

# thebigpicture

guideposts for the private investor

Week Commencing 24 May 2004

## **Publishing and Subscription Information**

*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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## FAMILY FRIENDLY OR VOTER FRIENDLY?

**Did the recent Australian government budget really favour families? Without being able to assess the distributional effects of taxation and expenditure policies we cannot tell.**

Not surprisingly, when the government said that families would be at the heart of its budget, few thought such a priority was inappropriate. Even the political opposition has had to concede that fighting on this ground is likely to be electorally counterproductive. It has indicated parliamentary support for the government's package.

This does not mean that the government will get the community approval it wanted for its family friendly policies. Prior to the last election, when the current government was fighting to regain its popularity, it spent freely to appease groups which had become hostile to its re-election. The strategy worked so well that government tacticians were always going to duplicate it in the current electoral cycle.

For that reason, it is not being too cynical to think that voters were the central feature of the budget with families just a coincidental characteristic of some of the beneficiaries.

Accolades for the government's initiatives are also less fulsome than it would prefer because of broadening recognition that its spending is higher simply because taxes are higher.

Overall, the government is budgeting to spend \$2,400 million less than it raises in revenues. In this budget, taxation accounts for 95% of the total revenue of \$193.2 billion expected in 2004/05.

This is actually an understatement because the government continues to exclude the proceeds of the \$34 billion Goods and Services Tax from its accounts arguing that the GST is a State tax despite it being administered by the Commonwealth under Commonwealth legislation and introduced after a national election campaign.

Interestingly, since none of the States report the GST as theirs either, government accounting is now about as reliable as Enron's used to be. Despite government grandstanding about corporate governance standards, Australia's GST is not reported in accordance with international accounting standards for the public sector.

Including the GST, by far the majority of tax raised affects families detrimentally. Income taxes, taxes on expenditure and user levies all have an impact on their well-being. Company taxes, accounting for some 20% of reported revenue, are levied on company profits initially. However, they also eventually have an impact on families by raising the prices they have to pay to buy goods or services.

Despite offsetting support measures, families as a group might be no better off if the incidence of taxes also falls on them. Unfortunately, the government is reluctant to accompany its decisions with the necessary distributional analysis so that people can assess whether this is so. One concern is that the government itself probably does not know.

The government would, however, characterise its policies as being progressive in the

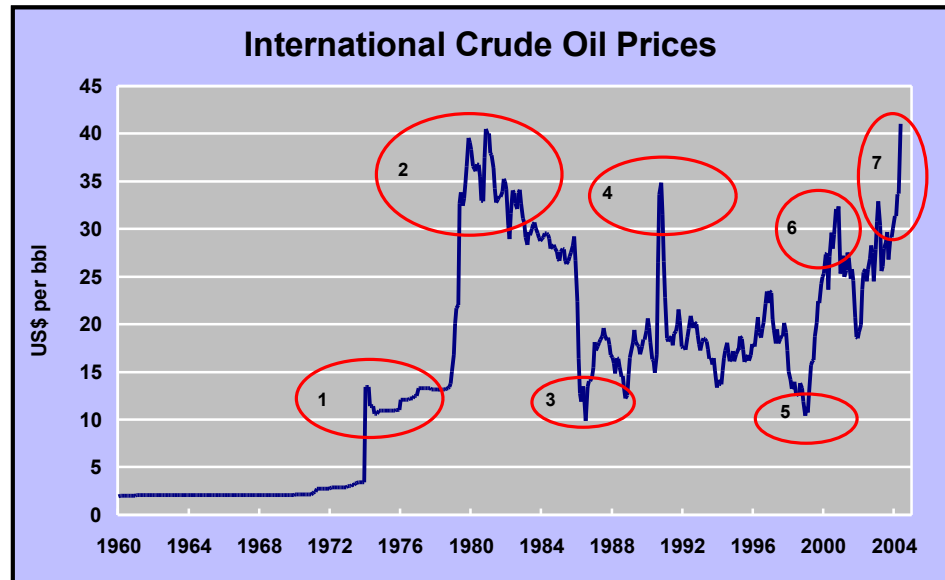
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*"Despite offsetting support measures, families as a group might be no better off if the incidence of taxes also falls on them.... One concern is that the government itself probably does not know."*

## THE WEEKLY CHART SPOT

## Crude Oil Price History

1. US production controls removed in March 1971 giving expanded OPEC membership additional market power; first oil price shock following Yom Kippur war in October 1973 and Arab production cuts
2. Second oil price shock following Iranian revolution and Iran/Iraq war
3. Demand weakens through slower growth and conservation efforts; producers do not respond quickly enough; Saudi abandons role as swing producer
4. Approach to first Gulf war in August 1990/January 1991
5. Asian economic crisis
6. Growth recovery and production cutbacks support higher prices
7. Iraq invasion and occupation by US forces; production disruption in



Source: Various incl. World Bank, United Nations and International Monetary Fund

## OIL PRICES: WHY NO CRISIS CONT'D

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were deployed to development efforts within the oil exporting nations, it took some time before investment decisions could be taken which would recycle the surpluses.

The early price rises had a significantly negative effect on global economic growth between the time the higher prices drained funds from the developed nations to the time those funds could be redeployed for investment.

Today, the international capital market is so highly integrated that higher oil receipts will be quickly recycled to areas of greatest return by financial intermediaries and investment managers working on behalf of the oil exporters.

The second challenge was particularly important for Australia whose inability to manage inflation expectations at the time caused the follow-on inflation to be much worse than it otherwise would have been.

A centralised wage fixing system fostered expectations that higher living costs would be compensated for in higher wages. In this system, higher oil prices would quickly become embedded in wage demands even as the government of the day argued that oil price changes should not be taken into account when setting wages. Its argument was not always accepted and as higher wages pushed costs up by even more, the spiral forced Australia's inflation well

above that of its trading partners.

Inflation was a problem for the western world. Worse than that was the coincidence of high inflation and weak growth. Tight monetary policies particularly in the USA under Federal Reserve Chairman Paul Volker helped reduce inflation. However, even in the USA, it was ten years before the sub-4% inflation performance of the early 1970s was duplicated.

In Australia, the return to pre-1970s inflation rates took another decade. Not until Australia reformed its wage setting processes, introduced flexible exchange rates and created a more competitive environment for its manufacturing industry did similarly tight monetary policies, and a prolonged recession, bring inflation to heal in the early 1990s. The upshot is an economy better able to cope with fluctuating oil prices and external shocks more generally.

Globally and domestically, therefore, oil prices in excess of \$40 a barrel are less troublesome than they were in the 1970s and 1980s.

That said, they will still have an effect. By reducing consumer spending power and increasing business costs, they will reduce overall rates of economic activity. Prevailing long enough, they could induce recession but that would also ensure adoption of alternative energy sources and permanently reduced influence for the oil exporters. ■

## ASX: WHERE CONFLICTS LURK

**The choice of a new CEO for the Australian Stock Exchange (ASX) offers a chance to contemplate his unique role. His differing stakeholders make for potential conflicts.**

The choice of a new corporate chief executive is often of interest as investors try to gauge whether his arrival will have any impact on the financial performance of the company he is to head.

The choice of ASX chief executive, however, has broader public policy issues attaching to it since the company is responsible for overseeing compliance with stock exchange listing rules, a task which places it at the centre of the national corporate regulatory framework along with the ASIC and the ACCC.

The ASX must apply the listing rules with vigour and without favour even to the extent of limiting the number of listed companies or excluding currently listed companies from participating on the exchange if they are unable to conform to its requirements.

At the same time, it has a clear financial interest in attracting more companies to be listed on the exchange and to allow companies leeway when they fail in their responsibilities to their shareholders.

No doubt the ASX would be on strong ground in saying that it has managed this potential conflict well and that its own best interests are served by ensuring an effective regulatory regime is in place. But it cannot pursue both objectives in an unqualified fashion.

From a public policy standpoint, being able to point to an exemplary track record is not sufficient reason to ignore risks which creep into decision making through subtle changes in standards which are often only seen with the benefit of hindsight.

A pointer to what can go wrong is the predicament faced by audit firms selling other business services to listed companies.

For several years, directors were questioned aggressively at annual meetings in Australia about this apparent conflict and the risks it represented. Almost without exception, company chairmen responded by saying that there were sound reasons why audit as well as other services could be provided by the same firm.

Sometimes, in responding, they went so far as to say that their companies were actually better off having the services performed by the same group. In any event, even if there were risks, they would say, there were constraints and safeguards which would prevent any potential conflict being realized. In short, the reaction was to say 'trust us, we are good people'.

By and large, that would have been a reasonable thing to do. As we have learned subsequently, however, through the experiences of Enron, HIH and, less catastrophically, National Australia Bank, among many others, it is the exception which potentially brings the system to its knees and detrimentally affects the welfare of individuals seemingly unconnected to the immediate circumstances, raising the need for a public policy response.

In recent examples of governance failure among public companies, the auditor was generally not guilty of explicit wrong-doing. More frequently, oversight failed through inattention to detail or bad practice which crept in at the margin simply because the system allowed it to happen.

In the case of audit services, policy makers concluded that the conduct of the kindly, avuncular chairman and his colleagues needed to be more circumscribed. The pendulum has swung and some of the new restrictions might be excessively severe. Nonetheless, despite earlier arguments, it is now widely accepted that combining audit and other business services in one supplier is poor risk management.

Experiences in recent years also show that public bodies are not necessarily better equipped to stop these risks being realised. So, the argument is not simply a choice between public versus private policing.

Back to the ASX, there is little doubt that a conflict exists. Under most circumstances, nothing untoward will happen. It is also hard to imagine or describe what could go wrong.

However, one of the primary lessons from governance failures is that if something can happen it most likely will – perhaps not soon but some time. For that reason, it might be just as well when a systemic risk is first perceived to remove it promptly rather than pretend that human behaviour can cope unchecked. ■

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## OIL PRICES: WHY NO CRISIS

**Internationally traded oil prices have hit record levels of over \$40 a barrel, four times the price level in the early 1970s when the world was in the midst of a 'crisis'. Everyone seems more sanguine now.**

There are some reasons why the high oil prices now prevailing are not likely to be as catastrophic as the rises in the 1970s and 1980s.

The price hikes in the 1970s and 1980s were part of a deliberate plan by oil producing nations to redistribute global wealth on a permanent basis. Their motivation was founded on three beliefs.

- Industrial countries would continue to be profligate in their energy usage as long as prices remained low.
- Wealthy industrial countries were preventing the economic development of poorer oil producing nations by siphoning away the value of their resources.
- Supporters of Israel needed to be punished.

In the early 1970s, fears of global commodity shortages, not just for oil, were creating expectations of generally rising

prices. Extremist views such as those espoused by Paul Erlich, a Stanford University academic, foreshadowed imminent global catastrophe ("In the 1970s, the world will undergo famines. Hundreds of millions of people are going to starve to death....")<sup>1</sup>. They foresaw the industrial world grinding to a halt as it could no longer supply its factories or feed its people.

In short, there was a sense that higher oil prices were a symptom of a new world order requiring a change in behaviour. Today, there is no general fear of resource shortages. Energy conservation practices are more commonplace. Alternative energy sources have not achieved widespread acceptance but there is some greater confidence that the technology is available should the need (in terms of permanently higher oil prices) arise.

The impact of the higher oil prices in the 1970s and 1980s was also more challenging for Australia on two fronts.

Sharp rises in oil prices drew financial resources away from the oil importing industrial economies. While some of the funds

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## FAMILY FRIENDLY OR VOTER FRIENDLY? CONT'D

*(Continued from page 1)*

sense that wealthier individuals pay a higher proportion of their income in tax than poorer individuals. At best, the government might be able to make a case for poorer families being better off (and wealthier families worse off) than they would have been without the measures.

But movements in other costs faced by families are also relevant. For example, rising petrol prices reduce the spending power of family budgets. In recent years, private school fees have been rising steeply, at rates well above general rates of inflation. Government encouragement for tertiary education institutions to charge fees also reduces family living standards. So does the rising cost of health care including care for the growing proportion of aged family members who must seek specialised accommodation

and living assistance.

Further disincentives for family formation will come as young graduates enter the work force already facing substantial debts and having to balance these against the financial commitments associated with having a family.

It is clear that the additional family support measures in the budget are dwarfed against the impact of some of these costs.

Whether families are better off now requires an assessment of their total purchasing power. Making a judgement on this point is not easy. The only thing that we can say with certainty is that concentrating on the budget spending items without giving due consideration to these other matters will give a misleading impression of family well being. ■

1. Paul R Erlich, *The Population Bomb*, Sierra Club-Ballantine, 1968