thebigpicture

guideposts for the private investor

Week Commencing 23 June 2003

HYPOTHECATION: THE NEXT ECONOMIC DEBATE?

Hypothecation might be the way to break the impasse between the need for more public sector funding of necessary services and the reluctance of government to increase general levels of taxes. Its emergence could suit all political parties but bring with it some significant implications for lifetime financial planning.

Earmarking tax revenues for specific purposes – hypothecation – might have once been a radical step in funding education, health and other public sector functions. However, the government has already initiated some radical changes to public sector funding with individuals being asked to fund a rising proportion of public sector activities directly. This has been especially evident in funding education and health where the Commonwealth government has been reluctant to raise taxes to maintain its historical contribution.

While constraining the size of the public sector may be a desirable outcome, the disagreeable feature of these changes is that they have prevented an explicit debate about service delivery and the distribution of the funding burden. Equity principles have not been addressed.

"The end result is that effective marginal tax rates - including the additional expenditures required to fund hitherto public sector activities - are more likely to be well over 50% than edging toward 30%."

Not having such a debate also prevents explicit financial planning for choices about education, health and retirement incomes. Some financial planning decisions are being based on a set of assumptions about the government's ongoing contribution which may no longer be relevant.

Hypothecation v Policy Flexibility

There has been a form of creeping hypothecation. An early example was the Medicare levy but, until recently, there were few others. More recently, we have had the Ansett airline ticket levy. The proceeds of the goods and services tax collected by the Commonwealth are wholly earmarked to fund state government functions to the extent that the Commonwealth refuses to acknowledge it as a tax omitting it from its own financial statements despite the protestations of the Auditor General who has qualified the Commonwealth's accounts in a way which would have long sunk the directors of a public company which had behaved similarly.

Certain pressure groups have long advocated hypothecation. The most conspicuous have been the various motor vehicle lobbies which have argued that funds raised through petrol, registration and usage levies ought to be spent on roads and other facilities for motorists rather than placed in consolidated revenue and spent based on overall public policy priorities.

Economists have generally opposed hypothecation. It takes away the ability to determine overall public policy priorities. It limits flexibility to redistribute resources among groups or individuals when that is considered desirable. It also limits the capacity of a government to effect fiscal policy. Large swings in taxes or expenditures would be harder if there were binding expenditure commitments.

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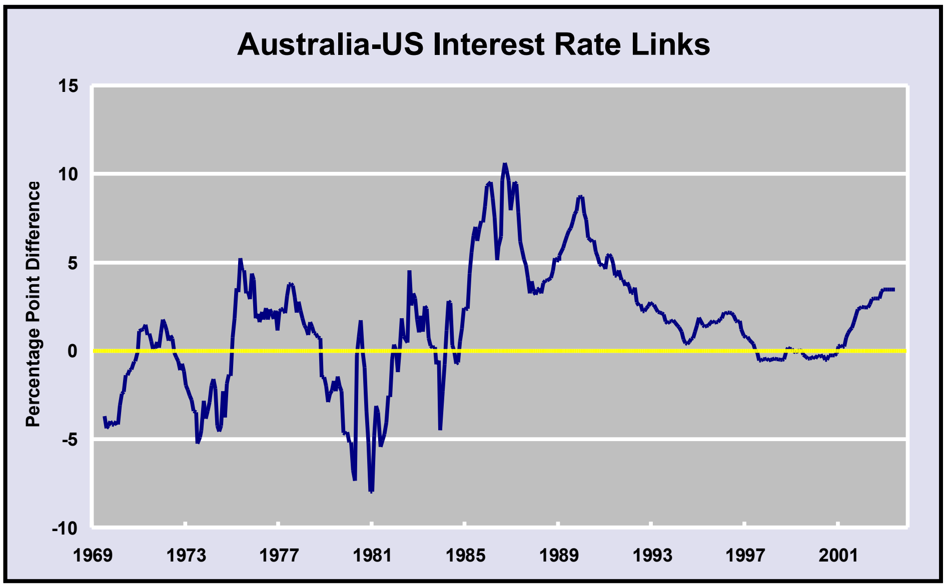
THE WEEKLY CHART SPOT



Source: US Federal Reserve Board and Reserve Bank of Australia

"Presently, it is not at all clear that the differences in economic circumstances are so great as to require such a large difference in monetary policy conditions. So, with the effluxion of time, Australian rates should converge toward US rates."

There is much speculation about a further fall in Australian interest rates. Part of the reason is that Australian rates are significantly higher than those in the USA. Do movements in offshore interest rates imply anything about what will happen to Australian rates?

The Australian cash rate, the principal monetary policy indicator used by the Australian Reserve Bank, is now 3.5 percentage points above the US Fed Funds rate, the equivalent measure in the USA. This is the largest difference since April 1992.

The relationship between interest rates in the two countries has had four broad phases over the last 35 years. The historical differences between Australian and US rates over this period are illustrated in the chart

Phase 1 persisted through the 1970s into the early years of the 1980s. During this period to the end of 1984, the average difference between policy rates in the two countries was 0.5 percentage points with Australian rates being lower on average than US rates. Although somewhat volatile, there was little significant difference on average between the two.

Phase 2 coincided with a troubled period for the Australian economy with relatively high inflation and pressures on the exchange rate from rising debt and relatively poor export performance. This period was noted for what Paul Keating dubbed 'the recession we had to have'. The Australian cash rate averaged 4.3 percentage points above the US rate. From 1990, rates began to converge but it took several years for the gap to close such was the difference which, at its peak, was over 10½ percentage points.

Phase 3, when rates were little different, was a relatively brief period during which Australia's inflation rate accorded more closely with that of the USA as both economies experienced a lengthy period of above average productivity growth culminating in concerns about recession as the equity asset price bubble burst.

Phase 4 has been underway since early 2001 with Australian rates beginning to deviate sharply from rates in the USA. Among the factors affecting this have been the relatively strong Australian growth profile and the apparently more aggressive stance of the US authorities where the bursting of the asset price bubble has appeared to have a more adverse effect on the real economy. Arguably, too, there was greater concern in the US over geopolitical issues which might have affected consumer and business confidence.

Each period has been sufficiently peculiar that it is hard to generalize a normal relationship between Australian and US interest rates. Having said that, there is some tendency for rates to equalize when there are no external shocks preventing that from happening.

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HYPOTHECATION: THE NEXT ECONOMIC DEBATE? CONT'D

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A Tempting Political Choice

The way in which macroeconomic policy is now conducted may allow a change in attitude. The Reserve Bank has become the economic policy leader since it has been accorded an independent role. At the same time, the government has effectively limited fiscal policy choice by a commitment to maintain modest surpluses through the economic cycle. For this, support appears to be bipartisan.

There is also bipartisan reluctance for generalized tax increases. Nonetheless, both sides of politics have priorities which would boost overall spending if implemented. For the Opposition, commitments in education and health are priorities. For the government, theirs are in foreign policy and defence. In the lead-up to the Iraq war, a special war levy was discussed publicly. Hypothecation is creeping into the set of policy choices.

For the Opposition, too, a specific purpose levy for, say, education might be a more palatable way to balance commitments between its traditional constituency and the constraints imposed by having to fend off the fiscally conservative financial markets.

Just as the government has set the example with the GST, there might be a temptation to differentiate between hypothecated revenues and general revenues which contribute to the budget balance. Politically, it might be more difficult for the current government parties to argue against this proposition having already adopted the principle to suit its purposes.

With the hypothecation option being a tempting one for both sides of politics and becoming more feasible to implement, the prospects for any longer term reduction in the top marginal rates of personal tax are eroded.

Reducing the top marginal tax rate had been a policy option to reduce the incidence of income shifting to take advantage of lower corporate tax rates. This is becoming a less realistic prospect. Indeed, the reverse might be the more realistic alternative.

Looking Ahead: The Planning Impact

How might expenditure and tax policies evolve? First, there is no longer scope to reduce expenditure or fund new expenditures through improved efficiencies. After trying for some 20 years, there is broad agreement that this is now too hard. Secondly, expect more specific purpose taxes to fund expenditure. Thirdly, expect governments to give more tax reductions – 'returning bracket creep' – to lower income individuals.

Such developments would immediately imply a more progressive tax scale than the one in place currently . At the same time, it is highly likely that private school fees and medical insurance premiums will continue to rise at rates well in excess of inflation.

Tertiary fees are also going to have an impact with parents either paying more for tertiary education or having their children borrow to fund their educations. It is also likely that individuals will be more likely to require re-educating during their working lives so that latter year education expenditure will also be more likely.

One way or the other, in the future, many individuals will face a lengthy period when 4-6 percent of their income will be going toward paying educational debts.

The related risk is that the upcoming generation faces economic life without the borrowers friend: inflation. There is no doubt that inflation benefits a borrower and disadvantages a lender.

The requirement to assume more debt is occurring at a time of diminishing inflation making the burden of repayment harder than for a similar debt level during the 1980s, for example, when double digit price inflation and income growth allowed rapid erosion of the real value of borrowings and the repayment burden.

The emerging financial picture is one in which higher income earners will have to pay well in excess of their current 48½% marginal tax rate for the level of services which might have been obtained over the past decade in Australia.

Not all of the extra payments will be made through traditional forms of taxation. Nonetheless, the impact on disposable income will be no less real for that.

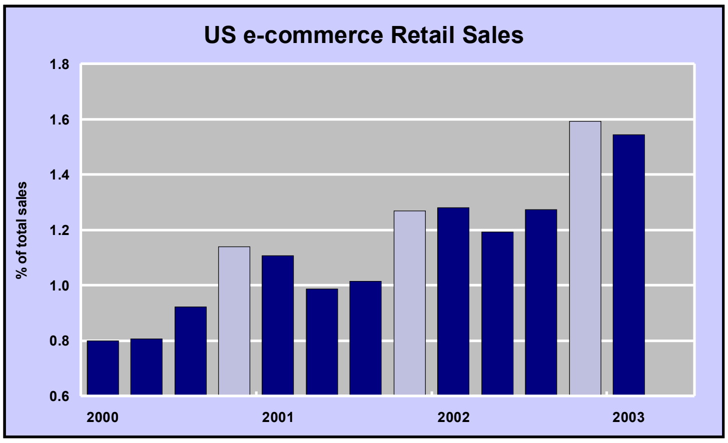
The end result is that effective marginal tax rates - including the additional expenditures required to fund hitherto public sector activities - are more likely to be well over 50% than edging toward 30%.

"There is also bipartisan reluctance for generalized tax increases. Nonetheless, both sides of politics have priorities which would boost overall spending if implemented."

e-Commerce: The Christmas Effect

The latest report by the US Department of Commerce on the uptake by consumers of e-commerce has shown that there has been little progress.

The chart shows the level of e-commerce retail sales in the USA as a percentage of total retail sales.



Now that the quarterly data series is three years old an interesting pattern is evident. In the December quarter of each year (highlighted in the chart with the shaded bars), consumers appear to increase their use of e-commerce. In the subsequent three quarters, there is little change or the usage rate drops back slightly (although not to the extent that the previous gain is lost).

It is tempting to conjecture a 'Christmas shopping' effect on the uptake of electronic trading. The Christmas period might be inducing some experimentation to make the shopping experience a more convenient one. Having risen, there is a tendency for that higher level of take-up to hold until the subsequent season.

That said, it is also very obvious that the overall level of acceptance remains low.

While there has been some recent recovery in information technology equity values – the S&P Global 1200 information technology sector has risen by 20% since the end of 2002 – it has not been based on evidence of an uptake in consumer usage. Information technology remains a business tool rather than the revolution which was to change the relationship between retailers and their customers.

"….the successful analysts will no longer be the ones which have the closest relationships with the companies they follow. Rather, they will be the ones with sufficient confidence in their own skills to be able to take on the company view fearlessly and to expose its weaknesses."

Australian-US Interest Rate Links cont'd

(Continued from page 2)

Of critical importance is the absence of any significant difference in inflation expectations between the two economies.

Presently, it is not at all clear that the differences in economic circumstances are so great as to require such a large difference in monetary policy conditions. So, with the effluxion of time, Australian rates should converge toward US rates. Given that, there should be some downward flexibility in Australian rates.

However, there is a policy preconception that Australian interest rates are already near the bottom of their cycle and that their normal level is somewhat higher. This had motivated a rise in the cash rate in mid-2002. Inflation pressures were thought to have been unusually low and, being likely to rise, it was reckoned that higher interest rates were needed to ensure that the longer term inflation objectives could be achieved through pre-emptive action.

There is a risk that policy makers have got this wrong: that longer-term conditions have changed so dramatically that inflation will be lower than had been expected for the foreseeable future. This would imply that rates would need to move lower.

Perhaps more likely, the US economy is emerging from a trough in activity which would imply that over the coming year rates in the US will tend to rise. If this happens and there is no significant additional shock to the Australian economy alone, the local economy might be able to avoid as aggressive a change in rates as might occur in the USA leading to a slower eventual convergence.