2025-26 Federal Budget

Ai Group Pre-Budget Submission

JANUARY 2025

About Australian Industry Group

Ai Group and partner organisations represent the interests of more than 60,000 businesses employing more than 1 million staff. Our membership includes businesses of all sizes, from large international companies operating in Australia and iconic Australian brands to family-run SMEs. Our members operate across a wide cross-section of the Australian economy and are linked to the broader economy through national and international supply chains.

Our purpose is to create a better Australia by empowering industry success. We offer our membership strong advocacy and an effective voice at all levels of government underpinned by our respected position of policy leadership and political non-partisanship.

With more than 250 staff and networks of relationships that extend beyond borders (domestic and international), we have the resources and expertise to meet the changing needs of our membership. We provide the practical information, advice and assistance you need to run your business. Our deep experience of industrial relations and workplace law positions Ai Group as Australia's leading industrial advocate.

We listen and we support our members by remaining at the cutting edge of policy debate and legislative change. We provide solution-driven advice to address business opportunities and risks.

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Introduction

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

Business profitability has been crimped by surging input and wages costs, and the rate of business investment growth is stalling. The labour market is a sole economic bright spot, but its resilience has been dependent on government spending as the private sector pulls back on 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 the effects of new economic policies emanating from the US, mean there remains significant risk to the inflation outlook.

During this period of economic weakness, rapid increases in spending by both Commonwealth and state governments have provided a lifeline. With much of the private sector facing very subdued conditions, this fiscal stimulus proved critical in staving off the risk of recession.

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.

In this context, the immediate priority for the 2025-26 budget should be to restore growth conditions in the private sector. Ai Group therefore welcomes and concurs with the Treasurer's recent assessment that "as growth recovers in our economy, the best kind of growth is private sector-led growth."

However, there remain many barriers to the types of private sector growth needed to deliver stronger economic outcomes. In this submission, we outline five areas – inflation and business costs, fiscal sustainability, the private sector labour market, productivity-enhancing regulatory reform and genuine tax reform – which will prove critical in improving private sector economic performance.

1. The imperative to control inflation and business costs

It is widely acknowledged that high inflation since 2021 has posed significant cost-of-living difficulties for many Australian households. What is less appreciated is that it has posed similar cost-of-doing business pressures as well.

Over the three years to the September quarter of 2024, the Producer Price Index – a measure of inflation for goods used by industry – has risen by 14.6%[1]. This is almost identical to the 14.8% increase seen for consumer prices. For some industrial sectors inflationary pressures have been more severe, with manufacturing inputs rising 29% and construction inputs rising 33% over the same period. Gas prices paid by manufacturers have risen by 52%.

Employment costs have similarly increased pressure on businesses. Over the last year the wages bill in Australia has risen by 4.0%, well-outpacing growth in the broader economy or business output[2]. The bulk of this growth was driven by increasing wage rates, with the Wage Price Index rising by 3.5%[3]. These wage rises are connected to high inflation, via links to CPI in the award and enterprise bargaining industrial instruments that together cover 57% of the Australian workforce[4].

However, given weak economic conditions, the capacity of businesses to absorb these rising input and wage costs has decreased compared to previous years. Business sales grew only 1.1% over the year to the September quarter of 2024, while gross operating profits fell 8.5%. Ai Group analysis of national accounts data show that gross operating margins in Australian industry declined from 15.8% to 14.2% in the year to the September quarter of 2024[5]. This is the steepest rate of annual decline in gross operating margins since the relevant series began in 2001.

It is not sustainable for businesses to keep absorbing inflation-driven input and wage costs without impacts on investment and employment. Falling margins impact profitability, reducing the financial resources available as well as confidence for new investment and employment generation. Non-mining investment is forecast to decline from 5.5% p.a. in 2023-24 to 2.5% in 2024-25, with no recovery forecast across the forward estimates[6]. Without a significant moderation in cost pressures on business, the wave of investment needed to kick-start private sector growth will not materialise.

It is therefore essential the federal budget makes controlling inflation, and therefore business costs, a central priority in 2025-26. We note that several household support measures in the last budget, including but not limited to energy bill relief, have reduced the burden of inflation on targeted households. However, these measures have come at a significant fiscal impost on the budget, yet have done little to support the impact of high inflation on business, or ultimately address the underlying causes of inflation itself. Fiscal and labour market policies (discussed below) are areas where greater prudence is needed.

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[1] ABS, *Producer Price Indexes* and *Consumer Price Index*, September 2024.
[2] ABS *Business Indicators Australia*, September 2024, Table 17.
[3] ABS *Wage Price Index*, September 2024.
[4] ABS *Employee Earnings and Hours*, May 2023.
[5] ABS *Business Indicators Australia*, Tables 6 and 15
[6] Treasury, *Mid-Year Economic and Fiscal Outlook 2024-25*, Table 2.2.

2. The need to improve fiscal sustainability

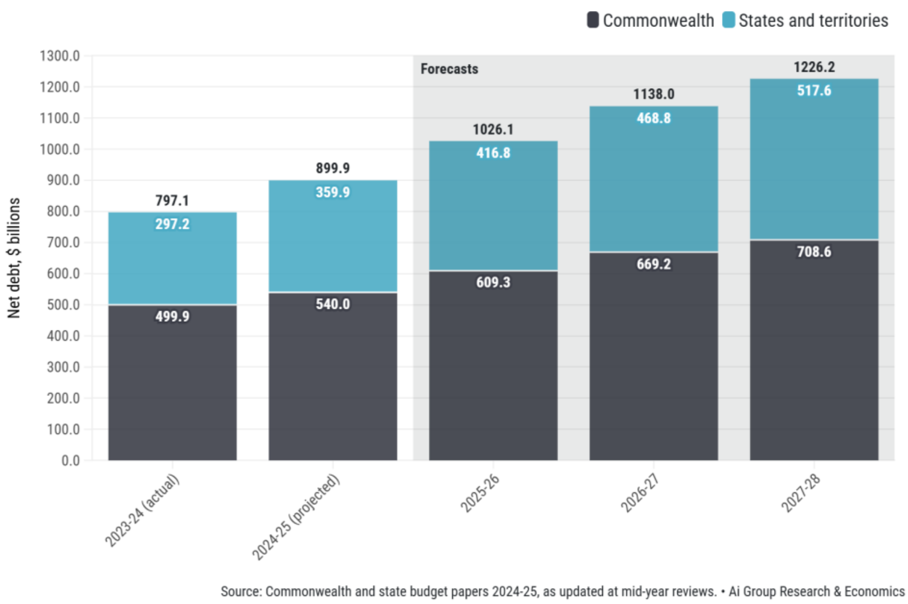
There has been a significant increase in government spending in Australia over recent years. In 2023-24, combined federal and state government spending rose by 7.9% to $953 billion[7]. As revealed in the *Mid-Year Economic and Fiscal Outlook (MYEFO)*, total government spending will increase by another 5.7% in real terms in the 2024-25 financial year. Federal spending is forecast to peak at 27.2% of GDP in 2025-26[8], 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. Given the poor performance of the private sector over the last year, the Australian economy would have fallen into near-recession conditions in its absence.

However, this rate of increase in government spending is not sustainable in the medium term. Federal spending has increased at a much faster rate than revenue, creating a widening fiscal deficit that will reach $26.9 billion in underlying, and $47.8 billion in headline terms this financial year[9]. MYEFO forecasts structural deficits in the underlying cash balance for the next decade[10]. 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 levels of public debt. 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.

Chart 1: Forecast net debt of Australian governments



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[7] ABS, *Government Finance Statistics*, September 2024.
[8] Treasury, *Mid-Year Economic and Fiscal Outlook 2024-25*, Table 3.2
[9] Treasury, *Mid-Year Economic and Fiscal Outlook 2024-25*, Table 3.7
[10] Treasury, *Mid-Year Economic and Fiscal Outlook 2024-25*, Chart 3.9

We are also concerned about the underlying causes for these spending increases. In MYEFO, the federal government described $8.8 billion of these as "unavoidable"[11], with ministers citing pensions indexation, new medicines listings and the sustainment of infrastructure pipelines as examples[12]. This reveals that these spending increases have not been a purposive act of counter-cyclical fiscal policy during a period of weak economic activity, but an in-built tendency for cost-increases in the design of existing programs.

There is an urgent need to bring the future path of spending – for both federal and state governments – 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 across the budget. The adoption of deliberate efficiency strategies and targets for major spending programs should be considered as a matter of priority. The federal government must also work with the states to ensure similar processes are implemented in areas where state spending is prominent.

3. Strengthening the private sector for durable labour market resilience

One of the few bright spots in Australia's recent economic performance is the labour market, which has proven surprisingly resilient despite very weak economic conditions. Unemployment has remained around 4.0% over the last year, 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 2) 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 85% of the 470,000 jobs created over the year to the September quarter 2024 in the public and non-market private sectors. These job creation rates identify mounting weakness in the private sector economy, and reveal there is more underlying fragility in the labour market than the headline employment numbers suggest.

This high dependence on government spending for job creation is of particular concern. The private market sector is the principal source employment generation, accounting for around two-thirds of jobs in Australia. As the 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 strength.

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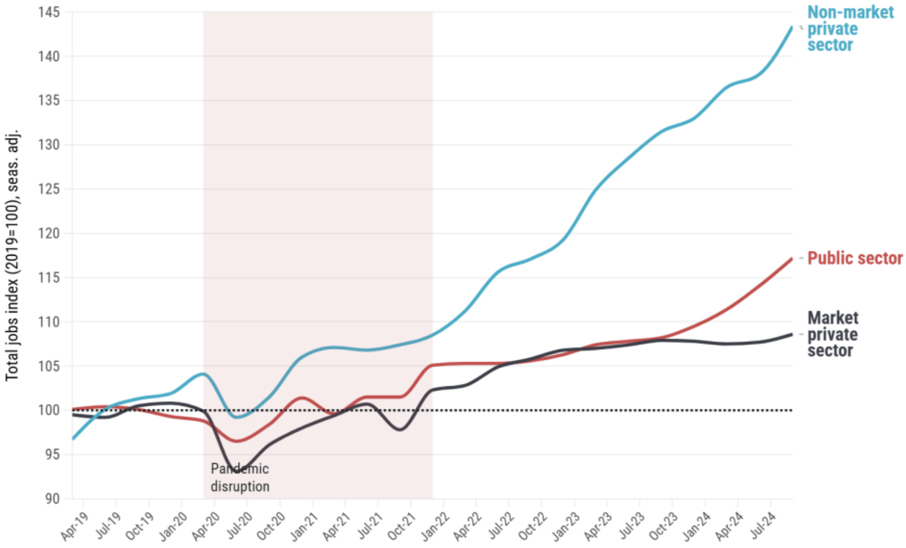
[11] Treasury, *Mid-Year Economic and Fiscal Outlook 2024-25*, p. 7.
[12] Jim Chalmer and Katy Gallagher, Joint Press Conference, Canberra, 17 December 2024 https://ministers.treasury.gov.au/ministers/jim-chalmers-2022/transcripts/joint-press-conference-canberra-5

Chart 2: 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

We also note weak private sector job creation has emerged at the same time as many of the federal government's new industrial relations laws have taken effect. These have greatly increased complexity, reduced flexibility, and imposed significant additional costs on Australian employers.

Much of the weak private sector job generation reflects the poor business conditions many industries are facing. However, the concurrent IR reforms have compounded these challenges. Through the independent statutory review of the *Secure Jobs, Better Pay (SJBP) Act*, the government should make amendments which improve simplicity and flexibility to support employers seeking to generate jobs[13].

4. Low productivity clusters demand urgent reform

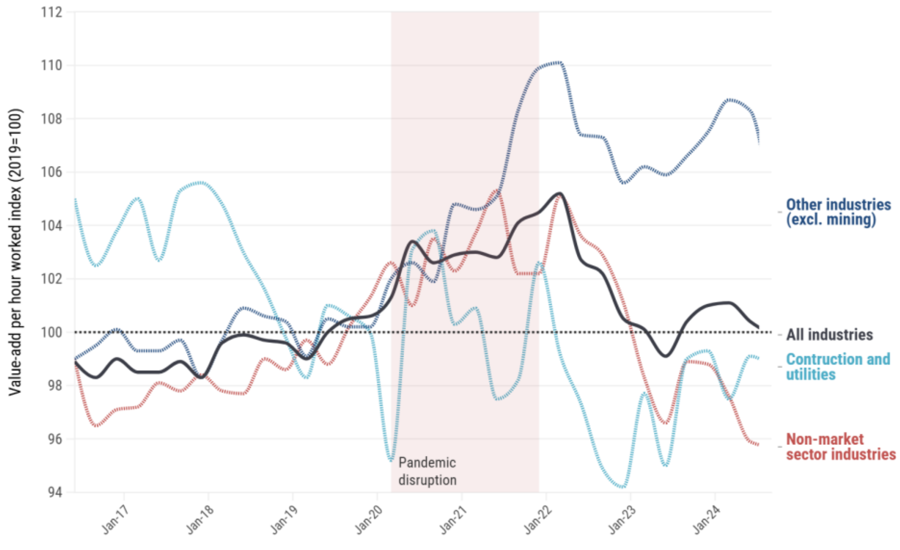
The challenges associated with Australia's poor productivity performance are well-understood and widely recognised. Current labour productivity is at the same level as immediately prior to the pandemic, which was itself the outcome of several years of weak productivity improvements.

It should be noted, however, that our productivity difficulties stem from a cluster of poorly performing industries. If we disaggregate performance by industry groupings, two are primarily responsible. First are the non-market sectors of healthcare, education and public administration, which have seen labour productivity decline significantly since 2022. Second are the construction and utilities industries, which have failed to recover from a major drop in productivity during the pandemic. 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 market sector.

[13]Further details are enumerated in Ai Group submission to the Review of the Fair Work Legislation Amendment (Secure Jobs, Better Pay) Act 2022, https://www.aigroup.com.au/news/submissions/2024/review-of-the-fair-work-legislation-amendment-secure-jobs-better-pay-act-2022/

However, there are also clusters of stronger productivity growth. Labour productivity in Australia's other market sector industries (exclusive of mining) have shown growth, and despite a fall in the most recent quarter remain 4.5% higher than pre-pandemic levels. This suggests that many market sector industries are delivering productivity gains, but at an aggregate level their contributions are being offset by the low-performance clusters.

Chart 3: Labour productivity by industry groups, 2016 to 2024



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

Some commentators have suggested that lower productivity performance is a natural consequence of structural change in the Australia economy. Many of the industries with lower productivity growth are labour intensive, and face natural barriers to certain forms of productivity improvement (for example the difficulty of automation in care settings). 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 be fruitfully applied to these industries. Indeed, if we cannot raise these industries' productivity, we may doom Australia to decades more of dismal productivity growth.

We note and welcome several 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 therefore essential that the budget 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. Tax reform must be central to any productivity agenda.

5. Genuine tax reform is urgent and essential

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.

We identify three major problems with the structure of Australia's tax system:

- 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[14].
- 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.
- 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[15]. A myriad of ad hoc state government levies has gradually accreted, producing an incoherent and inefficient system which drags yet 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. Tax reform has perhaps the broadest and deepest reach of any economic reform available to Australian governments. It should be a major priority for the 2025-26 budget. 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. The recent impact of the US Inflation Reduction Act on our clean energy investment prospects has sharpened minds regarding our tax competitiveness. A similar approach should be applied across all tax settings affecting business.

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. For business, much of the complexity emerges at the state level and the interaction of state and federal taxes.

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 designed or debated on their merits in supporting businesses to make productivity improvements. Given our national productivity difficulties, this should be a first-order criterion. The government's abolition of so-called 'nuisance tariffs' is a welcome example where productivity was foregrounded and should be repeated in all future tax reforms.

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[14] OECD *Revenue Statistics 2024.*
[15] ABS *Taxation Revenue Australia*, 2022-23 financial year, Table 10.

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