

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

THE BUDGET: IF IT LOOKS LIKE A DUCK....

Much of the budget is noise...and, therefore, to be ignored for investment decision-making. Having tied itself to the rhetoric of small surpluses, there is little scope for discretionary policy shifts of any great size by the government. As the economy has matured and the Reserve Bank has assumed greater control over economic policy the influence of a single annual budget has also diminished greatly.

Despite the many pages of coverage in the financial press, there is little in the budget which is likely to have a shorter-term impact on investment choices. However, there are matters of a longer-term nature which are likely to have an impact on individual saving and spending decisions and, ultimately, therefore, on longer term financial planning. This is most evident in education and health policy.

If anything, the budget is an attempt to neutralize debate about the size of government and the nature and quality of the services which it provides. Having once been elected as advocates of smaller government, the incumbents have frequently incurred criticism after acting on their rhetoric. In many instances, what had appeared well-argued positions about reducing the role of government were reversed to shore up electoral fortunes.

Apparently, complaints which had appeared to be about the size of government were actually complaints about the quality of government.

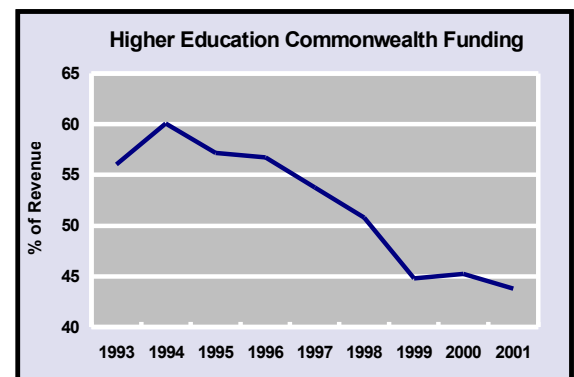
Now, rather than cutting back on services overtly, the government is adjusting to the mood. It is limiting service reductions but removing the government as financial intermediary by shifting a larger part of the funding task to individuals directly.

This has to be the best of all worlds: argue that the changes are all in the interests of greater efficiency, force decisions to cut back services onto the educators or medicos and maintain the rhetorical position as guardian of a low tax regime.

What had once been seen widely as bipartisan commitments to universal services in health and education have given way to these tactics. For example, tertiary education was once regarded as 'free' in the sense that it was wholly funded out of tax revenue. There was a strong community sense that financial capacity should have as little as possible to do with access to knowledge or skills. Over time and without significant debate beyond the confines of the student unions, the tax contribution has been reduced. Only a minority of higher education revenue now comes directly from taxes despite the government continuing to assert policy authority over the sector.

A similar change is being proposed by the government for the health sector by winding back the availability of tax funded health services.

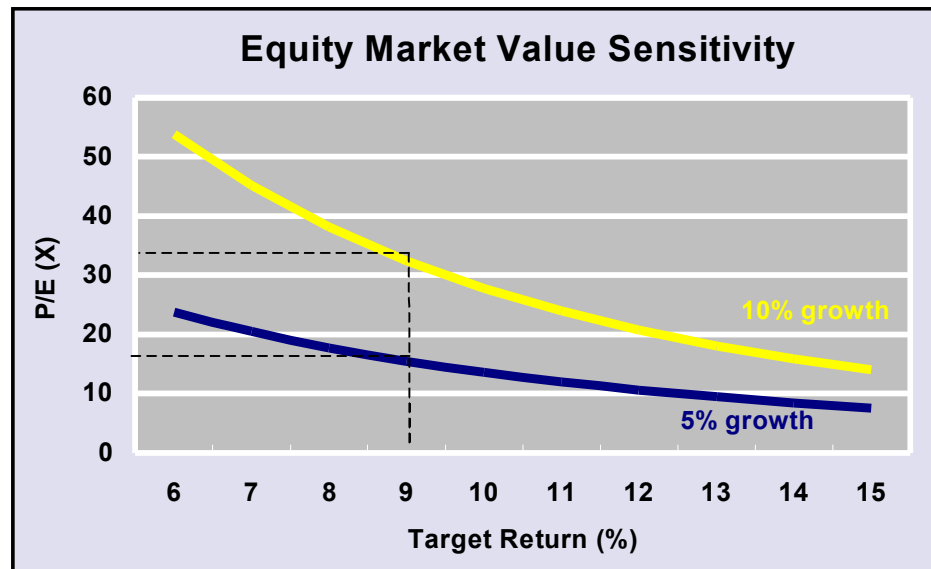
While the government might claim that its tax take is not rising significantly (and, therefore, the size of government has been constrained) the spend to support these services



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THE WEEKLY CHART SPOT

"... the message from the macro environment for investors continues to be that market values should remain depressed for the foreseeable future relative to where they were in the last years of the 1990s. If growth is only 5%... a p/e ratio in the vicinity of 15 is where fair value for the market exists."



Source: **thebigpicture** Economics

Because the role of the budget in macro policy has been greatly diminished, its direct impact on markets is correspondingly weak.

The government is now committed to a neutral fiscal policy. Small surpluses are being targeted while economic conditions are relatively comfortable. Consequently, large fiscal policy adjustments are less likely to occur in either direction. The day-to-day management of the economy is now largely in the hands of the Reserve Bank. Moreover, with a floating exchange rate and more flexible markets generally, adjustments occur across the economy in ways which are not reliant on explicit government decisions.

There was nothing in the budget papers which flagged any changes in the macroeconomic environment about which investors had not been warned previously. There are risks acknowledged but the budget documents are also replete with choruses of how favourable is the Australian economic condition.

The economic outlook which is being endorsed by the government is one of moderate growth and subdued inflation. Generally speaking, the government is assuming several years during which time the economy is likely to grow at about 3½% a year and annual inflation is likely to be about 2½%.

In this environment, underlying business profit growth of 6-7% a year could be expected unless something dramatic happens to business costs. But there is nothing on the horizon to suggest such a possibility. Nor does escaping the confines of Australia offer much solace. Developed economies outside Australia have economic profiles which are no better than the prospects within Australia. A company would have to be doing something very special to enhance its performance sustainably by moving offshore. Having access to Asian markets might offer some better prospects but, for most Australian companies, their involvement in the region will have to be extended greatly to offset the exposure to more slowly growing parts of the world.

So the prospective profit growth rate for a company within Australia is significantly lower than the long term average of 10% a year and the rate of growth which prevailed through the 1990s. In other words, the message from the macro environment for investors continues to be that market values should remain depressed for the foreseeable future relative to where they were in the last years of the 1990s.

Using **thebigpicture** investment decision-making model in the chart illustrates the impact. Being able to assume ongoing profit growth of 10% a year implies that a p/e ratio of 30 might be acceptable. If growth is only 5%, on the other hand, such a rating would be irrational exuberance and a p/e ratio in the vicinity of 15 is where fair value for the market is to be found.

THE BUDGET: IF IT LOOKS LIKE A DUCK... CONT'D

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is rising faster with a shift in funding from the public purse to the individual. Many of the changes will have an impact on individual finances not much different to higher taxes.

As the new tertiary fees system is put in place over the next few years, for example, more students will be graduating with a debt burden in the tens of thousands of dollars. They will have an obligation to repay the debt and associated debt servicing charges in accordance with their income levels. We are encouraged to conclude that this is not a tax.

It is, nonetheless, an obligation on an individual to fund the provision of public goods or services by paying an amount to the government out of income based on ability to pay. The Australian Tax Office will administer the arrangement as part of an individual's annual tax assessment. This is not a tax?

It was a US budget director under Ronald Reagan who suggested the test for recognizing a tax. It was, he said, like recognizing a duck: if it walked like a duck, swam like a duck and quacked like a duck, chances were it was a duck.

The government is seeking to have relatively high income earners with a university education make a larger contribution to national education expenses. Despite not making any explicit changes to the scale of personal tax rates, it has effectively raised the marginal tax on higher income earners to sustain the level and quality of service the community has come to expect.

This is just part of a complex web of extra charges and levies which the government has introduced to avoid debates about

the size of government. There are numerous others such as the Ansett levy and the surcharge on superannuation contribution some of which the government has gone to great pains to avoid having labeled as taxes.

The most egregious example of the non-tax is the GST. None of its proceeds are included as government revenue in the Commonwealth's accounts despite an enormous commitment of resources to developing public sector accounting standards. The fiction here is that this is a state impost over which the Commonwealth has no control. And yet, it was introduced after a national election campaign and expenses of administration fall to the commonwealth.

Within business, the equivalent style of accounting is now identified with Enron and HIH. In the government's case, there has been a qualified audit statement from the auditor general ("...the GST should be recognized as revenue of the Commonwealth Government in the CFS. The CFS audit opinion includes a qualification in relation to the omission of GST from the CFS.").

In today's governance environment, if the Commonwealth were a company, shareholders would feel justified in removing directors if the ASIC and the ASX had not already taken action.

None of this is to say that a belief in smaller government or a shift in the funding burden is an erroneous notion to be eschewed. However, effective policy normally requires that it be understood as fully as possible so that those affected can change their expectations about what services will be received and modify their expectations about their discretionary spending capacity on other goods.

"In today's governance environment, if the Commonwealth were a company, shareholders would feel justified in removing directors if the ASIC had not already taken action and if the company was able to maintain a stock exchange listing."

SHOULD WE TAKE THE GOVERNMENT SERIOUSLY? CONT'D

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legislative agenda, it can either attempt to reform the senate so as to make it easier for a party to gain a majority or it can seek a double dissolution to break the deadlock. In doing either, it risks losing government.

On the other hand, if it decides to forgo the legislation, it risks being seen as more interested in tactics than policy: appeasing those of its supporters seeking radical changes by having presented the legisla-

tion but avoiding the electoral opprobrium of effecting such change by letting the legislation languish and blaming, whenever it is handy to do so, the undemocratic forces in the upper house over which it has no control.

Some time in the coming year or so, ministers will have to declare themselves either as policy charlatans or as sincere advocates who are prepared to put the soft chairs at risk and pursue the dictates of their policy consciences.

USING DEBT: IT MAY BE TOO LATE

Recourse to debt funded education significantly changes the balance of individual finances. A higher debt tolerance might reflect the peculiar experience of those currently making policy. It might be inappropriate for a subsequent generation.

Those making policy today lived through the high inflation of the 1980s and then the 1990s asset bubble. Etched deeply in their consciousness is the knowledge that anyone incurring debt at the beginning of the 1980s would have had to repay far less in real terms than had been borrowed.

Most of this generation would regret having been so conservative in their approach to borrowing at the beginning of their professional lives. They are now doing much to make up for the deficiency.

From the perspective of the past 20 years, beginning professional life with a \$50,000 debt does not seem such a

handicap. But inflation is not like it was in the 1980s. According to the US Federal Reserve, there is now some risk that inflation is dangerously low. The asset bubble of the 1990s has burst. Population growth is set to fall to below replacement levels in many developed nations removing another source of demand and restricting income growth potential.

The decade long Japanese experience is illustrative of the risk. The general level of prices in Japan has not changed since 1993. Contrary to the experience of the 1980s, therefore, debt is holding its value (and borrowing makes less sense).

So, debt might have been the ideal education funding tool during the last 30 years. But that does not make it right for the next thirty years.

So often policy at any point in time tends to be a reaction to what went before rather than what might actually work. Is education finding another example in the making?

“So often policy at any point in time tends to be a reaction to what went before rather than what might actually work. Is education funding another example in the making?”

SHOULD WE TAKE THE GOVERNMENT SERIOUSLY?

Does the government really want its policy changes? Or is it simply playing a political game to wrong-foot its opponents?

Including legislation associated with this budget, within a few months there will be several bills which have been presented to the Senate but which that body has failed to pass within the required time period and in the necessary form. Section 57 of the Commonwealth constitution allows for the deadlock to be broken through a double dissolution of Parliament and then, if necessary, a joint sitting of the two houses.

The government has been reluctant to pursue the double dissolution as a means of achieving its policy objectives. Of course, in several conspicuous instances, the government has been able to trade policies with independent senators and has taken advantage of some of the political personalities in the upper house to get controversial legislation passed. Hence

GST, industrial relations and Telstra sale bills were passed despite there being an initial majority against the passage of the legislation in the Senate.

The Senate numbers now appear more solidly against the government. It seems highly unlikely that it will be able to chip off the necessary support to have the more controversial matters relating to health and education announced in this latest budget as well as already outstanding matters passed. But it could have easily guessed the reaction.

Practically, it now has two choices: change the Senate or forgo the legislation.

No matter how popular a party might be and how large a majority it might win in the House of Representatives, an upper house majority for anyone appears permanently beyond reach because of the Senate electoral system.

If the government wishes to pursue its

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