Election 2025:

Australia's economic outlook and reform

March 2025

Introduction

Australia is in the middle of the longest sustained period of low growth since the early 1990s. The high inflation and tight monetary policy settings of the last three years has dragged on the economy, with household consumption, industry output and business investment all showing ongoing weakness.

Business profitability has been crimped by surging input and wages costs, while the rate of business investment growth is stalling. The labour market is the sole economic bright spot, but its resilience has been dependent on government spending, which has masked mounting weakness in private sector hiring.

Consumer inflation finally eased towards normal levels in late 2024, providing much needed relief to households. However much of this result was achieved through price suppressing fiscal measures (such as household energy subsidies), and it is too soon to determine whether inflation will sustainably remain within target range.

Recent volatility in global financial and currency markets, and uncertainty regarding new policies emanating from the US, mean there remains significant risk to the economic outlook.

Rapid increases in spending by Commonwealth and state governments provided a lifeline to the Australian economy during this recent period of economic weakness. This fiscal stimulus proved critical in staving off the risk of recession as much of the private sector facing very subdued conditions.

However, this fiscal path is not sustainable in the medium term, given the growing gap between spending and revenue and structural deficits facing the Commonwealth and many state governments.

The immediate priority for the incoming Commonwealth Government should be to restore growth conditions to the Australian economy, particularly in in the private sector.

There are many barriers to the types of private sector growth needed to deliver stronger economic outcomes. In this policy statement, we outline five areas where policy reforms are essential to deliver durable economic recovery:

1. Ease cost of doing business pressures by controlling inflation
2. Improving fiscal sustainability across all levels of government
3. Strengthening the private sector for durable labour market resilience
4. Regulatory reform to enhance productivity in lower-performing industries
5. Reforming the tax system to be competitive, simple and productivity-enhancing

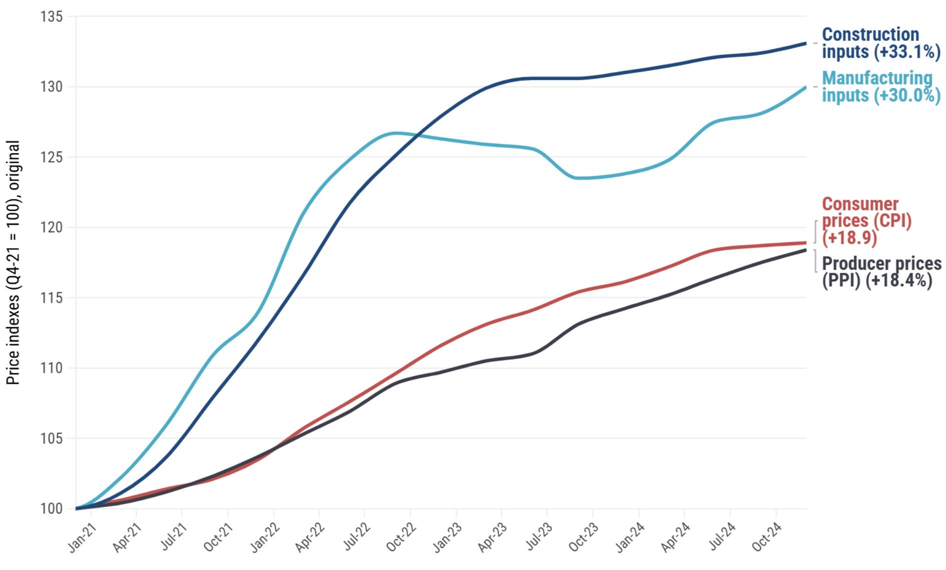
1. Ease cost of doing business pressures by controlling inflation

Since 2021 high inflation has imposed significant cost-of-living difficulties for many Australian households. It has also posed similar cost-of-doing-business pressures as well, with significant impacts for business performance.

Over the four years to the December quarter of 2024, the Producer Price Index – a measure of inflation for goods used by businesses – has risen by 18.4%. This is almost identical to the 18.9% increase seen for consumer prices. For some industrial sectors inflationary pressures have been more severe, with manufacturing inputs rising 30% and construction inputs rising 33% over the same period. Gas prices paid by manufacturers have risen by a staggering 51%.

Employment costs have similarly increased pressure on businesses. In 2024 the wages bill in Australia has risen by 4.8%, well-outpacing growth in the broader economy or business output. The bulk of this growth was driven by increasing wage rates, which in the private sector rose by 3.3% across 2024. These wage rises are connected to high inflation, via links to CPI in the award and enterprise bargaining industrial instruments that together cover just over half of the Australian workforce.

Chart 1: Australian industrial price indicators



Source: ABS CPI, ABS PPI • Ai Group Research & Economics

The capacity of businesses to absorb these rising input and wage costs has decreased given the relatively weak economic conditions in Australia. Business sales grew only 1.1% over the 2024, while profits fell 6.8%. Gross operating margins in Australian businesses declined from 16.1% to 14.9% in the year to the December quarter of 2024. This is the steepest rate of decline in operating margins since the relevant series began in 2001.

Businesses cannot keep absorbing inflation-driven input and wage costs without consequent impacts on investment and employment. Falling margins curtail profitability, reducing financial resources and confidence for new investment and employment generation. Business needs a moderation in cost pressures to drive the investment needed to kick-start private sector growth.

The impact of inflation on cost-of-living concerns has received considerable policy attention. Several household support measures announced in the last budget, including but not limited to energy bill relief, have reduced the burden of inflation on targeted households. These measures have come at a significant cost to the federal budget. However, they have done little to address the impact of high inflation on business, nor have they ultimately addressed the underlying causes of inflation itself.

It is therefore essential the incoming Australian Government makes controlling inflation, and therefore business costs, a central priority in 2025-26. Fiscal and labour market policies are areas where greater prudence is needed.

1. Improving fiscal sustainability across all levels of government

There has been a significant increase in government spending in Australia over recent years. In 2023-24, combined federal and state government spending rose by 7.9% to $953 billion. As revealed the March budget, federal spending will increase by another 8.7% in the 2024-25 financial year.

With these rates of spending much higher than underlying growth, the government share of the economy has been steadily rising. Federal spending is forecast to peak at 27.0% of GDP in 2025-26, the highest level since the economic reforms of the mid-1980s.

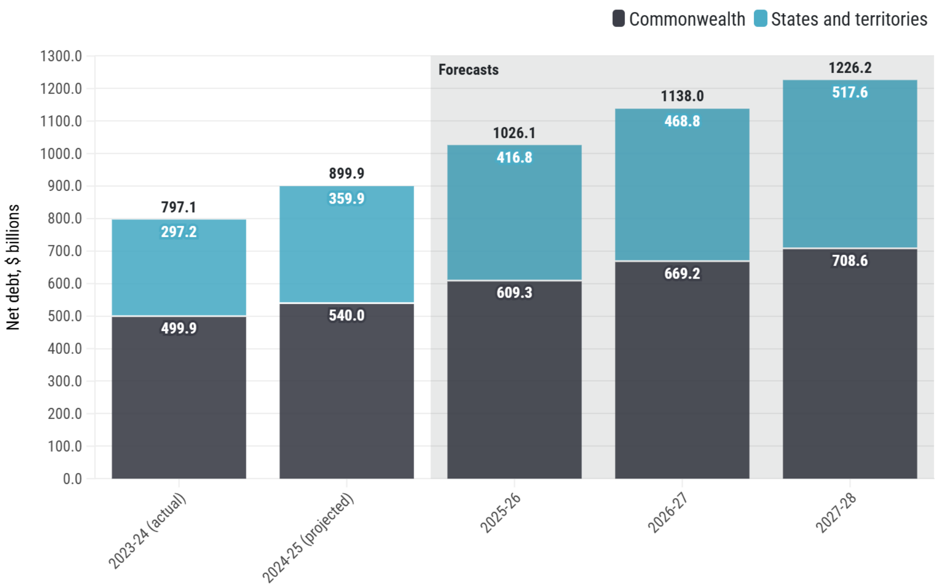
These increases to federal and state government spending have provided important fiscal support during a period of economic weakness. The Australian economy would have skirted very close to recession during the middle of 2024 had it not been for the contribution to growth flowing from the increase in public demand.

However, this rate of increase in government spending is not sustainable in the medium term. Federal spending has grown faster than revenue, creating a widening fiscal deficit that will reach $46.7 billion in headline terms this financial year. The March budget forecasts structural deficits in the underlying cash balance for the next decade. Many state governments face similar settings of rising expenditure placing pressure on fiscal balances.

Surging federal and state spending will have deleterious consequences for the prospects of a durable economic recovery in Australia. Managing structural deficits will necessitate either material cuts to key public services, an increase in taxes, and/or growing debt servicing costs. Analysis of the federal and state budget papers indicates that net public debt across all levels of government is forecast to increase by 53% to $1.2 trillion over the forward estimates.

The incoming Australian Government must bring the future path of spending under better control. While this is underway for some federal programs, such as reducing the growth rate of the National Disability Insurance Scheme (NDIS) expenditures, these efforts need to see much broader application. The adoption of deliberate efficiency strategies and targets for major spending programs should be considered as a matter of priority. The Commonwealth should also work with the states to ensure similar processes are implemented in areas where state spending is prominent.

Chart 2: Forecast net debt of Australian governments



Source: Commonwealth and state budget papers 2024-25, as updated at mid-year reviews. • Ai Group Research & Economics

2. Strengthening the private sector for durable labour market resilience

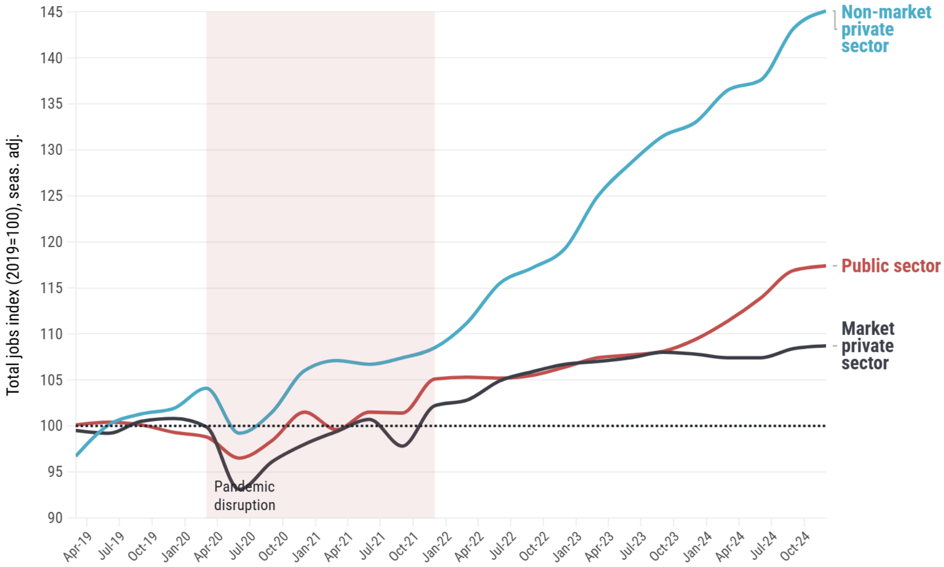
One of the few bright spots in Australia's recent economic performance is the ongoing strength of the labour market. Unemployment has remained around 4.0% over 2024, while participation, underemployment, youth, female and part-time employment indicators have all also been healthy. Labour market resilience has been critical in propping up the economy during a period of sustained low growth.

However, much of this labour market resilience itself is owed to increasing government spending. Ai Group analysis of labour market data (Chart 3) shows there has been very little growth in employment in the market private sector over the last two years. By contrast, employment in the public sector and non-market private sector – which is predominantly underpinned by increasing government spending – has accelerated.

This has led to an imbalanced pattern of employment generation, with 80% of 484,000 jobs created over the year to the December quarter 2024 in the public and non-market private sectors. This points to the mounting weakness in the private sector economy, and reveal there is more fragility in the labour market than the headline employment numbers suggest.

The private market sector is the principal source of employment generation, accounting for around two-thirds of jobs in Australia. This high dependence on government spending for job creation is of particular concern. As recent increases in government spending are unlikely to be sustainable in the medium term, it is critical the private sector engine of job creation is strengthened to maintain labour market health.

Chart 3: Australian job creation by sector and industry



Source: ABS Labour Account • Ai Group Research & Economics
Non-market private sector is public administration, healthcare & social and education & training

3. Regulatory reform to enhance productivity in lower-performing industries

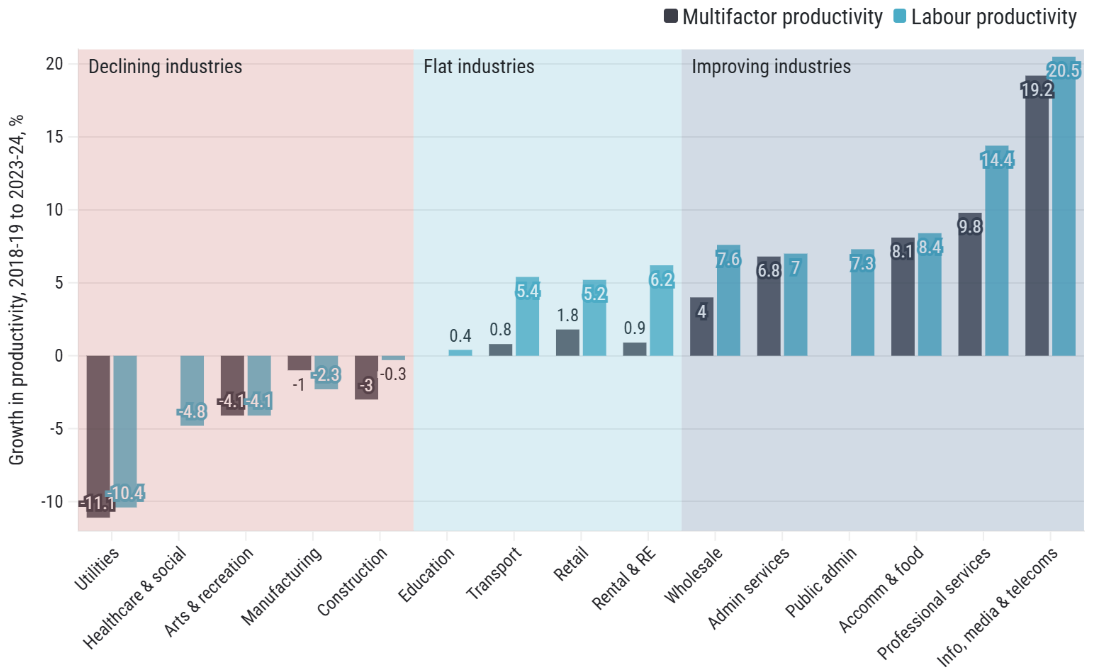
Australia's productivity performance since the pandemic has been dismal. Labour productivity currently sits at around the same levels as 2019, indicating we have now faced five years with no overall productivity growth in the Australian economy. As productivity is the well-spring of national wealth, this continued slide in national performance should be alarming for all Australians.

However, analysis of industry trends reveals clear clusters of weakness behind our productivity performance (Chart 4). A group of five industries – including utilities, healthcare, manufacturing and construction – have seen productivity decline since the pandemic. Another group of four have raised labour productivity, but seen overall (multi-factor) productivity stagnate.

All industries within these low performing clusters are subject to relatively higher levels of employment, pricing and/or standards regulation than is common across the rest of the Australian economy. This indicates there is a clear link between levels of regulation and productivity outcomes, a finding recently reaffirmed by Productivity Commission research into the construction industry.

Yet there are also clusters of strong productivity growth. Several industries have delivered significant uplifts since the pandemic, as high as 19% in information, media and telecommunications. This suggests that a group of high performers industries are capable of delivering productivity gains, but at the macroeconomic level their contributions are being offset by losses in the low-performance clusters.

Chart 4: Industry productivity performance since the pandemic



Source: ABS EIMFP, ABS Labour Account, ABS National Accounts • Ai Group Research & Economics
Multifactor productivity is not available for non-market sectors of public admin, education and healthcare & social

Many of the industries with lower productivity growth are labour intensive and face natural barriers to some forms of productivity improvement (for example, the difficulty of automation in care settings or on construction sites). As the share of these industries in the economy grows, it will inevitably become harder to raise overall productivity levels at the pace we have in the past.

These challenges do not mean that productivity in these low performance clusters should be ignored or deprioritised. Rather, they should be afforded the highest priority. Many of the major drivers of productivity improvement – such as increased utilisation of technology, increased human capital, labour market flexibility and knowledge diffusion – can and should be fruitfully applied to these industries

We welcome recent efforts to start tackling the productivity challenge. Key amongst these are reforms to the skills and training system, competition policy, early childhood education and regulatory reform funding for state governments. However, the payoff for these longer-term reforms will take many years to be felt. Moreover, none are specifically targeted to the lower-performing and higher-regulated industries which need productivity improvements the most.

It is essential that the incoming Australian Government prioritise and deliver a more fulsome and immediate productivity focus. This should target near-term results, given the pressing urgency to raise productivity levels. It should also focus on regulatory barriers to productivity, given that clusters of weak performance are associated with higher-regulated industries.

4. Reforming the tax system to be competitive, simple and productivity-enhancing

Since the Henry Tax Review of 2010, Australian governments have failed to deliver genuine tax reform. Piecemeal changes have had an impact at the margin, but the structural features of the tax system have remained unchanged. Many of the problems identified in the Henry Review have become more pressing in the intervening years.

There are three major problems with the structure of Australia's tax system:

1. Australia's company taxes are not internationally competitive. We rank second in the OECD for corporate profit taxes as a share of GDP. Our 6.6% rate is double the OECD average of 3.3%, and more than four times higher than the US.
2. We labour under a cumbersome two-tier corporate tax system that discourages investment and growth. There are complications around dividend imputations credits, the treatment of franking credits, and differential treatment for different ownership structures.
3. State government taxes are rapidly growing and often inefficient. The state and local government tax take has grown by 31% since the pandemic, and now accounts for 5.4% of GDP. A myriad of ad hoc has gradually accreted, producing an incoherent and inefficient system which drags further on investment competitiveness.

Genuine tax reform is a powerful policy tool because it impacts all the aforementioned economic challenges. Done right, it can unlock greater business investment, remove disincentives to job creation, improve fiscal sustainability, and augment productivity performance. It should be a major priority for the incoming Australian Government. Three principles which should inform near-term tax reform efforts:

First, international competitiveness must be front of mind. Capital is internationally mobile, and Australia is a comparatively high-cost investment jurisdiction. Uncompetitive tax settings will price us out of areas where we do not possess commanding natural advantages. To restore competitiveness we should consider cutting the overall corporate tax rate to 25 per cent. This should be matched with a proper set of simplification reforms, which streamline the complicated system of rules and exemptions that interfere with sensible business activity.

Second, there needs to be greatly improved simplicity across the tax system. Tax reforms which add complexity are inimical to the reform agenda. Tax simplification must also include the states and be undertaken as a whole-of-governments agenda. The Commonwealth needs to lead a proper reform of tax federalism in Australia that enables a simple and competitive system across all levels of our economy.

Third, and recalling one of the major findings of the Henry Tax Review, there needs to be a greater focus on productivity. Rarely are tax reforms debated on their merits in lifting productivity performance. But with almost no productivity improvements in the Australian economy for five years now, we need to use the tax reform lever to turn this national crisis around.

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