000 including directors and senior leaders from business, government and the not-for-profit sectors. The mission of the AICD is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society.

The AICD advocates on a broad set of policy matters and takes a strong interest in matters of national importance, governance of the nation, and economic conditions.

We conduct research and provide resources – many of which are referenced in this submission – to our members and stakeholders.

Should further information on the content of this submission be required please contact me via mthirlwell@aicd.com.au or 02 8248 8406.

Sincerely

Mark Thirlwell MAICD
Chief Economist

Australian Institute of Company Directors 2020-21 Pre-Budget Submission

Despite an impressive run of recession-free growth, Australia's recent growth performance has been disappointing. Our most recent survey of Australia Institute of Company Directors (AICD) members suggests that directors are concerned about prospects for the economy.

Directors see key challenges for Australian businesses deriving from a mix of global (economic policy uncertainty, climate change), regional (China's growth outlook) and domestic (Australia's lacklustre productivity performance, excessive regulation/red tape) factors.

Our survey results suggest that directors are relatively unconcerned by the current state of the budget balance or the level of government debt, likely reflecting the successful budget repair the government has delivered to date along with the prevailing low level of government borrowing costs. There is some evidence that directors would be prepared to trade off the size of future surpluses in favour of increased public infrastructure investment.

With directors also sceptical of the efficacy of further rate cuts to stimulate the economy, this argues that fiscal policy should be available to play a greater role in stabilisation policy in the future, if required.

Directors see the energy – climate change policy nexus as a critical priority for the federal government in both the short and long term. AICD member polling shows a marked increase in directors' focus on climate change in recent years.

Directors identify low productivity growth as a key challenge for the economy, which they would like to see tackled by less short-termism, an increase in infrastructure spending and a greater focus on fostering innovation. Despite the welcome increase in investment in recent years, directors still judge infrastructure investment to be too low.

Priorities for future infrastructure investment include water supply, renewable energy and rural infrastructure.

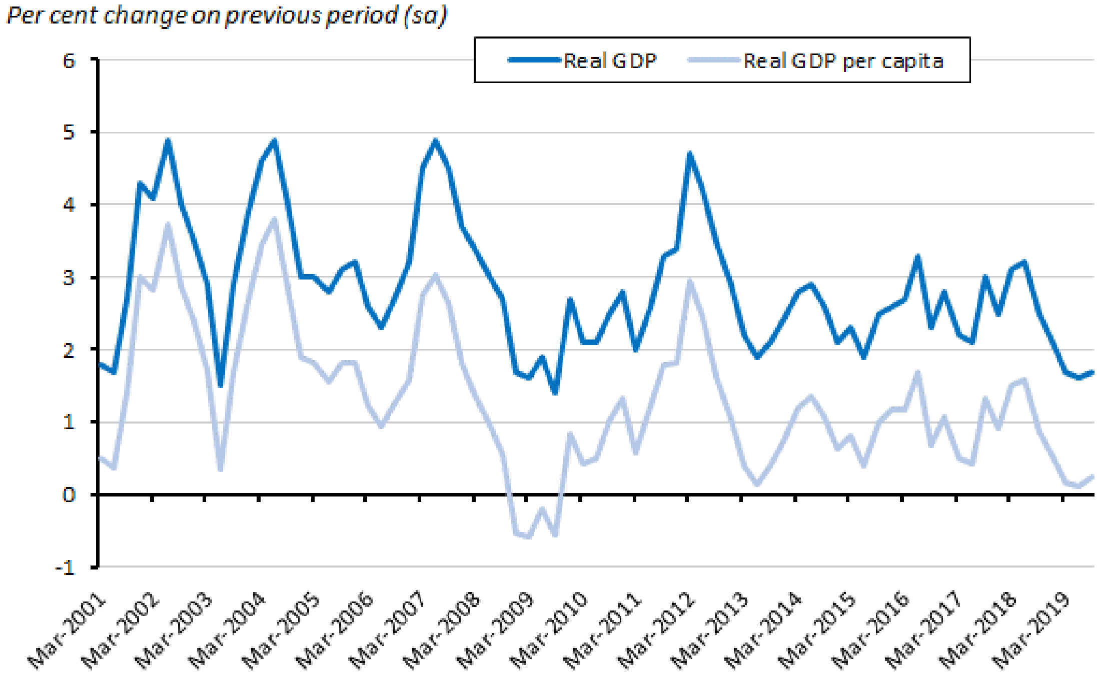
Directors' priorities for taxation reform include the level of personal taxation and the level of company tax, as well as economically inefficient state taxes. Ideally, tax reform would be delivered as part of a comprehensive package, along the lines proposed in the AICD's Blueprint. The AICD recognises the political difficulties involved but continues to believe that a comprehensive tax reform package that rebalances Australia's tax mix away from its current excessive reliance on inefficient direct taxes remains an important policy goal.

With low levels of private business investment contributing to Australia's poor productivity performance, and in the absence of a more comprehensive taxation reform, the AICD is broadly supportive of recent discussions calling for a temporary investment allowance, although our polling suggests other factors appear to be relatively more important in influencing capital spending.

An under-performing economy

Although Australia continues to benefit from a record run of recession-free economic growth that has been the envy of many of our peers, our recent growth performance has nevertheless been disappointing. Last year, the pace of annual economic growth slowed to a sub-two per cent rate, which is well below official estimates of a potential growth rate of around 2.75 per cent. Moreover, much of this headline GDP growth reflects relatively strong population growth, currently running at around 1.5 per cent per annum. In per capita terms, GDP growth has been only a little above stall speed over the past several quarters.

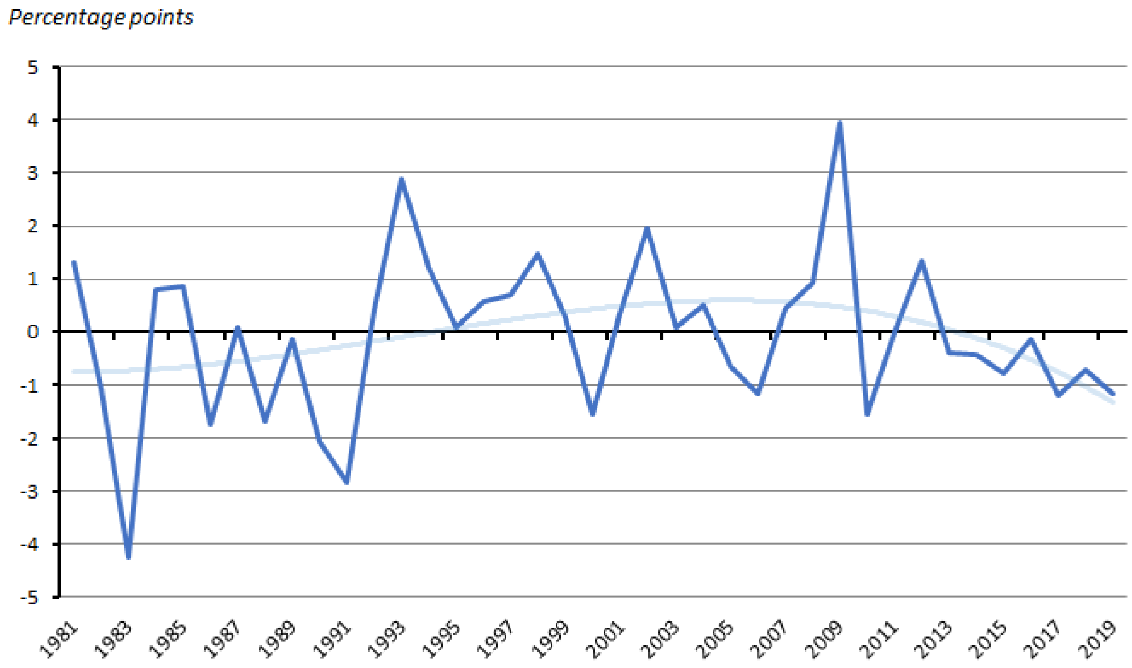
Australia: Real GDP and GDP per capita



Source: Bloomberg and ABS

Measured in per capita terms, Australian growth has been below the average growth rate for advanced economies since around 2013.

Australia: Growth gap vs advanced economies in terms of GDP per capita, 1981-2019E



Source: Bloomberg and IMF World Economic Outlook database October 2019. Growth gap is growth in real GDP per capita in Australia *minus* growth in real GDP per capita in advanced economies.

Directors are concerned about economic prospects

The AICDS's most recent survey of director opinion on the economy – the H2:2019 Director Sentiment Index (DSI)[1] – reported a relatively sombre view of Australia's near-term economic prospects, with respondents concerned by both the domestic and international economic outlook. The overall DSI moved further into negative territory, falling from minus 16.9 in the first half of the year to minus 21.2 in the second, delivering the weakest index reading since the second half of 2016.

About the AICD's Director Sentiment Index (DSI)

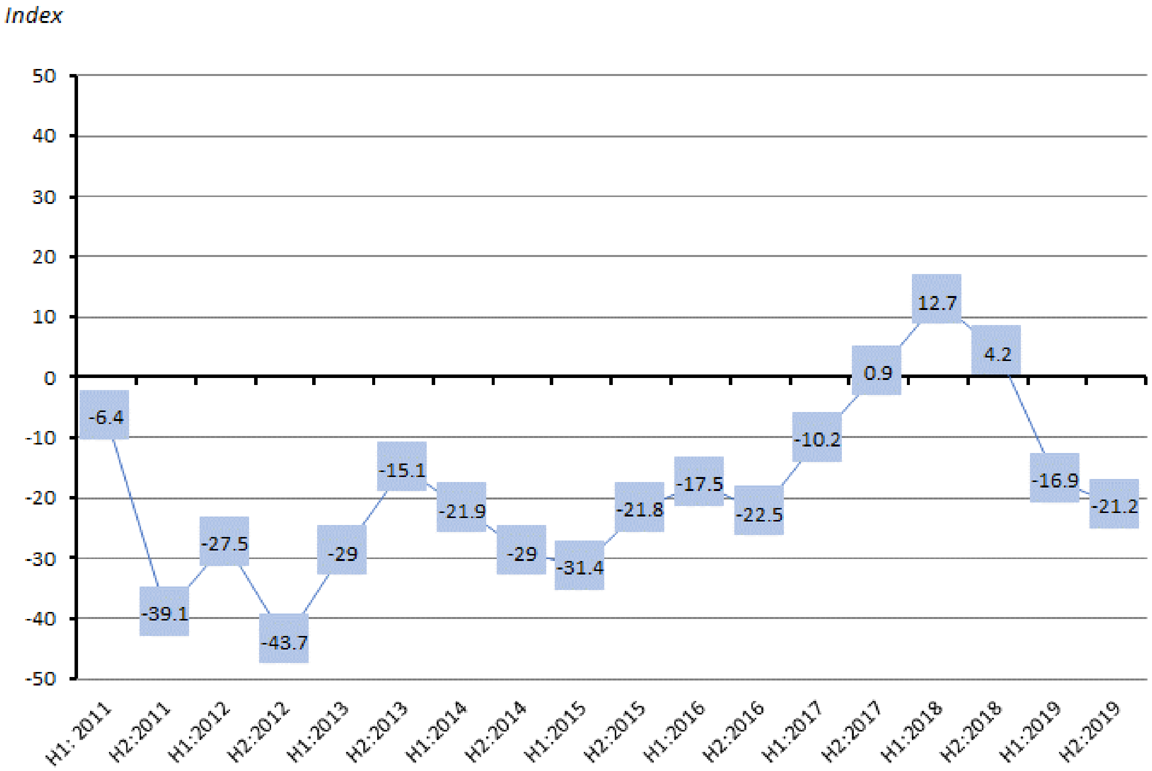
The DSI results are a representation of the views of the Australian Institute of Company Directors (AICD) membership, making the DSI a valuable indicator of the opinions and future intentions of directors on a range of issues including the Australian and world economies, government policy and governance regulation. The first DSI was conducted in November 2011 and since then, the DSI has been conducted twice a year, each year.

The most recent DSI covers the second half of 2019. The survey was conducted between 12 and 26 September 2019 and captures the views of 1,489 AICD members.

More information about the DSI, including the results of all previous surveys, is available from the AICD web site at: https://aicd.companydirectors.com.au/advocacy/research

[1] See box for details on the DSI.

Australia: Overall Director Sentiment Index



Source: AICD Director Sentiment Index (DSI), H2:2019

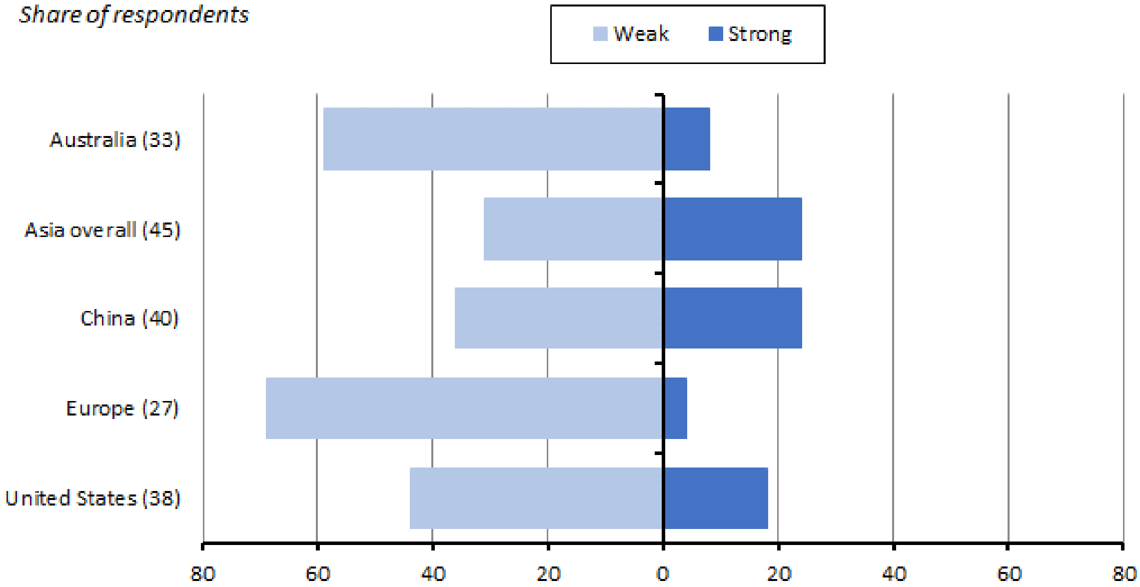
Roughly 49 per cent of respondents thought that the health of the Australian economy at the time of the survey was weak or very weak, compared to just 11 per cent who judged it to be strong (the remaining 40 per cent thought the economy was 'OK').

Those numbers became more pessimistic, however, when directors were asked about their assessment for the next 12 months, with the share of respondents judging the economy likely to be weak rising to 59 per cent, the share thinking that it would be strong falling to eight per cent, and the share opting for 'OK' dropping to 33 per cent.

Directors were also concerned about the prospects for other major economies and Australian trading partners, although it should be noted that global economic and financial market sentiment has improved since the time of the polling.

Global: Expected health of economy over next 12 months

Share of respondents



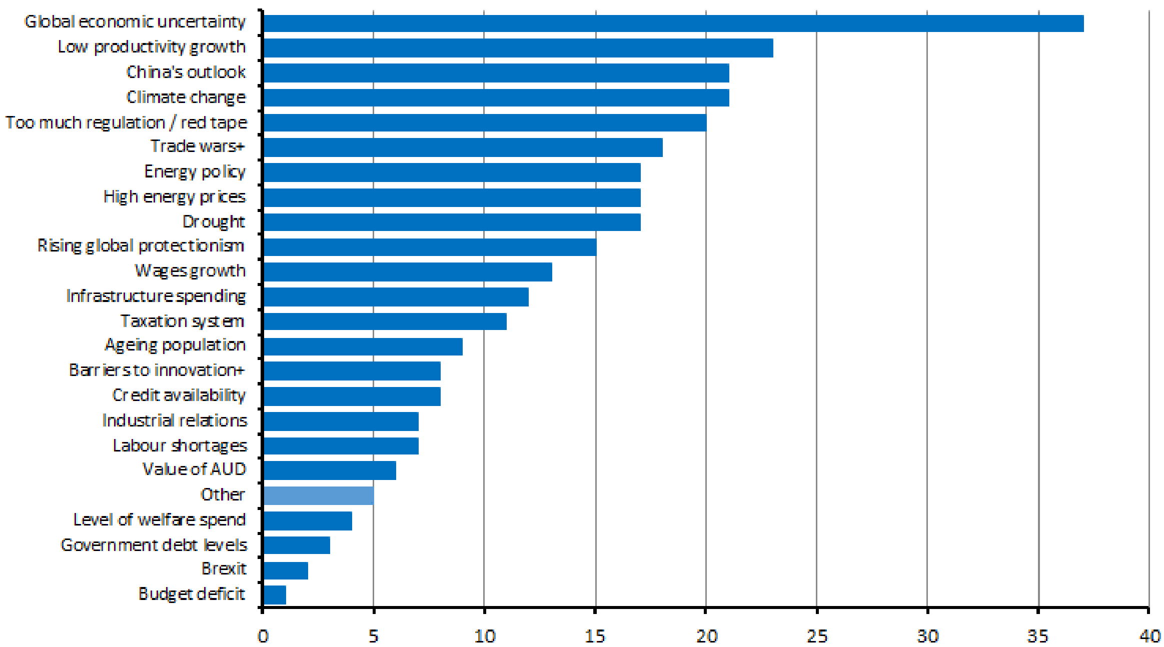
Source: AICD Director Sentiment Index (DSI), H2:2019. Note: (1) Weak combines very weak and somewhat weak and strong combines quite strong and very strong; (2) Share of respondents saying 'OK' is not shown in bars but is given by the figure reported in brackets next to region / country.

Leading economic concerns are global uncertainty, productivity growth, China and climate change

In the DSI, directors identified the main economic challenges facing Australian businesses as a mix of global, regional and domestic concerns.

Australia: Main economic challenges facing Australian businesses (top three)

Per cent



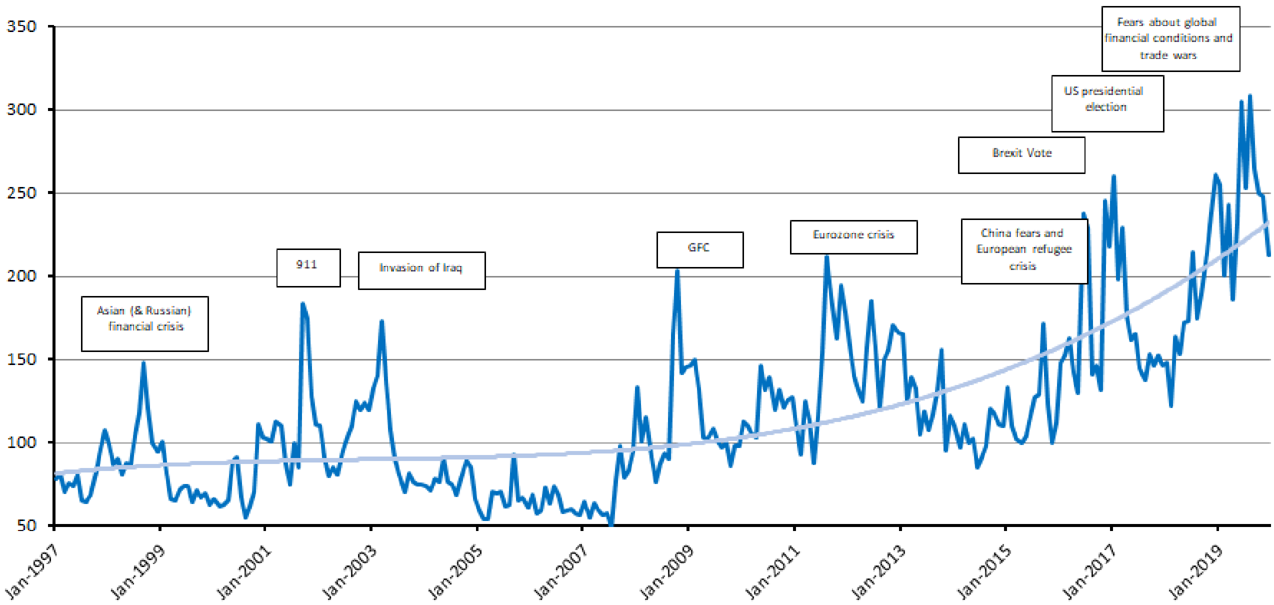
Source: AICD Director Sentiment Index (DSI), H2:2019. + indicates new factors added in this DSI.

Directors nominated the level of global economic uncertainty as the most important economic challenge, with the share of respondents selecting this factor up sharply to 37 per cent in the H2 DSI from 27 per cent in H1. This result was consistent with very high measures of global economic policy uncertainty, driven in part by high levels of trade policy uncertainty (trade wars and rising global protectionism were also relatively high on directors' list of concerns).

A ceasefire in the US-China trade and technology conflict in the form of a 'Phase 1' trade agreement and a decline in Brexit-related uncertainty has seen improvement in sentiment since the time of the DSI, although measures of policy uncertainty remain high in historical terms.

Global Economic Policy Uncertainty index

Index, higher reading indicates higher level of uncertainty, weighted current price GDP. Long-term average = 100.



Source: Bloomberg and www.PolicyUncertainty.com. The index is a GDP-weighted average of national indices for 20 countries: Australia, Brazil, Canada, Chile, China, France, Germany, Greece, India, Ireland, Italy, Japan, Mexico, the Netherlands, Russia, South Korea, Spain, Sweden, the United Kingdom, and the United States. Each national index reflects the relative frequency of own-country newspaper articles that contain a trio of terms pertaining to the economy, policy and uncertainty. Data to December 2019.

Other critical economic challenges facing Australian businesses identified by directors include low productivity growth (23 per cent), China's outlook (21 per cent), climate change (21 per cent) and the drag from excessive regulation or 'red tape' (20 per cent).

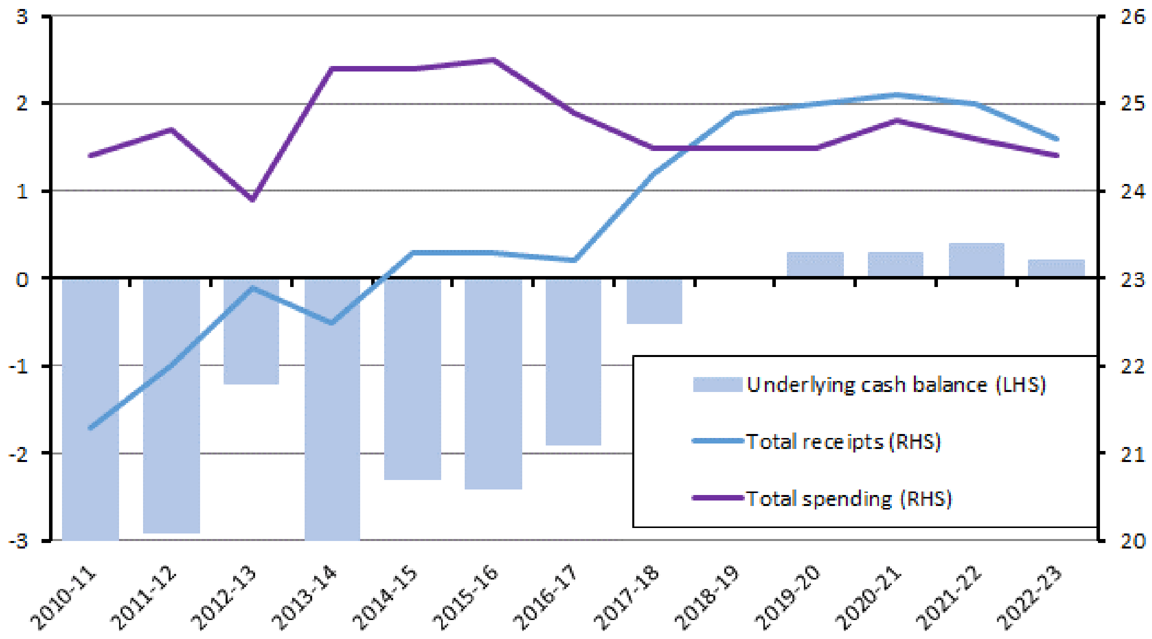
Budget deficit and government debt levels have fallen down the worry list

With the government having effectively returned the budget to balance in 2018-19 (when measured as a share of GDP), with the MYEFO projecting a sequence of modest future budget surpluses, and with government borrowing costs having fallen to very low levels, government debt (three per cent) and the budget deficit (one per cent) are now seen as one of the top three economic challenges facing Australian businesses by only a small minority of directors, according to the DSI.

A similar result holds true for federal government policy priorities (see below) with only seven per cent of directors seeing the budget deficit as a top five issue that the government should focus on in the short run, rising to eleven per cent of directors holding the same view for the long run.

Australia: Budget spending, receipts and underlying cash balance

Per cent of GDP



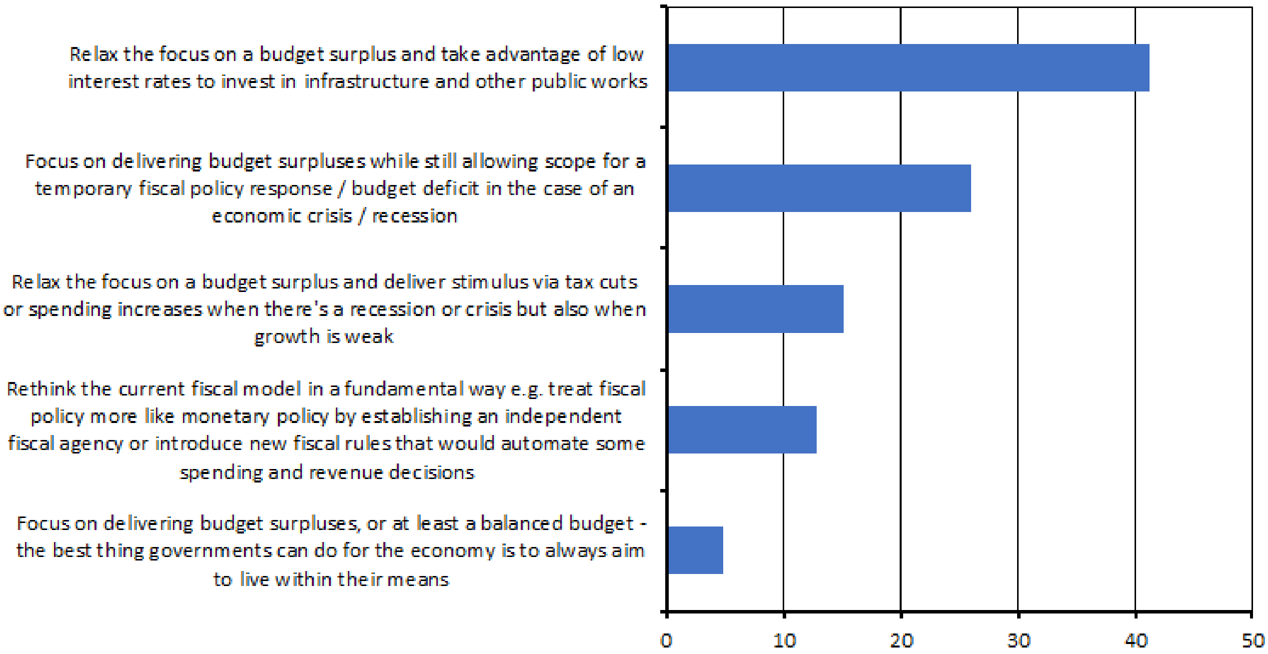
Source: MYEFO 2019-20. Note net future fund earnings are included in the underlying cash balance from 2020-21.

Indicative evidence[2] from the AICD's Leaders Pulse suggests that directors' preference for fiscal policy is for a cautious relaxation of the current focus on delivering a budget surplus, with the government able to take advantage of low interest rates to invest in infrastructure and with directors willing to countenance a temporary deficit if required to support economic growth.

[2] These results should be treated with caution, as (1) the sample size for the Leaders' Pulse is much smaller than for the DSI and (2) the sample for the Pulse is not designed to replicate the composition of the DSI sample.

Australia: Directors' views on fiscal policy

Per cent of respondents



Source: AICD Leaders Pulse, October 2019. *Q. Australian governments have made delivery of a budget surplus a cornerstone of fiscal policy. Which of the following best captures your view of how governments should approach fiscal policy in the future?*

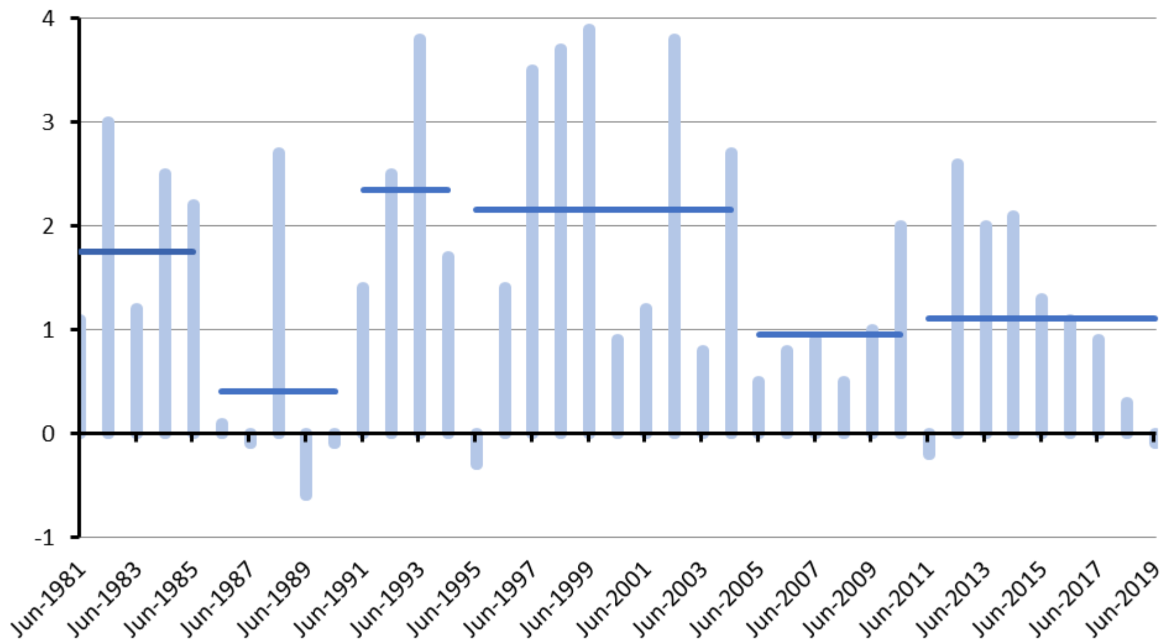
With additional polling suggesting directors are sceptical of the ability of the RBA to deliver further stimulus to the economy in the form of lower interest rates, the implication is that fiscal policy should now be prepared to play a relatively greater role in stabilisation policy, when required, than has been the case in recent years, when monetary policy has typically done most of the heavy lifting.

The challenge of low productivity growth

Some of Australia's disappointing recent growth performance is likely to have been the product of international factors, including the high level of global economic policy uncertainty. More concerning for the longer-term outlook, however, is that productivity growth has also been lacklustre. The annual pace of labour productivity growth – a measure which is typically closely correlated with developments in living standards – has now fallen for five consecutive years, with output per hour contracting in 2018-19 and annual productivity growth averaging less than one per cent over the past half-decade. That compares unfavourably with the long run average of two per cent growth.

Australia: Labour productivity growth (annual)

Per cent change over previous year



Source: ABS. Measure here is GDP per hour worked.

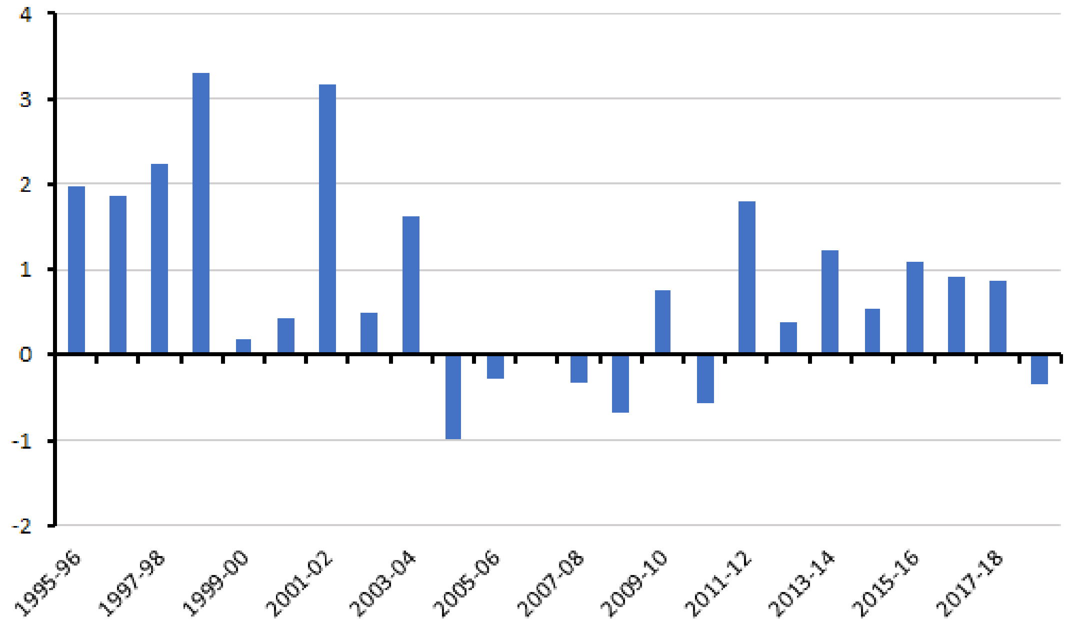
The slowdown in productivity growth is a global phenomenon, so some of the causes of this underperformance once again lie beyond our borders. But there are domestic factors at play, too. Growth in labour productivity is the product of changes in the amount of capital available per worker (the capital-labour ratio) and the efficiency with which capital and labour inputs are used in production (captured by multifactor productivity or MFP growth).

In the case of the former, the Productivity Commission noted last year that while increases in the capital-labour ratio ('capital deepening') have historically played a major role in driving Australia's labour productivity, 'this engine of growth has faltered', reflecting a marked slowdown in the pace of business investment that was large enough that in 2017-18 the economy experienced a fall in the capital-labour ratio ('capital shallowing').[3] At the same time, the pace of MFP growth has also been poor in recent years, indicating that the efficiency with which those inputs of capital and labour are being used is similarly struggling to improve.

[3] Productivity Commission Productivity Bulletin, May 2019.

Australia: Multifactor productivity (MFP) growth

Per cent change on previous year, hours worked basis

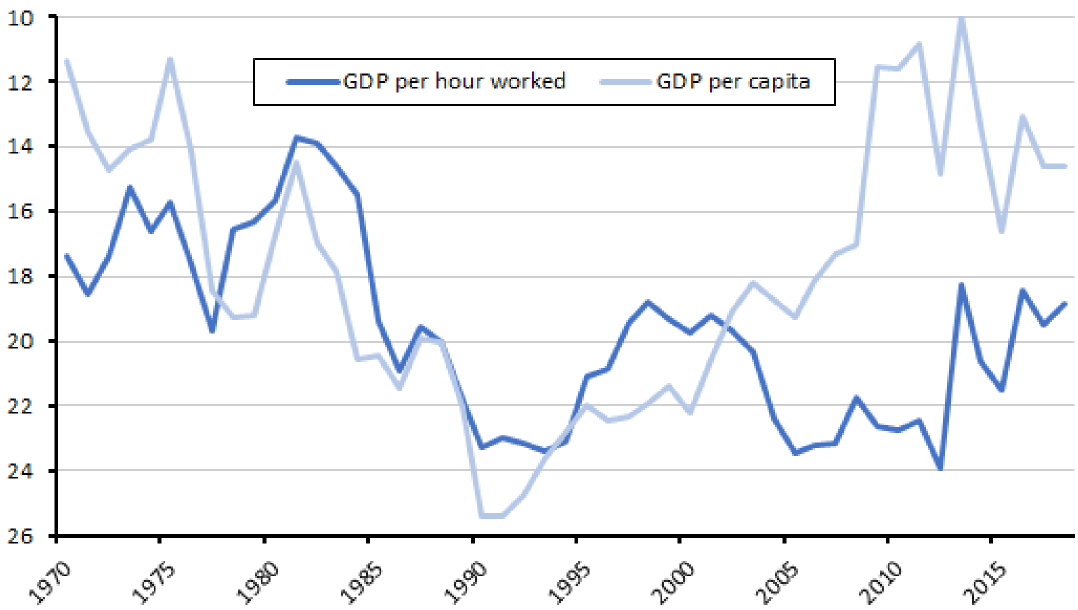


Source: ABS

Taking the United States as the global productivity frontier, Australia's productivity gap – measured in terms of GDP per hour – is now little changed from where it was at the start of the 1970s.

Australia: Productivity performance gap with United States

Percentage points, inverse scale



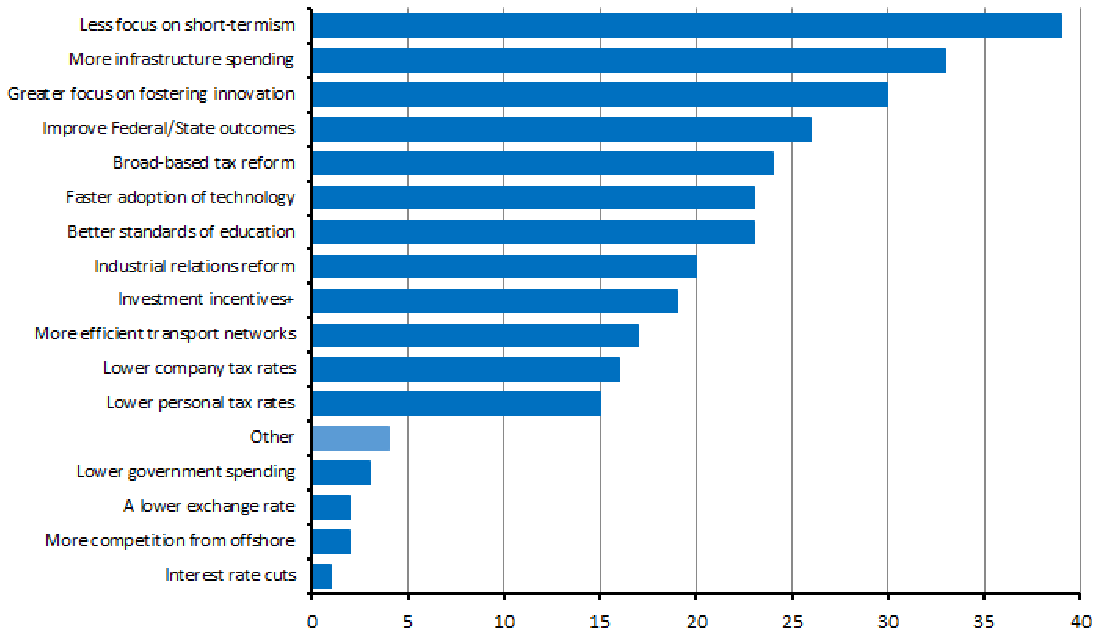
Source: OECD. GDP is in PPP terms. The performance gap measures the difference between US levels of GDP per capita and GDP per hour worked and Australian levels.

As noted above, directors are concerned by Australia's recent productivity performance, citing it as the most important domestic economic challenge facing businesses.

According to our DSI results, the top three measures directors think could help lift national productivity would be a reduced focus on short-termism (chosen by 39 per cent of respondents), an increase in infrastructure spending (33 per cent) and a greater focus on fostering innovation (30 per cent). Directors also judge that improved Federal-State relations and a package of broad-based tax reform could make a significant contribution to boosting productivity growth.

Australia: Main measures to lift national productivity (top three)

Per cent



Source: AICD Director Sentiment Index (DSI), H2:2019. + indicates new factor added in this DSI.

One way to address 'short-termism' in the context of government policy is through a transparent and public articulation of strategic objectives, supporting policies, associated time factors and estimated costs in a way that is designed to minimise community uncertainty. At the global level, there is evidence that high levels of policy uncertainty are associated with higher risk premia, lower investment, lower levels of business activity in terms of market entry and technological upgrading, and lower business and consumer confidence. In an Australian context, results from the DSI suggest that a reduction in Australian economic policy uncertainty could make a significant contribution to encouraging businesses to increase their investment rates (see below). In recent years, there has been a high level of uncertainty around the energy – climate change policy nexus.

Strengthening innovation at the boardroom level

Last year, new research conducted jointly by the AICD and the University of Sydney Business School took an in-depth look at how Australian boardrooms deal with innovation in practice.[4] The AICD's study found that Australian directors recognise the importance of innovation, but that more needs to be done to prioritise its delivery, and that Australian boards currently have relatively low levels of innovation and digital literacy. Directors identified human talent shortages, limited financial resources, and a focus on short-term financial performance as key barriers to innovation. They also saw Australia's regulatory environment as contributing to a risk-averse corporate culture.

The *Driving Innovation: The Boardroom Gap* report five key recommendations intended to help Australian boards do a better job in prioritising innovation:

- improve directors' technology and digital literacy;
- set clear expectations of management regarding calculated risk-taking to drive innovation;
- develop a shared language with management, and a narrative for investors/members on innovation;
- ensure innovation features regularly on boardroom agendas; and
- establish a budget and executive incentives for long-term innovation.

The AICD has begun a program of work to support directors in lifting their digital and tech capability, while looking to new initiatives to support directors in elevating innovation on board agendas.

While the AICD's work on innovation has been focused on the contribution that boards can make, there is clearly an important role for government policy here, too. As already noted, there is evidence that efforts to reduce policy uncertainty can encourage increased investment, including in innovation. A concrete example here is the persistent uncertainty around the R&D tax incentive, which has likely had damaging consequences.

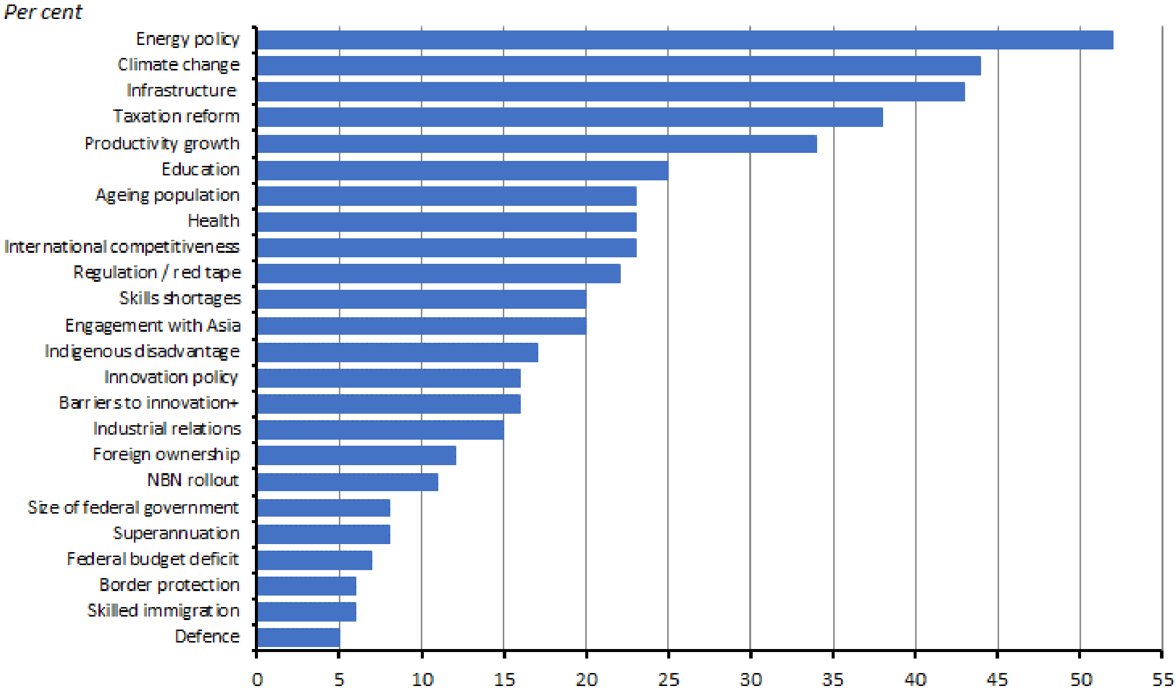
Regulatory policy also has a critical role to play here. The AICD fully recognises the importance of effective regulation in delivering well-functioning markets and building community trust and confidence in business but is also conscious that regulatory frameworks need to be carefully designed to ensure that they still provide enough scope for businesses to pursue innovation and risk-taking. According to the DSI, directors think that too much regulation and red tape is now the second most pressing domestic economic challenge facing Australian businesses.

Policy priorities for government: the climate change-energy nexus and infrastructure

Productivity growth is only one of the top five policy priorities that directors think the federal government should focus on in the next three years, but it is closely connected to the other four. According to the DSI, the top five issues that Canberra should address in the short term5 are energy policy (52 per cent), climate change (44 per cent), infrastructure (43 per cent), taxation reform (38 per cent) and productivity growth (34 per cent).

[4] Download full study at: http://aicd.companydirectors.com.au/drivinginnovation
[5] For the purposes of the DSI, short term is defined as the next three years while long term covers the next ten to 20 years.

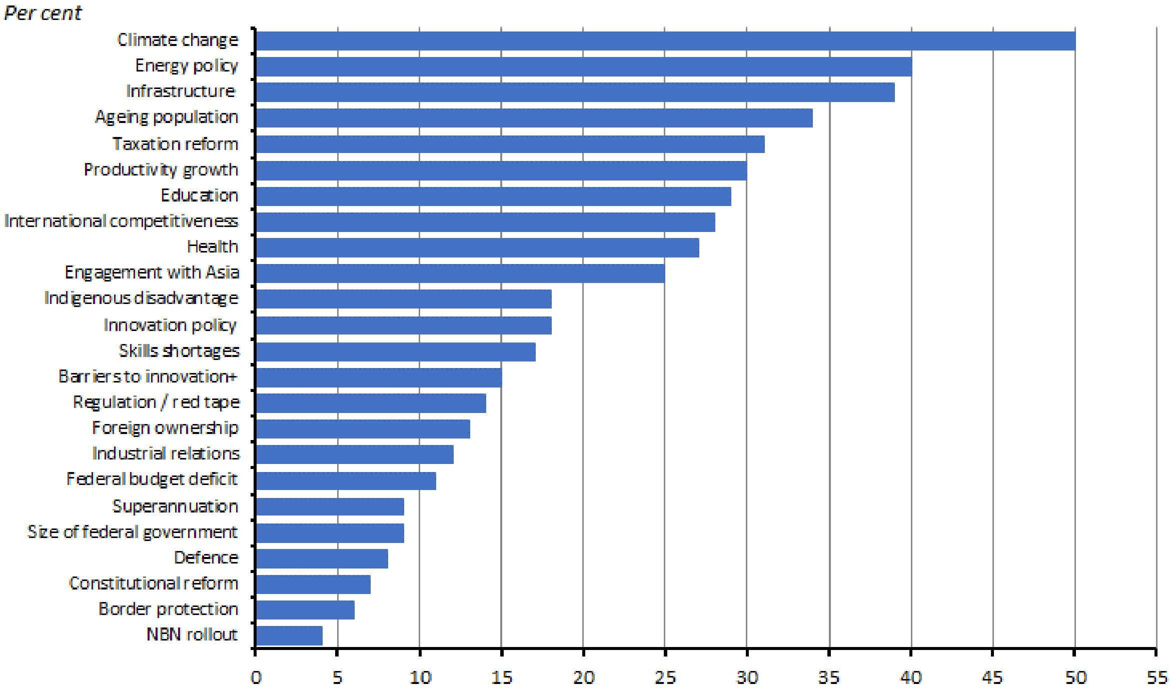
Australia: Issues federal government should address in short term (top five)



Source: AICD Director Sentiment Index (DSI), H2:2019. + indicates new factor added in this DSI. Only options with five per cent or more shown above. Childcare policies and Constitutional reform (both three per cent) not shown. Short term refers to next three years.

When the outlook is extended to the long term, the top five priorities are climate change (50 per cent), energy policy (40 per cent), infrastructure (39 per cent), ageing population (34 per cent) and taxation reform (31 per cent), with productivity resting just outside the top five.

Australia: Issues federal government should address in long term (top five)



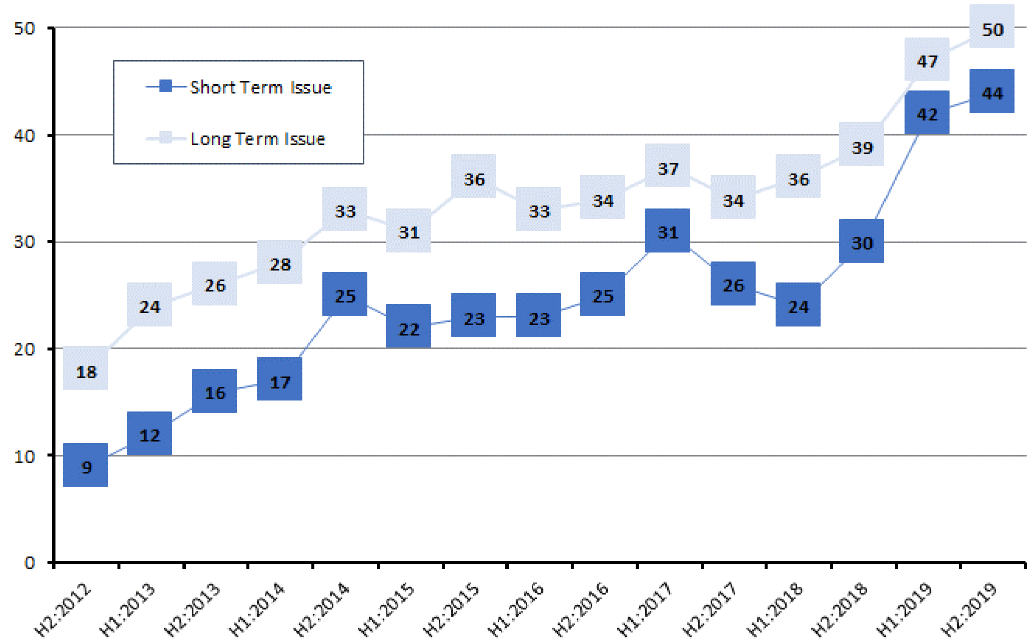
Source: AICD Director Sentiment Index (DSI), H2:2019. + indicates new factor added in this DSI. Only options with four per cent or more shown above. Childcare policies and skilled immigration (both three per cent) not shown. Long term refers to next ten to 20 years.

Climate change and energy policy

DSI results indicate that the climate change – energy policy nexus is a clear policy priority for directors. The history of the DSI survey to 2012 reveals that directors have become increasingly concerned about climate change both as a short-term and a long-term government policy priority. It seems likely that this summer's terrible bushfires will have pushed climate change even further up the policy agenda, an assumption that will be tested in the first DSI of 2020.

Australia: Climate change as a DSI policy priority

Per cent of respondents selecting climate change as a top five policy priority



Source: AICD Director Sentiment Index (DSI), past issues

There is also a strong relationship between climate and energy policy and concerns over Australia's productivity performance. The Productivity Commission's 2017 five-year productivity review argued that [Recommendation 5.1] 'Australian governments must work cooperatively to resolve the issues currently confronting Australian energy markets. They must…stop the piecemeal and stop-start approach to emission reduction, and adopt a proper vehicle for reducing carbon emissions that puts a single effective price on carbon.' [6]

Supporting infrastructure investment

Investment in infrastructure is another key - and closely related - policy priority for directors. The June 2019 Australian Infrastructure Audit concluded that although there had been significant progress in investments to close infrastructure gaps, '*changing and growing demand, and a mounting maintenance backlog, mean a new wave of reform and investment is necessary to ensure quality of life and economic productivity are enhanced over the next 15 years*' and also warned that while 'Australia's national productivity and global competitiveness rely on efficient infrastructure networks…we are falling behind our international competitors'.

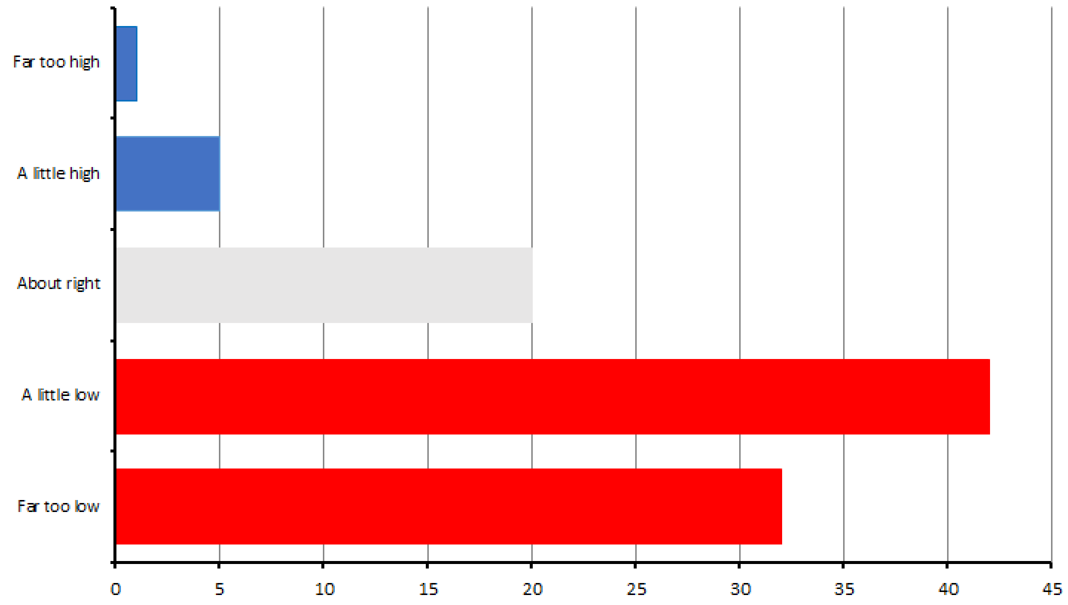
Directors have made a similar judgment. Thus, despite welcome recent increases in public infrastructure spending, more than seventy per cent of DSI respondents assess that the current

[6] Productivity Commission, Shifting the Dial: 5 year productivity review.

level of spending is still too low, with 42 per cent saying that spending is a little low and 32 per cent saying that it is far too low.

Australia: Opinion on the current level of government spending on infrastructure

Per cent

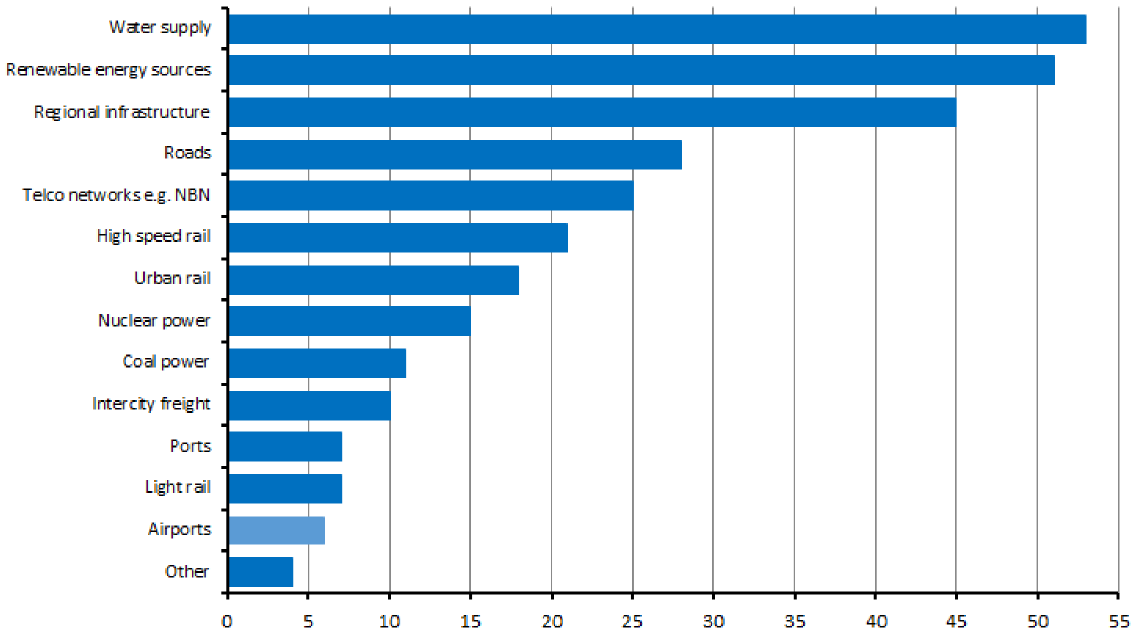


Source: AICD Director Sentiment Index (DSI), H2:2019.

There is also a clear overlap with directors' concerns relating to energy and the environment, with the top three priorities for infrastructure investment identified by directors comprising water supply (nominated by 53 per cent of respondents and up markedly from 40 per cent in the DSI conducted in the first half of 2019), renewable energy sources and regional infrastructure.

Australia: Top three areas for infrastructure investment

Per cent



Source: AICD Director Sentiment Index (DSI), H2:2019.

While directors are keen to see an increase in infrastructure spend, the AICD also emphasises that the quality of the governance of that expenditure remains critical. In its 2017 Shifting the Dial report, the Productivity Commission emphasised that [Recommendation 4.1] it was *'essential that governments ensure that proposed projects are subject to benefit-cost evaluations, and that these as well as evaluations of alternative proposals for meeting objectives are available for public scrutiny before decisions are made.'*

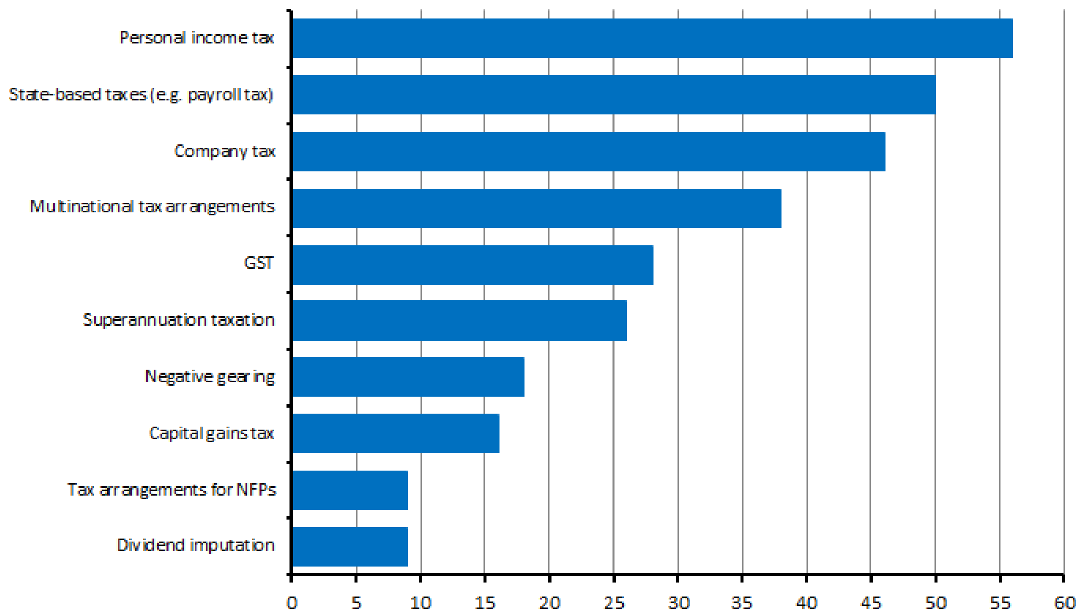
Comprehensive taxation reform

Directors continue to see scope for further taxation reform. Although the government's three-stage income tax reform package was approved by Parliament in July and will deliver lower rates of personal income tax, 71 per cent of DSI respondents still think that the current level of personal taxation is too high (with 46 per cent judging it to be somewhat high and 25 per cent far too high). In addition, 54 per cent of respondents think that corporate tax levels are too high (44 percent saying somewhat high and ten per cent saying far too high).

Directors' priorities for reform are personal income tax (56 per cent), state-based taxes such as payroll tax (50 per cent) and company tax (46 per cent).

Australia: Priorities for tax reform (top three)

Per cent



Source: AICD Director Sentiment Index (DSI), H2:2019. Note question frames priorities *'in any future comprehensive review of the current taxation system'*.

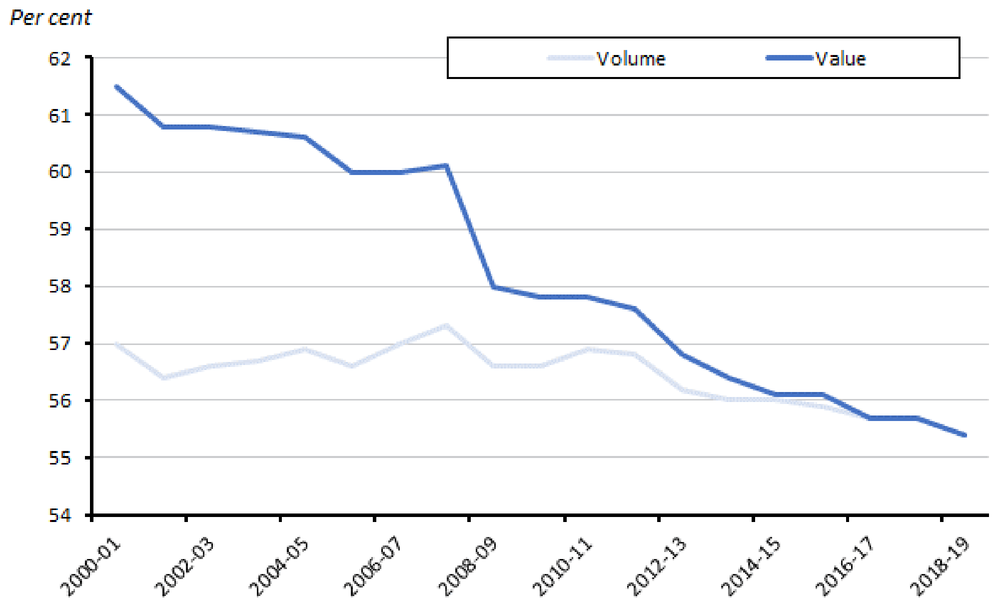
The AICD's Blueprint for Growth (2017)[7] set out a tax reform package designed to promote economic growth, improve fairness and increase competitiveness based around a change in the tax mix away from inefficient direct taxes funded by a lift in the goods and services tax (GST) rate (with compensation).

While some of the most egregiously distorting taxes – such as stamp duties and payroll taxes – are levied at the state level, there is still scope for further action on taxation by the federal

[7] http://aicd.companydirectors.com.au/advocacy/research/governance-of-the-nation-a-blueprint-for-growth-2017

government. The Blueprint argued that truly comprehensive tax reform in Australia continues to require discussion of the GST to provide a more sustainable and efficient revenue base for the economy and thereby provide additional fiscal space for tax reform in other areas, including personal and company tax.

Australia: Share of household spending subject to GST



Source: Parliamentary Budget Office (2019).

Importantly for Australia's investment and productivity performance, the Blueprint also advocates a staged reduction in Australia's corporate tax rate as part of the same comprehensive reform package.

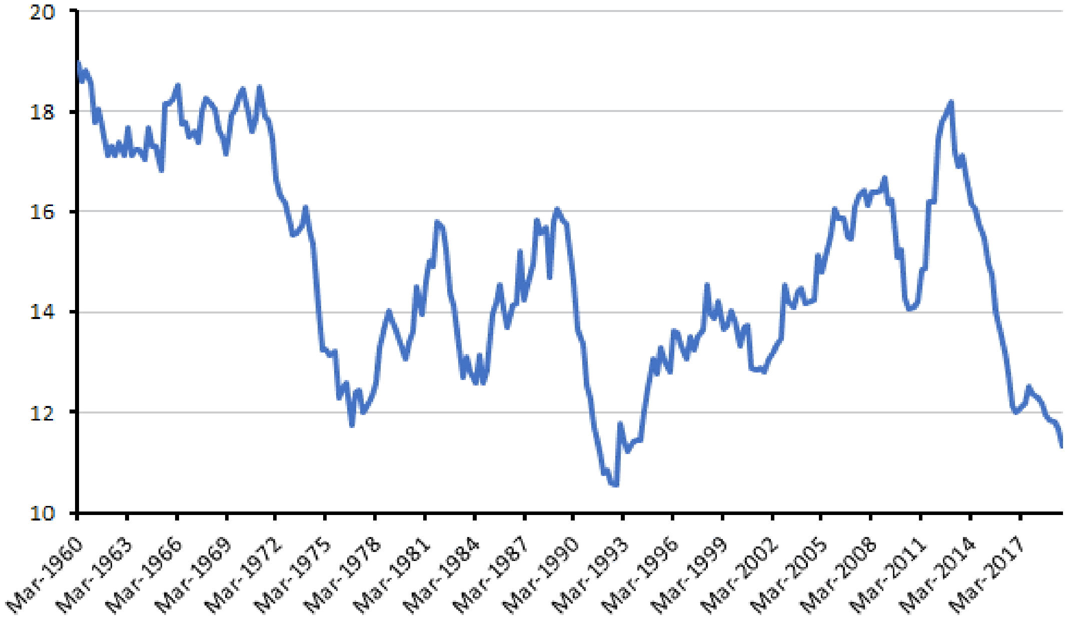
While fully recognising that the current political debate renders discussion of both GST and company tax reform difficult, the AICD continues to believe that in the long run both measures will need to play a central role in the future of Australia's taxation system.

Supporting business investment

Australia's new business investment has fallen to close to multi-decade lows as a share of GDP. As noted above, this decline in the rate of capital spending has adverse implications for Australia's productivity performance and our long-term growth prospects. As a potential response to this problem, there has been some discussion of the introduction of an investment allowance.

Australia: New business investment

Per cent of nominal GDP, quarterly sa

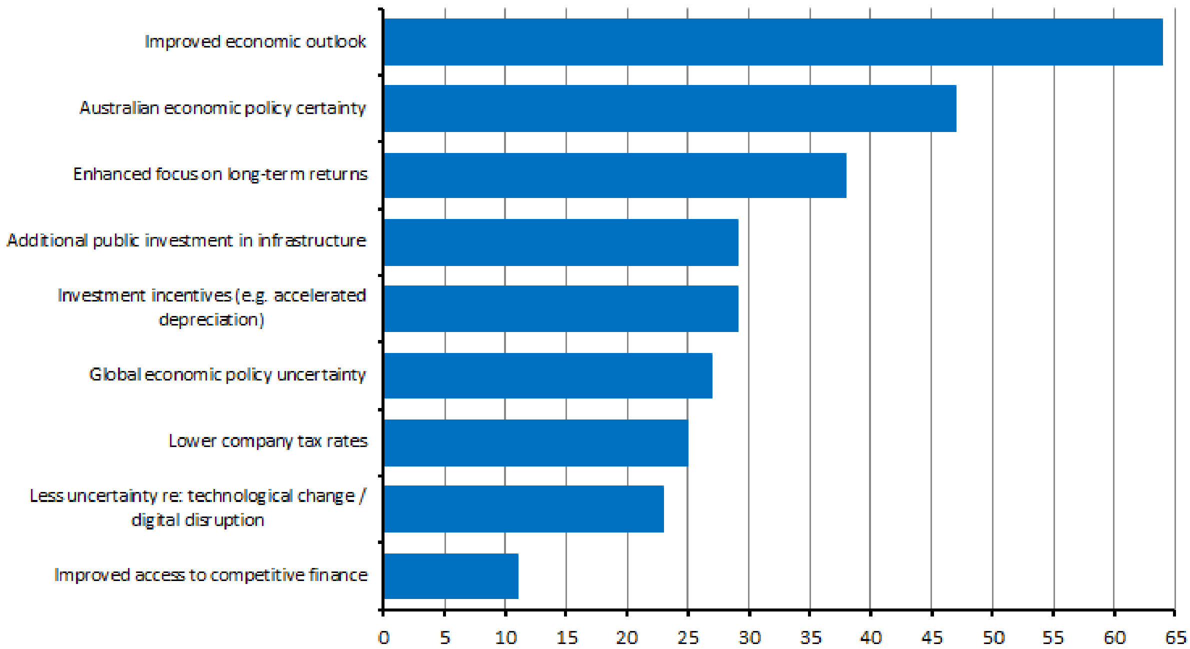


Source: Bloomberg and ABS. New business investment is private business investment adjusted to exclude net purchases of second hand assets.

Given the current context, the AICD would welcome the introduction of such an initiative as a measure designed to help lift the economy's capital stock, although in the long term, the ideal policy response continues to be a comprehensive tax reform package, including a reduction in the company tax rate, as noted above.

Australia: Factors encouraging your business to increase its investment (top three)

Per cent



Source: AICD Director Sentiment Index (DSI), H2:2019.

Finally, results from the DSI suggest that a new investment allowance on its own may have only a limited impact on investment spending, however, depending on the size of the concession involved and the prevailing economic environment. Thus, some 29 per cent of respondents said that the provision of investment incentives would encourage their business to increase investment levels over the coming year, about the same share as those who thought increased public infrastructure investment would encourage private capital expenditure and slightly ahead of the share of respondents nominating lower company tax rates (25 per cent). But more important factors identified by respondents were the overall economic outlook, the level of economic policy certainty, and an enhanced focus on long-term returns.