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Australia



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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This survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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The Secretariat's draft report was prepared for the Committee by David Turner and Vassiliki Koutsogeorgopoulou under the supervision of Peter Hoeller.

The previous Survey of Australia was issued in February 2005.

BASIC STATISTICS OF AUSTRALIA (2005)

THE LAND

Area (1 000 km ²)		Major cities (mid-2004, thousand inhabitants)	
Total	7 692	Sydney	4 225
Agricultural (2004)	4 401	Melbourne	3 593
		Brisbane	1 778
		Perth	1 455
		Adelaide	1 123

THE PEOPLE

In thousands, 2004/05		Total labour force (million)	10.55
Population (end of period)	20 329	Civilian employment (% of total)	
Natural increase	127	Agriculture, forestry and fishing	3.6
Net migration	110	Industry and construction	21.0
Number of inhabitants per km ²	2.6	Other activities	75.3

PRODUCTION

Gross domestic product (GDP)		Gross fixed capital investment	
In billion AUD	929	In % of GDP	26.0
Per head (USD)	34 813	Per head (USD)	9 057

GENERAL GOVERNMENT

% of GDP, 2004		Public consumption (% of GDP)	18.1
Current and capital expenditure	35.0		
Current revenue	36.6		

GOVERNMENT COMPOSITION

Senate (seats)		House of Representatives (seats)	
Liberal Party of Australia	34	Liberal Party of Australia	74
Australian Labour Party	28	Australian Labour Party	60
The National Party of Australia and Country Liberal Party	5	The National Party of Australia	12
Other	9	Other	4
Total	76	Total	150

Next general elections for House of Representatives: between mid-2007 and January 2008

FOREIGN TRADE

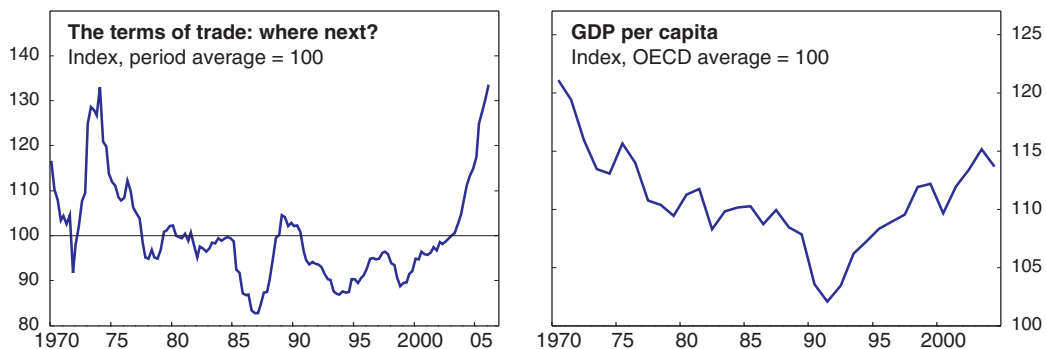
Exports of goods and services (% of GDP)	19.1	Imports of goods and services (% of GDP)	21.1
Main merchandise exports (% of total)		Main merchandise imports (% of total)	
Fuels	25.6	Machinery and transport equipment	44.3
Raw materials	21.6	Other manufactured products	25.3
Food, beverages and tobacco	15.6	Fuels	11.1
Manufactured goods	12.5	Food, beverages and tobacco	4.4
Machinery and transport equipment	9.5		

THE CURRENCY

Monetary unit: Australian dollar (AUD)		Currency unit per USD, average of daily figures	
		Year 2005	1.313
		June 2006	1.352

Executive summary

Sometimes referred to as the “lucky” country, Australia has been riding the global boom in commodities, benefiting increasingly from its proximity to Asia. But Australia “has also made its own luck” through a series of structural reforms and the introduction of a robust macroeconomic framework which have bolstered resilience. This is illustrated by its macroeconomic stability in the face of a string of recent shocks, in stark contrast to the macroeconomic chaos which followed the commodities boom of the early 1970s. A further test of this new resilience will occur at some point when the terms of trade decline – this underlines the need to continue prudent macroeconomic policies.



Reforms have also boosted productivity, with living standards steadily catching up with the best performing countries since the early 1990s. The long-term challenge is to sustain this performance, particularly in the face of population ageing, which will require progress on a number of fronts:

- Improving fiscal relations across levels of government. Many public services are funded jointly by the central government and the states. Clarifying roles and responsibilities would raise public sector efficiency. Particularly in the areas of hospital services and old-age care, fragmentation in decision making leads to cost and blame-shifting. Addressing these problems has been placed on the agenda.
- Boosting productivity growth. Following a surge in the second half of the 1990s, productivity growth has reverted to its long-run average. Infrastructure bottlenecks have held back export growth in some cases. More importantly, there is still further business in the reform of network industries and inefficient use of water remains a major concern. The slow pace in overcoming market segmentation and instilling greater competition in these sectors is partly due to the joint responsibilities of the federal government and the states, although, the Council of Australian

Governments has recently agreed to a National Reform Agenda that aims to re-invigorate and broaden the reform process. In this context, improving workforce skills will also be important.

- Raising labour market flexibility and supply. The recent industrial relations reform is a further move away from a system that had been highly prescriptive. Room for further simplification remains, which would allow greater scope for bargaining over workplace conditions. In addition, labour supply can be raised further, particularly from lone parents, second earners, disability beneficiaries and those aged over 55. The recent tightening in eligibility requirements for welfare benefits goes in the right direction, but should also be applied to the stock of all beneficiaries. A priority for future tax cuts should be to reduce “low wage traps”.

Australia has a strong track-record in pushing ahead with sensible reforms. Further reform is needed to underpin vigorous growth and sustainable prosperity in the face of population ageing.

Assessment and recommendations

Reforms have raised both economic performance and resilience

Recent macroeconomic performance continues to be impressive: gross domestic product (GDP) growth since the turn of the millennium has averaged above 3% per annum and, including the terms-of-trade gains, growth in real gross domestic income has averaged over 4%, among the handful of OECD countries achieving such rapid growth; the unemployment rate has fallen to around 5%, its lowest level since the 1970s; inflation has remained within the target range; and, following a long stretch of fiscal surpluses, Australia is now one of the few OECD countries where general government net debt has been eliminated. Living standards have steadily improved since the beginning of the 1990s and now surpass all G7 countries except the United States. Wide-ranging reforms, particularly to promote competition, were instrumental in this respect. They promoted productivity growth, most notably in the second half of the 1990s. The greater flexibility engendered by these reforms, together with the introduction of robust monetary and fiscal policy frameworks, has also bolstered the economy's resilience to a series of major shocks over the last decade: the Asian crisis in the late 1990s, the global downturn at the turn of the millennium, followed by a major drought, the ending of a house price boom and currently, the commodity price boom.

But challenges remain

The major short-term challenge is to manage the consequences of the commodities price boom that has boosted the terms of trade by around 30% over the last three years, but is likely to decline at some point. The buoyancy of tax revenues, which is significantly higher than can be explained by the commodities boom alone, also raises a complex question as to how ambitious short-term fiscal objectives should be. Over the longer term, the key challenge is to sustain the growth in living standards, particularly in the face of population ageing. In many areas this would be facilitated by, or even requires, improvements in the operation of fiscal federalism. The efficiency of government services can be raised by clarifying responsibilities and improving co-operation in those areas, notably health, where the federal government and the states both have responsibilities. Similarly, productivity can be enhanced by further co-operation to reform infrastructure and network industries as well as making more efficient use of the available water supply. Productivity can also be boosted by up-skilling the workforce and by taking advantage of the reformed framework for industrial relations to promote necessary workplace re-organisation. Finally, to counter the adverse effects of ageing on labour supply, consideration should be

given to whether further reform is required to lessen welfare dependency and promote the labour force participation of particular groups – notably women, single parents, the disabled and those aged over 55.

Growth is likely to remain strong, but terms of trade changes have led to regional and sectoral divergences and pose future risks

Currently, one of the main driving forces of economic activity is the global boom in mining commodities in which Australia is a major exporter. The terms of trade are currently around a 32-year high and business investment, especially in mining and associated infrastructure, is growing at double digit rates. The commodity price boom gained momentum just as consumers' expenditure slowed following the cooling of the housing market at the end of 2003. There are some regional divergences in activity depending on the relative impact of these two shocks. The commodity-rich states of Western Australia and Queensland are growing faster than others, especially New South Wales, where house prices have been weakest. In aggregate, output growth has been sustained at around 3%, although activity slowed during the second half of 2005 largely due to a disappointing export performance and weak housing investment. Headline consumer price inflation reached 3.0% in the March quarter of 2006 compared with the medium-term target of 2 to 3%. This partly reflects rising petrol prices. Consumer price inflation, excluding energy and seasonal foods, did not increase and remained in the lower half of the target range. Nevertheless, the Reserve Bank did raise the policy rate to 5¼ per cent in May, the first move in 14 months, citing the strength of the global economy and its likely impact on export earnings, as well as the pick-up in household credit growth and an increase in other core (weighted median) measures of inflation.

Output growth should pick up in 2006 and 2007, to 3 and 3½ per cent, respectively. The interest rate rise should dampen the recent pick-up in household credit and ensure that consumption growth remains consistent with a gradual increase in the saving ratio. Business investment will be underpinned by tight capacity in commodity sectors and strong profitability more generally. The additional capacity should allow higher resource-based exports so that if the terms of trade remain at recent levels the current account deficit may fall to just over 5% of GDP next year, down from a record high of 6¼ per cent of GDP in 2004. The major uncertainty for the outlook concerns the timing and extent of the eventual downturn in commodity prices. The continuing strength of China and its seemingly insatiable demand for hard commodities may mean that the upswing is more prolonged and the monetary authorities will need to remain vigilant to inflation risks.

Some sectors have been adversely affected by the commodities boom and the associated increase in the exchange rate. It is important that any policy response to consequential structural adjustment occurs with minimal disruption rather than seeking to prevent adjustment.

Fiscal policy needs to continue to steer a prudent course

The authorities' budget projection, which is similar to the OECD's, predicts a fall in the consolidated general government surplus from 1.3% of GDP in 2005/06 to 0.5% of GDP

in 2006/07, with the federal tax cuts imparting some fiscal stimulus. How large a surplus should be targeted depends partly on how much of the recent surge in the terms of trade will be permanent. If the terms of trade were to revert to their long-run average, an extreme assumption in the short run, nominal GDP would decline significantly and tax revenues could fall by around 1¼ per cent of GDP. The assumption incorporated in recent budget projections of federal surpluses of about 1% of GDP over the next four years is that about half of the improvement in the terms of trade relative to its long term average, will be reversed in the two years following the budget year. Accordingly, the prospective federal surpluses are consistent with the federal government's objective of balancing the budget in the medium term. The assumed decline in the terms of trade provides for some 'fiscal insurance' by slowing projected revenue growth and is a prudent departure from the traditional methodology which implicitly would have assumed an unchanged terms of trade. Given continuing momentum in global growth, especially from China, the assumption that there may be some long lasting improvement in the terms of trade is reasonable, but there are obvious uncertainties as to the timing and extent of an eventual decline. *In the event of a more pronounced fall in the terms of trade and a downturn in the global economy, it will be important to allow the automatic stabilisers to work, including, to allow at least temporarily modest fiscal deficits if that downturn were severe.* Importantly, government sector net debt has recently been eliminated, providing an extra measure of fiscal flexibility. Conversely, *if there were to be further increases in commodity prices in the short term, it would be desirable to save any resulting positive surprises to tax revenues rather than being used for permanent tax cuts or spending initiatives.* This would avoid crowding out private spending and create a cushion for when the commodities cycle turns.

Recent income tax cuts are welcome but further changes to raise transparency and simplify the tax system are also needed

Recent cuts in higher rates of personal income tax and the widening of thresholds address concerns about the tax burden on skilled workers raised in the previous Survey and are to be welcomed. Indeed, as discussed further below, the extent of these changes are such that the priority for any future tax cuts should now be at the lower end to address the problem of "low wage traps". This would build upon measures in recent years to reduce benefit withdrawal taper rates in the Family Tax Benefit system and the targeted tax relief recently provided to low income earners.

Recent reforms will have reduced fiscal drag but it still remains high by international comparison due to the heavier reliance on personal income tax. Indexing tax brackets to wage growth would increase transparency; however, it would also reduce the flexibility to undertake further targeted reform of the tax system. The government commissioned Taskforce report "Rethinking Regulation" noted that attention should also be given to further simplification of the tax system, to reduce compliance costs. A range of measures were announced in the 2006/07 Budget that will reduce the complexity of the tax law and compliance costs for taxpayers, dramatically in the case of superannuation changes. The government should continue to seek opportunities to simplify the tax system. One option which might be considered is to allow taxpayers a standard minimum deduction. While this would be contrary to the general principle that taxpayers should be able to deduct only expenses actually incurred, in some other countries this approach has effectively removed

the need for taxpayers with simple affairs to lodge tax returns. A further simplification which should be considered would involve broadening the GST base. Revenue from this measure could be used to reduce the direct tax burden on labour and further address the vertical fiscal imbalance. However, such a change in the tax base would require the agreement of all state governments and would also require significant changes to the financial arrangements between the federal and state governments.

*Australia is relatively well placed to deal
with the fiscal pressures from ageing*

In common with most other OECD countries the major long-term fiscal challenge relates to pressures from population ageing, although Australia appears to be better placed than most, having just eliminated net government debt. Pensions costs are also less sensitive to ageing than in most other OECD countries because the public (first pillar) pension system is flat rate and means-tested, with a comparatively low replacement rate, and an increasing share of the elderly will rely on incomes from (second pillar) occupational pensions. The Australian government has established the “Future Fund” to build up assets to pay for future pension liabilities of its own employees, with returns excluded from the governments “underlying cash balance” fiscal objective – this implies a structural tightening of fiscal policy. The Future Fund is explicitly quarantined from other possible medium-term objectives. This is laudable, especially in the light of cross-country evidence which shows that attempts to pre-fund public pension liabilities by accumulation in social security systems have, without a high degree of explicit separation, often been thwarted by increases in general government expenditure.

*The escalating cost of pharmaceuticals
is a concern*

The main long-term fiscal pressures are instead likely to come from rising health spending, where the recent and prospective rapid rise in pharmaceutical spending is of particular concern. The Pharmaceutical Benefit Scheme (PBS) has considerable advantages in keeping the cost of drugs low in international comparison, while also allowing many new and innovative drugs to be made available if they pass rigorous cost-effectiveness analysis. The use of co-payments, with a differential between the general population and concessionary beneficiaries, is important to promote cost awareness and keep overall costs down. However, the Australian government should explore alternative indexation arrangements for PBS co-payments to increase patient awareness of costs. Under the present system, whereby the level of co-payments is normally up-rated annually in line with the consumer price index, there will be a tendency for co-payments to continuously fall as a share of prescription costs or for the government to be required to implement large increases at discrete intervals which may be controversial. One option is to tie indexation to wage growth or average subsidy paid under the PBS. Another option would be to set a minimum absolute co-payment, but above this threshold the co-payment would be a percentage of prescription costs rather than a fixed nominal amount as at present. All these options would need to take account of the existing safety net arrangements and the need to maintain access to very high cost pharmaceuticals. *In addition, an increased focus should be*

placed on preventive health measures to minimise future growth in health care costs and reduce long-term fiscal pressures.

Co-operative fiscal federalism works well overall

The special chapter in this Survey considers fiscal federalism, which is inevitably a difficult and controversial issue, but one which permeates many areas which are key to determining long-run economic performance. As in other countries where such systems operate there is an inevitable tension between pressures for greater subsidiarity to harness localised knowledge and accountability and those for more centralisation to pursue national objectives. While it is difficult to judge whether the current balance is ideal, in international comparison the overall system does appear to work well. In particular, there is an established co-ordination process with a proven track record for delivering reforms, even if the process is sometimes frustratingly slow.

Spending assignments between the central government and the states should be clarified

Key areas of public service provision are subject to complex joint government involvement, sometimes leading to inefficiencies. Fragmented decision making and funding arrangements are particularly notable in hospital services and old-age care, creating incentives for cost and blame-shifting between government levels. States have responsibility for funding public hospitals, while the Commonwealth funds private medical services under Medicare and is responsible for old-age care. This can, for example, induce public hospitals to refer patients being discharged to their general practitioner, rather than providing post-hospital services directly. Moreover, aged care is funded by the states if a person is in a hospital and paid by the federal government if the person is in an aged care facility. Efficiency gains in the health sector could be reaped by a better co-ordination of health care supply between the central government and the states. The potential for cost and blame-shifting between government levels seems to be lower in education. Even so, *clarifying government roles and responsibilities in all areas of government could significantly improve public sector efficiency.* A collaborative approach between government levels to overcome some of these problems has been adopted. Building on earlier arrangements, the Council of Australian Governments has recently endorsed a *National Reform Agenda that focuses not only on competition and regulatory issues, but also on human capital issues. It is imperative that the Commonwealth and state governments co-operate closely to ensure the timely implementation of the reform agenda.*

A simpler system of inter-governmental transfers involving so-called “specific-purpose payments” would contribute to a clearer specification of spending responsibilities. *The specific-purpose payments should become less complex and inflexible.* A first step would be to develop an outcome/output performance and reporting framework for each SPP. This is an ambitious task as outcome/output measures of service delivery are difficult to clearly define, measure and enforce in a robust way. Nevertheless, such frameworks could ultimately lead to *a move towards the funding of such payments on an outcome/output basis in certain areas, such as education.*

*The vertical fiscal gap raises design issues
for inter-governmental transfers, while inefficient
state taxes should be abolished*

A vertical fiscal imbalance exists because the largest tax bases are assigned to the Commonwealth, while expenditure responsibilities are significantly more decentralised. The existence of a vertical imbalance does not by itself indicate a problem, and there is little agreement over the ideal degree of centralisation. But there are concerns that it undermines the accountability to taxpayers for expenditure decisions; creates duplication and overlap in the provision of services; constrains beneficial tax competition across jurisdictions; and weakens incentives for tax and microeconomic reform. On the other hand, this imbalance and the associated need for specific-purpose payments provides the federal government with a lever with which to pursue national objectives. If some increase in the revenue-raising capacity of the states to meet their expenditure responsibilities were considered warranted, *the most direct solution would involve broadening the states' land property and payroll tax bases. A less direct option would be to allow the states to "piggyback" on the personal income tax levied by the Commonwealth, with the centre making "tax room" by lowering its personal income tax.* An advantage of this option is that it would not significantly raise tax administration costs, since it would still be administered and collected by the Commonwealth. However, a difficulty is that its introduction would require a fundamental adjustment of Commonwealth-states financial arrangements which would require agreement of all jurisdictions. In any event, the efficiency of the state tax system should be raised by eliminating the remaining distortionary stamp duties.

*Unfinished business in reforming essential
infrastructure service provision needs
to be tackled*

Major progress has been achieved in providing a coherent framework for delivering infrastructure services, but unfinished business remains. Further reforms would raise productivity and reduce bottlenecks, including those most visible recently when many ships were forced to queue, some up to a month, to load commodity exports. The new National Reform Agenda builds on and continues the National Competition Policy reform programme, focusing on reform in the areas of energy, transport and infrastructure regulation. However, important implementation details are still to be determined, particularly in relation to electricity market reform and road and rail freight infrastructure pricing, so reform outcomes remain uncertain. Cooperation between the federal and state governments will be crucial for establishing a final programme that delivers the necessary reforms. In the light of regulatory delays relating to infrastructure development, the time taken for regulatory decisions should be closely monitored, especially where it is likely to impinge on export performance. The Council of Australian Governments has agreed that an appropriate time for such decisions should be at most six months, rather than as in some recent cases a number of years. This decision was part of a broader COAG agreement on arrangements for a simpler and consistent national approach to the economic regulation of significant infrastructure. It is important that these arrangements be implemented expeditiously, but *if delays continue to be excessive then further intervention by the Commonwealth would be appropriate.* The central and state governments should establish an

integrated transport reform agenda within a co-operative framework covering all elements of transport. *Competitive neutrality across all transport modes should be achieved; barriers to competition in individual modes be removed; and interfaces between modes enhanced.* Governments should also complete all outstanding National Competition Policy electricity reforms, lifting price regulations for households and instilling stronger competition in the electricity generation sector. The level of government and private sector expenditure on infrastructure has lifted markedly, partly in response to the commodities boom. It is important that this expenditure is not pushed to a level beyond the infrastructure supply capacity of the economy as this will add to cost pressures. Furthermore, in the Australian context, the major challenge is to improve pricing and regulatory arrangements, rather than increasing the total volume of infrastructure.

Water supply is a priority for reform

The scarcity of water remains a major issue and progress in this area has been disappointingly slow. *The National Water Initiative is a framework agreement between the federal and state governments which provides for further reforms and it is vital that these are pushed ahead rapidly.* It aims at establishing a water market with tradable water entitlements. This is a prerequisite to better integrate the rural and urban water reform agendas and to ensure that water prices reflect the scarcity of water and of environmental amenities. *To this end, cross-subsidisation of water usage between urban and rural users, and also between different types of agricultural users, should be phased out.*

Industrial relations arrangements have been reformed, but remain complex

Industrial relations arrangements have evolved gradually from a prescriptive, very complex, set of rules, largely set by a judicial body, the Australian Industrial Relations Commission (and its state equivalents), to a much more flexible system, with many enterprise and individual agreements. However, the Commission, in setting awards, continued to restrain bargaining over working conditions. The WorkChoices Act, which came into effect in March 2006, moves the industrial relations arrangements towards a simpler, national system. It also established a new, independent body, the Fair Pay Commission, which will set and adjust a single minimum wage for adults, wages for award classification levels and for youth wages. Its first decisions will be taken shortly. The government now sets minimum conditions for leave and maximum ordinary hours of work, which together with the wages set by the Fair Pay Commission constitute the Australian Fair Pay and Conditions Standard. Also the number of matters that are included in federal awards has been reduced. Overall, the system has been simplified, leaving more room for bargaining and has streamlined the process of making workplace agreements. But the system is still complex: federal legislation runs to nearly 700 pages, distinct federal and state systems remain, and businesses have complained about compliance costs.

*There is room to provide for greater flexibility
in workplace conditions*

The new system of industrial relations will need some time to bed down before its effect on aggregate bargaining outcomes can be fully appreciated. Opponents fear that greater flexibility will lead to widening income inequality and poverty. Despite these concerns, the rationale for maintaining the award system should be questioned now that the WorkChoices Act provides for the setting of national minimum standards in terms of wages and working conditions. Therefore, these awards should be either gradually phased out subject to these minimum standards or substantially rationalised further in terms of their number and content. Developments in the minimum wage will depend on the decisions of the Fair Pay Commission. Its remit has a strong emphasis on the employability of the low paid. The minimum wage is high in international comparison and the number of low skilled who are long-term unemployed or disabled is also high, thus raising concerns about the adverse effects of the minimum wage on labour demand for the low skilled. At the same time, the minimum wage is a blunt tool to enhance fairness, as more than half of the low paid live in families with income above the median. Therefore, the adequacy of incomes from working should be addressed through other social policy instruments such as changes in income tax rates and thresholds at lower incomes or an employment-conditional tax credit, while maintaining the system of separate taxation of each spouse. Finally, there remains considerable room for the up-skilling of the low paid, through a strengthening of the vocational education and training system.

*Recent reforms should boost labour force
attachment*

International comparisons of labour force participation rates suggest that there is scope for catching up with the best performing countries by increasing participation among welfare recipients, those aged over 55 and women with families. Accounting for hours worked makes female labour supply even lower than headcount measures, given the high incidence of part-time work. Despite low unemployment, reliance on income support remains high, with the numbers of disability pensioners and lone parents on welfare having increased markedly since the mid-1990s although these trends have been recently reversed. In addition, the percentage of lone parents on welfare who are also working has been increasing over the past few years. Notwithstanding these recent improvements, a particular concern is the high proportion of people living in jobless families, which is well above the OECD average, with about three-quarters of such families headed by lone parents. The promotion of individuals' attachment to the labour force, through reducing income support dependency, was the focus of welfare reform in recent years. Building on previous initiatives, the "Welfare to Work" reform package in the May 2005 Budget included a combination of changes to payments and work incentives, workforce participation requirements, and employment and related services for four priority groups, namely people with a disability, principal carer parents, mature age people and very long-term unemployed. The new arrangements comprise tighter eligibility and participation requirements for new Disability Support Pension applicants, with working capacity above 15 hours per week. For principal carer parents, the reforms involve part time participation requirements for those with a youngest child aged 6 or over, changes to Parenting Payment eligibility, and provision of additional employment and related services.

But further action is needed to promote participation of the disabled, women with families and those aged over 55

While recent Welfare to Work initiatives are welcome, reforms should go further. It is particularly welcome that under these reforms employment prospects for people 55 and over will no longer be taken into consideration when determining eligibility for the Disability Support Pension. Greater emphasis has also been placed on the assessment of rehabilitation needs for people applying for a disability pension. *However, the tighter eligibility requirements applicable to new entrants should be extended to all recipients.*

Similarly, *tighter eligibility criteria for recipients of parenting payments should not just apply to new claimants but extended to the stock of all existing recipients.* Access to affordable child care also plays an important role in promoting the employment opportunities for lone parents and women with families. Efforts towards reducing the cost and increasing the availability of child care places should be maintained. The structure of the Child Care Benefit should be changed to reflect the age-related cost profile of child care provision. This benefit should be made more conditional on employment, in contrast to the present situation where it is still available for up to 20 hours to families where no family member works. Steps taken to reduce the financial disincentives to take a job for lone parents and second earners, most of whom are women, are welcome, especially given the high prevalence of jobless households with children. However, one consequence of measures to reduce “inactivity traps” is that they create high effective marginal tax rates from moving up the wage distribution as benefits are withdrawn. Tackling such “low wage traps”, which appear more extreme in international comparison, either by addressing allowance and parenting payment income tests or by reducing the lowest income tax rate or raising the threshold at which income tax is first paid, should be a priority. Relevant considerations for evaluating these options are the fiscal cost and the labour supply response.

To encourage older workers to continue working after they become eligible for an Age Pension the income-test taper on earnings should be further eased as marginal effective tax rates for the elderly can be nearly 70% over a wide range of income. Incentives to retire early under the Superannuation Guarantee scheme could be reduced by aligning the eligibility age of superannuation (currently 55, but to be increased to 60 by 2025) with that of the Age Pension (age 65) over time. *If evidence of significant “double dipping” emerges, the generous tax-treatment of superannuation if drawn as a lump-sum after the age of 60 should be withdrawn and limits placed on the exemption of owner-occupied housing in the means test for the Age Pension.* Implementation of the proposals to simplify superannuation announced in the 2006/07 Budget would further encourage workforce participation by older workers.

Chapter 1

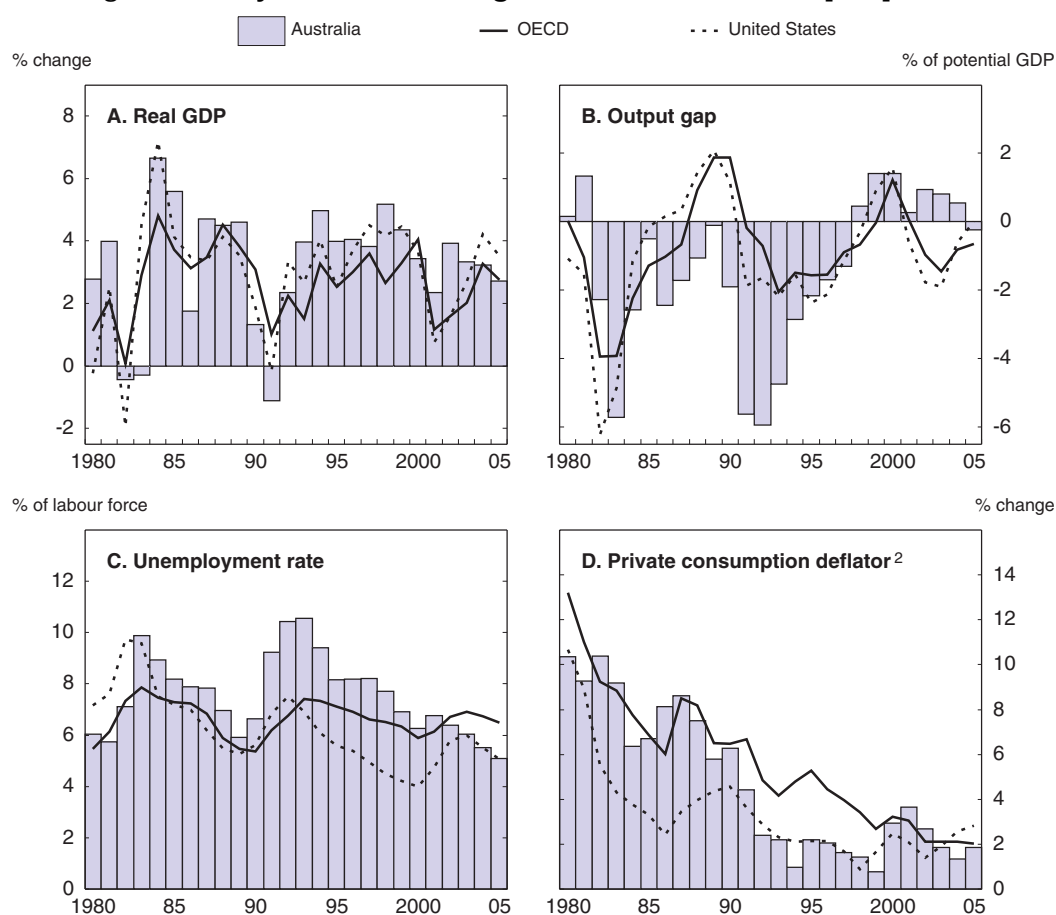
The short-term challenge: riding the commodities rollercoaster

The major short-term challenge is to maintain macroeconomic stability in the face of a commodities price boom that has boosted the terms of trade by around 30% over the last three years. Recent monetary tightening in the face of relatively weak output growth needs to be seen in the context of strong income gains due to the surge in the terms of trade and the prospective effect this is likely to have on spending. Unusually buoyant tax revenues related to the commodities boom also raise the question as to how ambitious short-term fiscal objectives should be. Recent budget tax cuts are also considered in the context of previous Survey recommendations and a recent study comparing Australia's tax system with that in other OECD countries.

Recent macroeconomic performance

Since 2000 growth has remained robust with output remaining close to estimated potential (Figure 1.1, panels A and B) despite the global slowdown in the early 2000s, a major drought, and most recently the ending of a house price boom.

Figure 1.1. **Key indicators in long-term and international perspective**¹



1. Provisional data for 2005.

2. OECD excludes high inflation countries.

Source: OECD Economic Outlook 79 and National Accounts databases, July.

The commodities boom is a driving force

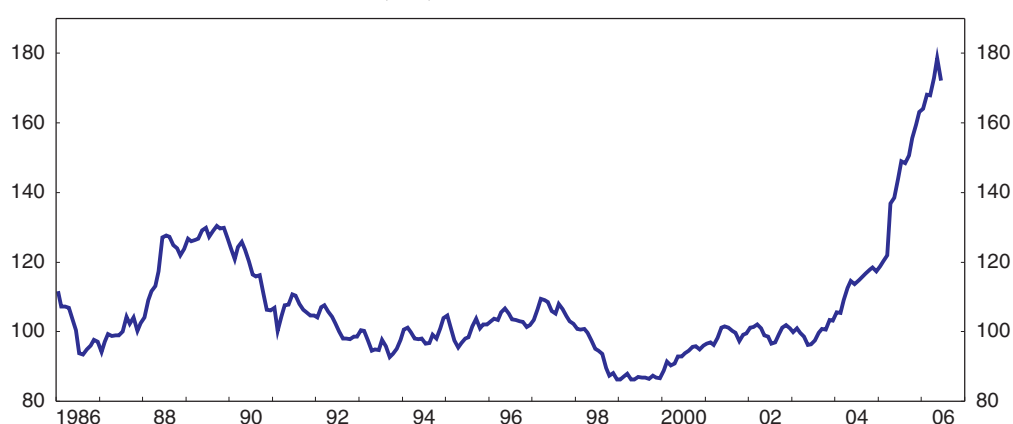
Currently, the main driving force of economic activity is the global boom in mining commodities in which Australia is a major exporter (Table 1.1 and Figure 1.2). Strong mining profits have supported the corporate sector and boosted business investment. The mining sector accounts for around 4% of GDP, although for only about 1¼ per cent of total

Table 1.1. Australia is a major producer of metals and minerals
Ranking among all countries

	As exporter	As producer	Reserves
Gold	3rd	5th	2nd
Iron ore	1st	3rd	3rd
Bauxite	..	1st	1st
Coal	1st	5th	6th
Uranium	2nd	2nd	1st
Nickel	2nd	2nd	1st

Source: Australian Bureau of Agricultural and Resource Economics (ABARE) quoted in Grant *et al.* (2005), "Mining and Commodities Exports", *Economic Roundup*, Spring, The Treasury, Australian Government, Canberra.

Figure 1.2. Australian commodity prices are booming
Index (SDR) for all items, 2001/02 = 100

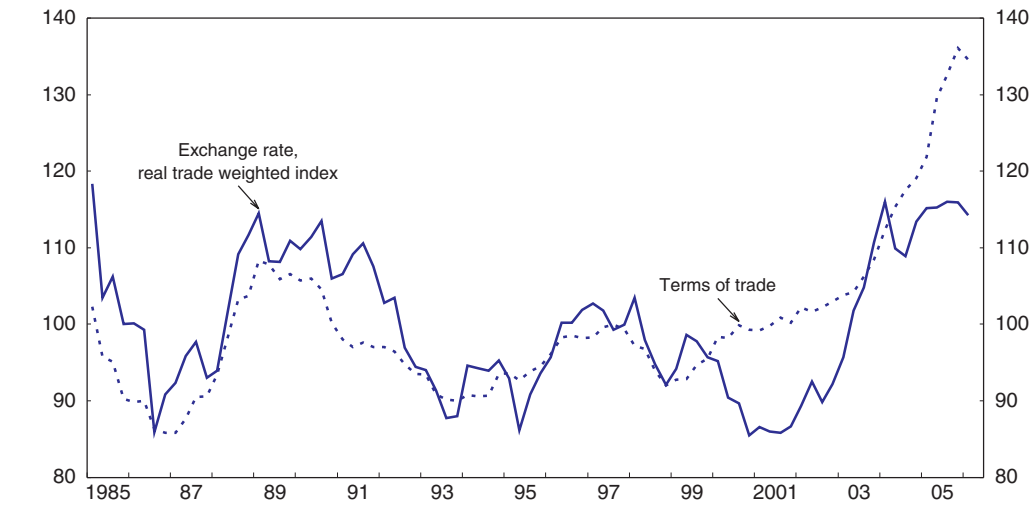


Source: Reserve Bank of Australia.

employment given its high capital intensity, with a further 5% of GDP generated by manufacturing industries which process minerals (Grant *et al.*, 2005). Exports of resource commodities accounted for more than 40% of all exports by value in 2005, although recent growth in export volumes has been disappointing, partly because of infrastructure constraints (Chapter 4).

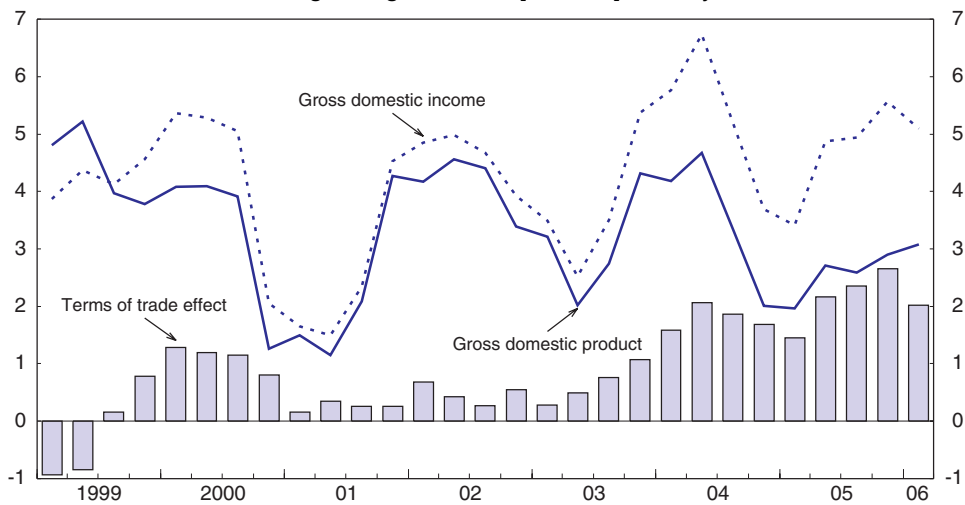
The effect of the commodity boom goes well beyond the immediate impact on the resource sector. The terms of trade have risen to a 32-year high (Figure 1.3), which is reflected in a large differential between real GDP and real gross domestic income growth; in the year to the final quarter of 2005 the former was 2.9%, whereas the latter was 5.6% (Figure 1.4). This difference is important for assessing both recent monetary policy action and the underlying fiscal stance, as discussed below. Part of the income gain accrues to foreigners given that foreign ownership of the resources sector is significant.¹ However, the majority accrues domestically which stimulates spending and boosts production. The exchange rate has also risen with the terms of trade, although by less than might have been expected on the basis of past relationships (Figure 1.3). The loss in competitiveness from the appreciation of the exchange rate has limited growth in non-resource export volumes, although high levels of capacity use may also be diverting output to the domestic market. The higher exchange rate has also led to real income gains through lower import prices, encouraging consumption and investment.

Figure 1.3. **Real exchange rate and the terms of trade**
Index, period average = 100



Source: Reserve Bank of Australia and OECD Economic Outlook 79 database.

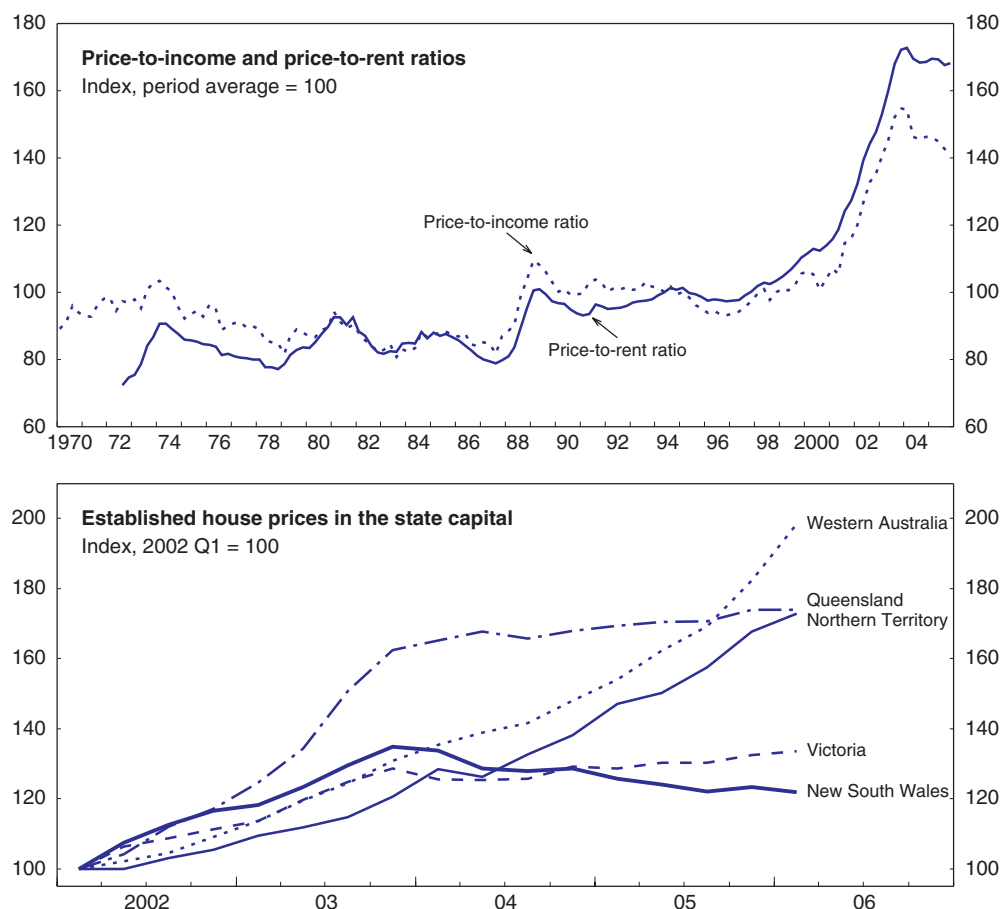
Figure 1.4. **Real income growth is outpacing real output growth**
Percentage change over same period of previous year



Source: ABS (2006), Australian National Accounts: National Income, Expenditure and Product (cat. No. 5206.0).

But the ending of the housing boom is acting as a drag

The commodity price boom gained momentum just as consumers' expenditure slowed following the cooling of the housing market at the end of 2003 (Figure 1.5, upper panel). The consequent abrupt slowdown in housing wealth growth, and the following moderation in consumption growth has led to some recovery in the household saving ratio. It had fallen from positive territory at the beginning of 2002 to a trough of $-4\frac{1}{2}$ per cent in early 2004 and has risen to -2% by the end of 2005. Nevertheless, given continued strong real income growth, the consumption slowdown has been comparatively benign. Moreover, the risk of a sharp fall in house prices at this stage appears low, even if there was a significant further rise in interest rates (OECD, 2006).

Figure 1.5. **The house price boom has ended benignly**

Source: ABS (2006), *House Price Indexes: Eight Capital Cities* (cat. No. 6416.0) and OECD calculations.

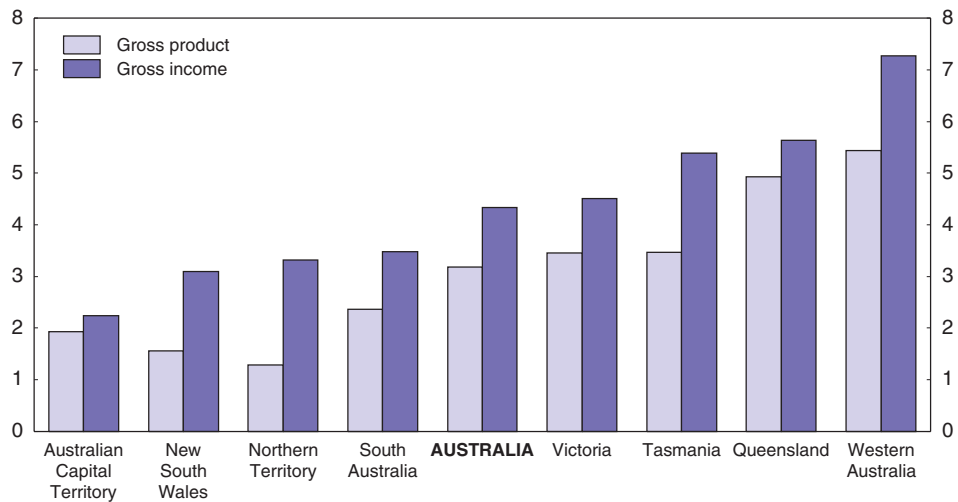
Regional divergences are striking, but not unprecedented

The impact of the two shocks is most striking at the regional level (Figure 1.6). Growth is strongest in those states, Western Australia and Queensland, where most mining activity is located, particularly the former where the housing market has not slowed down. Conversely, states with little mining activity and where either house prices have been weakest (New South Wales) (Figure 1.5, lower panel), or where there is a greater concentration of manufacturing (Victoria and South Australia) are growing more slowly. The end of the house price boom holds back activity most in New South Wales where house prices have been falling and low residential investment permits suggest that housing investment is unlikely to pick up soon.

Regional divergences are not, however, large in historical perspective; while the dispersion in the annual growth rate of gross state product was significantly higher in recent years than on average over the preceding decade, it is noticeably lower than at times during the 1980s and especially during the terms of trade shock of the early 1970s (RBA, 2006). Moreover, these growth differentials have so far only led to limited inflationary tensions, particularly compared with the terms of trade boom in the 1970s when wage pressures in tight sectors quickly spilled over into aggregate inflation (Gruen, 2006a). Indeed, an encouraging development has been that wage inflation has remained tame,

Figure 1.6. **Regional disparities in growth**

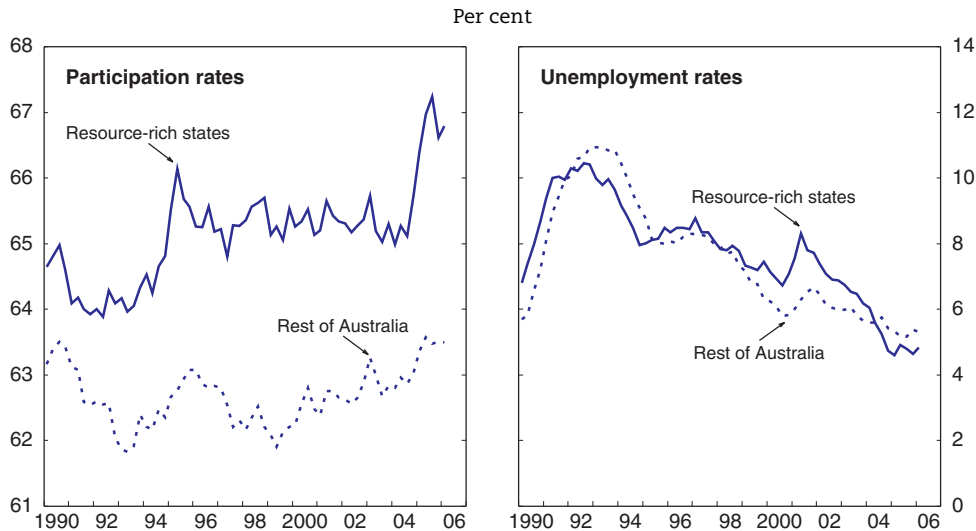
Average growth in real gross state income and real gross state product (per cent per annum), 2001/02 to 2004/05



Source: ABS (2005), Australian National Accounts: State Accounts (cat. No. 5220.0).

while participation in the resource-rich states has risen strongly, partly reflecting interstate migration (Figure 1.7). At the national level, the unemployment rate has stabilised at around 5% since the end of 2004, its lowest level since the mid-1970s (Figure 1.1, panel C) and close to estimates of the structural rate. Surveys suggest that capacity utilisation has risen close to historical peaks and also that skilled labour shortages have become a more prominent factor holding back production.

Figure 1.7. **Labour market developments in resource-rich states and the rest of Australia**



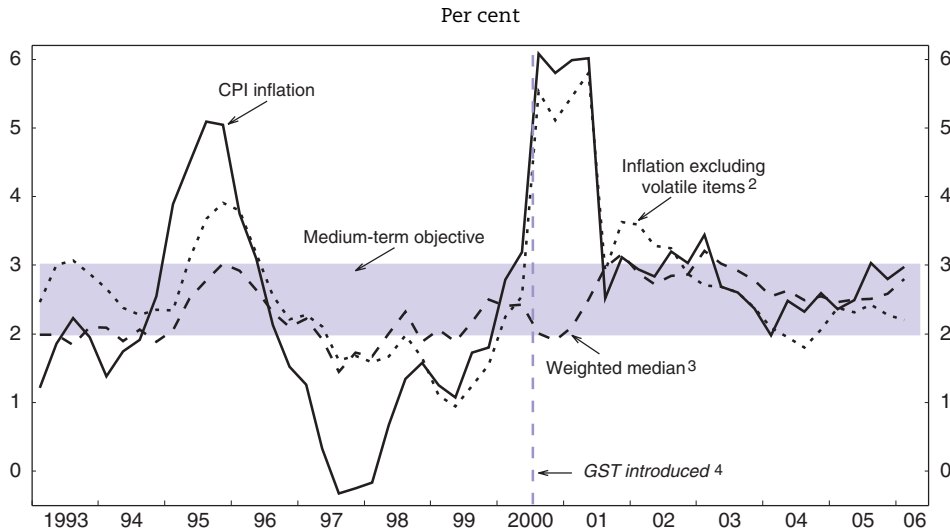
Source: The Treasury, Australian Government.

Monetary policy

In the current global upswing, the Reserve Bank began raising interest rates earlier than most other central banks; the cash rate was increased from 4.25% at the beginning of

May 2002 to 5.25% by the end of 2003, with further $\frac{1}{4}$ percentage point increases in March 2005 and, most recently, in May 2006. During this period headline consumer price index (CPI) inflation strayed outside the 2-3% target range in late 2002 through to early 2003 (Figure 1.8), but as the target is defined in terms of a medium-term average (Box 1.1) this is not inconsistent with the objectives of the monetary framework.

Figure 1.8. **Headline and core inflation**¹



1. The inflation target was expressed in terms of the "Treasury underlying inflation rate" up to late 1998, from which time it has been expressed in terms of the "headline" consumer price index (CPI).
 2. Volatile items excluded are fruit and vegetables, and automotive fuel.
 3. Weighted median measure based on seasonally adjusted quarterly price changes excluding tax effects.
 4. The inflation surge in 2000/01 relates to the introduction of a Goods and Services Tax (GST) in July 2000 at a rate of 10%.
- Source: ABS (2006), *Consumer Price Index, Australia* (cat. No. 6401.0) and Reserve Bank of Australia.

Inflation fluctuated around the centre of the target range for most of 2004 and the first half of 2005. During this period, strong domestic demand and growing labour cost pressures were offset by the fall in import prices that resulted from the large appreciation of the exchange rate during 2002 and 2003: the Reserve Bank has noted that the appreciation had a smaller effect on inflation than would have been expected based on earlier experience. Since then, headline CPI inflation has risen to near the top of the target range, and was 3.0% in the year to March 2006. Reflecting the increase in world oil prices, the increase in the price of automotive fuel has been a major contributor to the recent strength in inflation.

There is no single measure of core inflation in Australia, and the Reserve Bank monitors both exclusion-based measures (e.g. CPI inflation excluding volatile items, usually defined as fruit and vegetables and automotive fuel) and its own statistical (i.e. weighted median and trimmed mean) measures. The exclusion-based measures have suggested inflation remains subdued, with inflation in CPI excluding volatile items at 2.2% in March 2006. On the other hand, the Bank's weighted median and trimmed mean measures of core inflation moved into the upper half of the target range in March 2006, and increased a little more than the Bank had forecast.² Overall, the Bank's assessment was that underlying inflation was around 2¾ per cent. The lesser weight given by the Bank to the exclusion-based measures is consistent with a view that globalisation has not just

Box 1.1. The monetary policy framework

The inflation target. A distinguishing feature of the inflation target is that it allows more discretion to the central bank than in many other inflation targeting regimes. The target for monetary policy is to achieve an inflation rate of 2-3% on average, over the cycle. Thus, the inflation target is defined as a medium-term average rather than as a hard-edged target band within which inflation is to be held at all times. This formulation is preferred because it allows for the uncertainties that are involved in forecasting, and lags in the effects of monetary policy on the economy.

The track record. Since the introduction of the medium-term flexible targeting regime in 1993, the average CPI inflation rate has been close to the 2½ per cent mid-point of the inflation target, with core inflation almost invariably within 1 percentage point of this rate, while unemployment has fallen almost continuously from 10½ per cent in 1992 to about 5% now. Thus in terms of outcomes for both inflation and the real economy this inflation targeting regime has achieved what it was designed to do.

Governance and accountability. The Reserve Bank of Australia (RBA) is an independent and self-funded statutory authority, and is accountable to Parliament. The RBA is overseen by the Reserve Bank Board, to which the Bank's management (embodied by the Governor) is accountable. The RBA Board consists of nine members: the Governor, Deputy Governor and the Secretary to the Treasury, in addition to six non-official members appointed by the Treasurer. The latter have typically had backgrounds in business – including in the rural, mining, retail and manufacturing sectors – and are appointed for their broad industry experience rather than monetary policy expertise. However, it has been common practice for one of the non-official members to be an academic appointed for relevant technical expertise. Most of the Bank's governance arrangements relate to the role of the Board, with others being specific to the Governor in his role as the Chairman of the Board.

The conduct of monetary policy is explained publicly through several channels. The Bank makes a public announcement of any policy change, giving detailed reasoning for it. It publishes four Statements on Monetary Policy each year, which contain an account of the considerations for the policy stance adopted by the Bank. The Governor appears twice each year before the House of Representatives Standing Committee on Economics, Finance and Public Administration, to answer questions on the Bank's conduct of policy. Senior officials of the Bank also make regular public speeches.

Is the Reserve Bank transparent enough? There are different ways of assessing the degree of central bank transparency. One methodology is the “check-list” approach of Eijffinger and Geraats (2005) which suggests that the RBA has one of the lowest degrees of transparency of nine leading central banks considered. However, that study fails to find any correlation whatsoever between higher transparency and better policy outcomes. Indeed, this is hardly surprising given that differences in transparency among the major central banks are relatively small compared with the gains that all major central banks have made in improving their communication practices over recent decades. Another approach is to measure how financial market prices respond to policy announcements and other forms of communication. Studies following this approach show that responses to RBA communications are little different to those of other central banks, suggesting that it is conveying a similar amount of information to the market as other central banks (Connolly and Kohler, 2004).

Box 1.1. The monetary policy framework (cont.)

Although Australia's economic performance under its current policy regime has been impressive, some aspects of the current framework which score poorly on Eijffinger and Geraats's measure of transparency are as follows:

- *Publication of explanations for "no-policy-change" decisions.* Although the RBA was the first of these central banks to publish detailed explanations for policy changes, it does not publish a statement after each Board meeting on the argument that its views are expressed regularly by other means and that excessively frequent communication can be counter-productive (Edey and Stone, 2004).
- *Greater emphasis on forecasts as a communication tool.* While the RBA publishes a fair amount of information on forecasts it also argues that putting greater emphasis on forecasts as a communication device reflects a simplistic and mechanistic view of the way monetary policy is conducted.
- *Publication of Board minutes and voting records* has been viewed as inappropriate in the context of the overall RBA model of a monetary policy committee designed on the principle of collective accountability with a majority of "non-expert" members.

An example of a board comprising members appointed for their monetary policy expertise is the Bank of England's *Monetary Policy Committee* which does publish the minutes of its policy deliberations. Publication of minutes may be appropriate within such models as it allows for the judgments of experts to be scrutinised and enhances accountability. However, in the Australian context, it is argued that exposing the deliberations of the RBA Board to public scrutiny may undermine its decisions by exposing members to increased pressure from their perceived "constituencies". Similarly, one rationale for not publishing voting records of the Governing Council of the European Central Bank is to reduce pressure on members to vote according to national rather than euro-area-wide interests.

In summary, it would appear that if reforms, especially in respect of publishing minutes or voting records, were to be considered then they would probably need to involve a complete rethink of the composition of the Board, rather than involving piecemeal changes which appear inconsistent with the current set-up. However given successful outcomes from the conduct of monetary policy, as well as the findings of various official reviews, including most recently the *Government's Review of Corporate Governance of Statutory Authorities and Office Holders* (the Uhrig Review) in 2004, there is little appetite for changing what has so far been a successful formula.

brought about a spike in oil prices, but rather a prolonged upward shift while at the same time putting downward pressure on a range of other manufactured imports (King, 2006). On this view the wedge between headline and exclusion-based measures of inflation is the result of the latter excluding one aspect of the rise of China (the effect on oil prices) but not other effects (the effects on manufactured goods).

The statement accompanying the May increase in official rates indicated that the Reserve Bank was focussing not on the relatively weak GDP growth outturns seen through much of 2004 and 2005, but rather on strong real income growth and the strength of the global economy and its likely *future* impact on income and spending, as well as recent signs of a pick-up in household credit growth. Indeed, data releases subsequent to the decision tend to vindicate the tightening: GDP in the first quarter of 2006 rose 0.9% on the previous

quarter, which together with upward revisions to earlier quarters, took the annual growth rate to 3.1% which is much closer to estimates of potential growth; employment growth in May was also strong with the unemployment rate falling to 4.9%, its lowest level since the mid-1970s.

Short-term prospects

Output should accelerate in 2006 and 2007 (Table 1.2). Recent indicators of consumer activity suggest consumption has strengthened in the first half of 2006. However the rate rise should slow the recent pick-up in household credit and the saving ratio should recover gradually. Business investment will be underpinned by tight capacity in commodity sectors and strong profitability more generally. The additional capacity should allow higher resource-based exports and, provided there is no renewed appreciation of the exchange rate, there should be a recovery in non-resource exports. While the terms of trade may stabilise in the short term at levels reached during the first quarter of 2006, this still implies a significant year-on-year increase in 2006. This, together with a pick-up in export volumes, should see the current account deficit fall from a record high of 6¼ per cent of GDP in 2004 to just over 5% of GDP, which though large should not be a matter for immediate policy concern (Box 1.2). While higher oil prices may keep headline inflation

Table 1.2. **Short-term outlook**

Percentage change

	Outcomes				Projections	
	2002	2003	2004	2005	2006	2007
Gross domestic product (GDP)						
In constant prices	3.9	3.3	3.2	2.7	2.9	3.7
Private consumption	3.8	3.8	5.8	3.0	3.1	2.6
Government consumption	3.0	3.7	3.7	2.8	3.2	3.2
Gross fixed investment	16.4	8.0	7.8	7.6	8.0	7.1
Private sector	17.7	9.0	7.7	8.2	8.8	7.2
Government	5.3	-1.5	8.7	0.4	-1.2	6.5
Final domestic demand	6.4	4.8	5.9	4.1	4.3	3.9
Stockbuilding ¹	-0.2	1.1	-0.5	0.2	-0.2	0.0
Total domestic demand	6.2	5.9	5.3	4.3	4.1	3.9
Goods and services						
Exports	0.1	-2.3	4.1	2.1	1.7	9.2
Imports	11.1	10.4	15.1	8.6	6.3	9.5
Net exports ¹	-1.8	-2.3	-2.2	-1.5	-1.1	-0.6
GDP deflator	2.9	3.0	3.5	4.5	4.2	2.8
GDP in current prices	6.9	6.4	6.9	7.4	7.2	6.6
Memorandum items						
Potential output	3.3	3.5	3.5	3.4	3.3	3.1
Output gap (% of potential GDP)	0.9	0.8	0.5	-0.2	-0.6	-0.1
Consumer price index (CPI)	3.0	2.8	2.3	2.7	3.0	2.6
Employment	2.0	2.2	1.9	3.3	2.0	1.2
Unemployment rate (% of labour force)	6.4	6.0	5.5	5.1	4.7	4.7
Current account balance (% of GDP)	-4.0	-5.6	-6.3	-5.9	-5.5	-5.3
Government net lending (% of GDP)	0.8	1.6	1.6	1.5	0.9	0.5

1. Contribution to GDP growth.

Source: OECD Economic Outlook 79 and National Accounts databases, July.

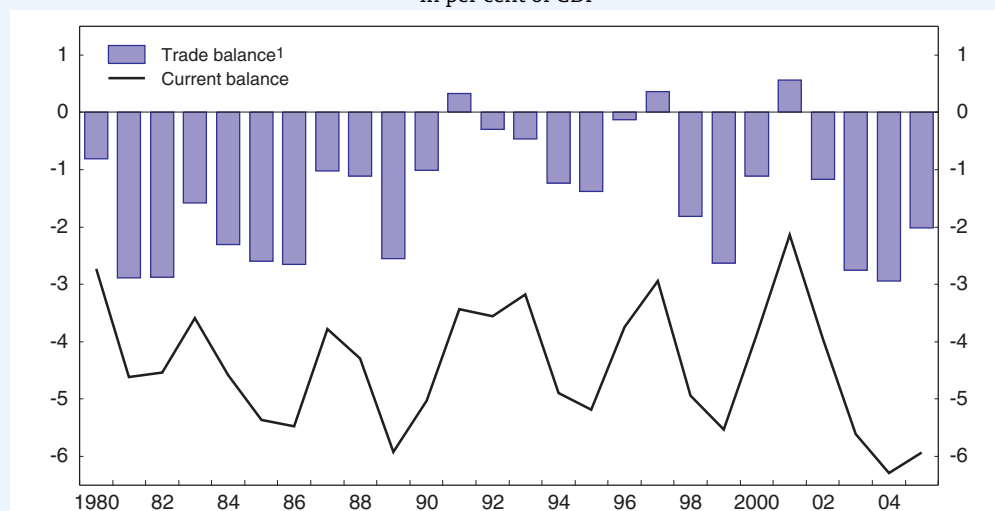
Box 1.2. Is the large current account deficit a concern?

Australia has consistently run a current account deficit, averaging 4½ per cent of GDP over the last two decades. In 2005 the current account deficit was just under 6% of GDP, with the trade deficit in goods and services of 3¼ per cent of GDP and a deficit on investment income of 2% of GDP. As a consequence net foreign liabilities reached about 60% of GDP in 2005. Despite growing concerns about global current account imbalances, there are reasons to argue that the Australian current account deficit is not a cause for immediate concern.

In order to run a stable current account deficit a country with significant foreign debt must eventually run a stable surplus on goods and services trade to ensure that foreign debt does not grow faster than GDP. Australia's balance of trade has also been in modest surplus on several occasions in the recent past (Figure 1.9), suggesting that adjustment should be possible without putting excessive strain on the economy. In this respect flexible labour and product markets are important features which should help to ensure that resources can be re-allocated between non-traded and traded goods sectors with a minimum of disruption.

Figure 1.9. **Current account and trade balance**

In per cent of GDP



1. In goods and services.

Source: OECD Economic Outlook 79 and National Accounts databases, July.

From a saving and investment perspective, the deterioration in the current account reflects strong growth in investment. Since 2000, nominal investment has been increasing as a share of GDP, initially driven by strong dwelling investment, but more recently by strong business investment. On the other hand, national saving has remained broadly stable as a share of GDP, in part because of support from the strong fiscal position of the government sector. Thus the counterpart of the current account deficit is entirely private sector borrowing, which is in large part explained by the run up in house prices in combination with a deregulated financial system. As housing wealth stabilises in relation to household income the household saving rate should increase and help to reduce the current account deficit. From a policy perspective this does, however, provide an additional motivation for ensuring the government does not run a structural deficit and also that policy settings do not inadvertently discourage private savings.

Box 1.2. Is the large current account deficit a concern? (cont.)

Recent survey evidence also suggests that despite having substantial net foreign liabilities there is limited exposure to foreign currency risk. In particular, about 95% of external liabilities are either in Australian dollars or hedged to Australian dollars, while foreign currency assets exceed foreign currency liabilities (Becker *et al.*, 2005). An important implication of this is that any sudden depreciation of the exchange rate would not immediately increase the domestic currency burden of servicing the outstanding foreign debt. It might also be noted that net foreign liabilities expressed as a share of private sector wealth, rather than GDP, have been falling over the last decade (Gruen, 2006b and RBA, 2006).

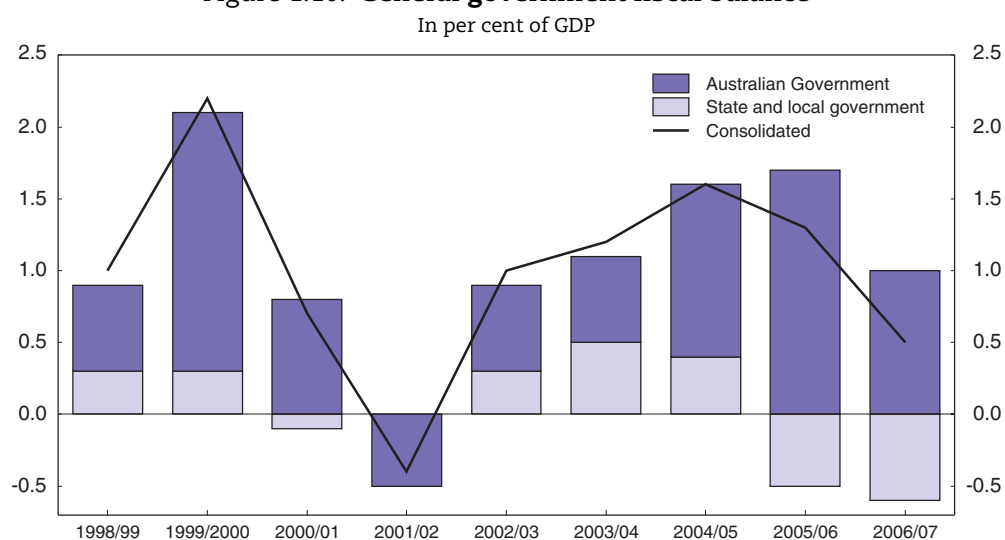
above or near the upper limit of the target range in the next quarters, the course of interest rates will be more influenced by developments and forecasts for measures of underlying inflation.

The major uncertainty concerns the timing and extent of the eventual downturn in commodity prices. The continuing strength of China and its seemingly insatiable demand for commodities may mean that the upswing is more vigorous in which case further monetary tightening may be needed. The implications for fiscal policy of such a scenario are discussed below.

Fiscal policy

The combined balance of the federal and state governments has been in modest surplus in all but one of the last eight years (Figure 1.10). It slipped temporarily into deficit in 2001/02 following the global economic slowdown, but since then has recorded a string of surpluses of around 1 to 1½ per cent of GDP, although the surplus is expected to fall to ½ per cent of GDP in fiscal year 2006/07. Sustained surpluses have resulted in a steady fall

Figure 1.10. General government fiscal balance

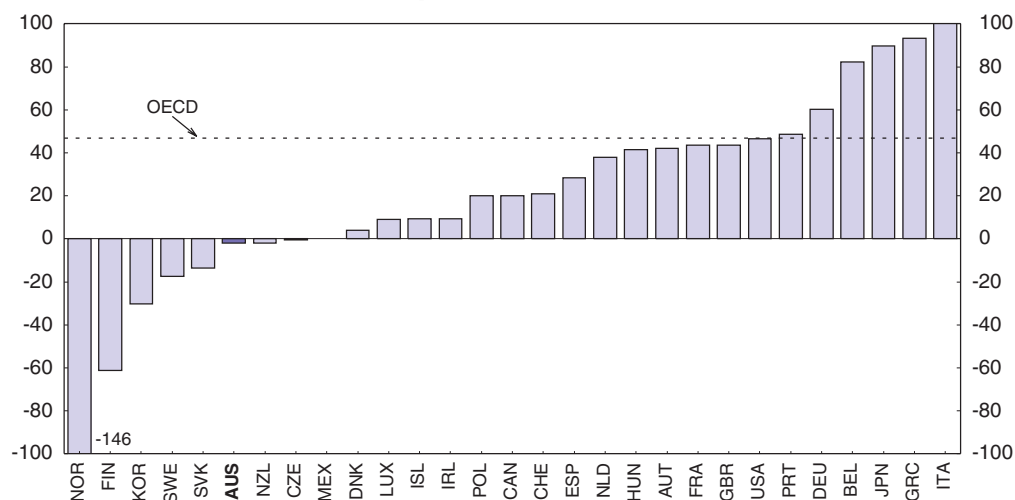


Source: Australian Government (2006), *Budget Paper No. 1: Budget Strategy and Outlook 2006-07*, Australian Government, Canberra.

in consolidated general government net debt, which was eliminated in 2004/05 with Australia joining a small group of OECD countries, where general government financial assets exceed debt (Figure 1.11).

Figure 1.11. **General government net debt**

In per cent of GDP, 2006¹



1. Projections.

Source: OECD Economic Outlook 79 database.

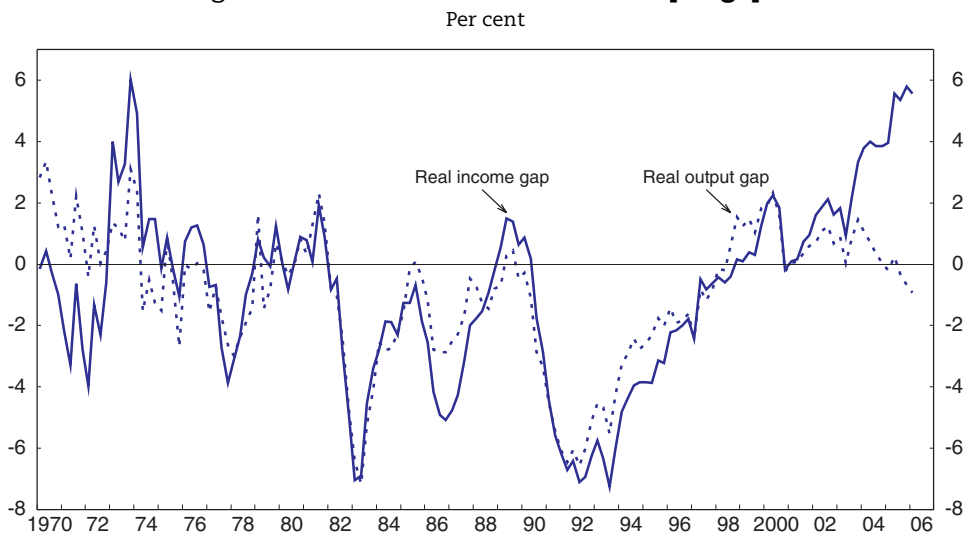
The strong terms of trade have boosted the fiscal balance

Recent surpluses might be regarded as essentially structural, as standard calculations of the cyclical component of the fiscal balance (Girouard and André, 2005) have remained relatively small over recent years given the limited size of the estimated output gap (Figure 1.1, panel B). However, the output-gap based calculation and interpretation of the cyclical or transient component of the fiscal balance may convey a misleading picture in the case of commodity-rich countries, where the fiscal position may be particularly sensitive to movements in the terms of trade (Ford, 2005). Indeed, although the fiscal strategy of the federal government explicitly refers to the cycle, official scepticism about the practical usefulness of both the output gap and cyclically-adjusted fiscal balances means that such measures are not published by the government. In this context a macroeconomic model simulation conducted by the OECD on the Treasury's TRYM model is illustrative of the potential problems of cyclically adjusting the fiscal balance in the presence of a terms of trade shock; a rise in world commodity prices lowers the level of GDP (due to the loss of competitiveness of non-resource exports), although it raises real gross domestic income and real gross national expenditure and boosts the fiscal balance (Annex 1.A1). Clearly in these circumstances the implied inverse association between the output gap and the fiscal balance does not readily fit with the standard OECD methodology of calculating the cyclical component of the fiscal balance.

An alternative approach is to base the calculation of the transitory component on a measure of the real income rather than the real output gap. The real income gap is the same as the output gap when the terms of trade are at their equilibrium level, which is here taken to be the long-run historical average.³ An increase in the terms of trade relative to their long-run equilibrium will raise both real domestic income relative to real GDP as well

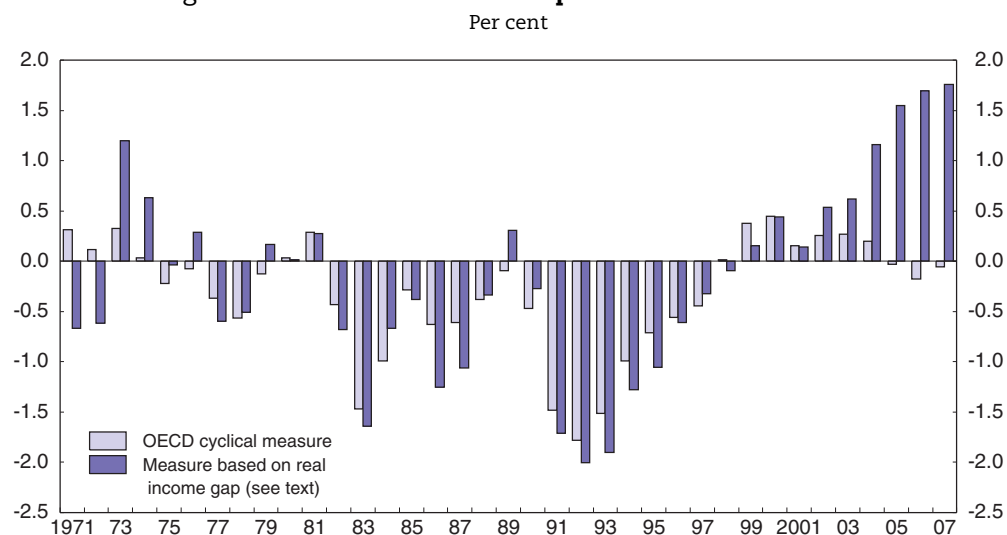
as nominal GDP by boosting the GDP deflator. As tax receipts are quite closely related to nominal GDP, an increase in the terms of trade will also boost tax receipts. For most OECD countries the difference between the real output and real income gaps is small. However, for a major commodity exporter during a commodity price boom the difference can be substantial; for Australia the real income gap in the final quarter of 2005 is estimated to be plus 5½ per cent whereas the standard OECD measure of the output gap was minus ½ per cent (Figure 1.12). Assuming a unitary elasticity between nominal GDP and aggregate tax revenue, every percentage point of the real income gap translates into a temporary tax share equal to 0.3% of GDP, because the average share of tax receipts in GDP is 30%.⁴ The difference between this alternative calculation and the standard OECD calculation of the cyclical component is small over much of history, but currently substantial (Figure 1.13); based on the real income gap the temporary component of the fiscal balance is about 1¾ per cent of GDP in 2005 and 2006,⁵ whereas, according to the standard OECD methodology it is close to zero.

Figure 1.12. **Real income and real output gaps**



Source: ABS (2006), *Australian National Accounts: National Income, Expenditure and Product* (cat. No. 5206.0) and OECD Economic Outlook 79 database.

There is, however, at least one major caveat to the calculation based on the income gap. It assumes that the equilibrium terms of trade will revert to their long-run historical average. An extreme alternative assumption would be that the current elevated terms of trade represent a new sustainable equilibrium. In this case the real output and real income gaps would coincide and so imply that the transient component of the fiscal balance is negligible. The official view underlying the recent federal budget lies between these two extreme cases, namely that the terms of trade are likely to fall in future years, but remain at levels well above the long-run historical average. This is consistent with a view that the prospective growth of China, together with gains from being a substantial net importer of information and communication technology products (for which there has been a trend fall in prices), have led to a permanent favourable shift in the terms of trade. In particular, on a per capita basis, China lags well behind developed regional neighbours such as Japan and Korea in terms of consumption of a range of resources and resource intensive products

Figure 1.13. **The transient component of tax revenues**

Source: ABS (2006), *Australian National Accounts: National Income, Expenditure and Product* (cat. No. 5206.0) and OECD Economic Outlook 79 database.

such as steel (Maurer et al., 2004). On the basis of the budget assumption that the terms of trade eventually fall (but only by 2008/09) from 28% above the long-run historical average (since 1960) to about 14% above it, the transient component of the fiscal balance would currently be about $\frac{3}{4}$ to 1% of GDP, which compares to a projected general government surplus (for the Australian government and the states) of $\frac{1}{2}$ per cent of GDP in 2006/07.

The federal government's fiscal position

The strengthening in the general government finances over recent years is entirely due to improvements at the federal rather than state level. This is perhaps not surprising given that the federal government tax revenue bases (particularly corporate profits) are more responsive to the commodity boom than those of the states. The series of federal government surpluses are consistent with the broad objectives of the medium-term fiscal strategy "to maintain a budget balance, on average, over the cycle" and more particularly "to maintain budget surpluses over the immediate 2-year forecast period while growth prospects are sound" (Box 1.3).

A striking feature of recent federal budgets has been the series of positive fiscal surprises (Figure 1.14). Tax revenues for the immediate year ahead have been under-predicted in each of the last four budgets by an average of AUD 6.8 billion, about 0.8% of GDP, with the fiscal balance under-predicted by AUD 7 billion. An important factor behind the buoyancy in corporate tax receipts (Figure 1.15) is the surge in commodity prices which has boosted corporate profitability. Business direct taxes were 5.7% of GDP in 2004, 2 percentage points above the average since 1960, and the third highest in the OECD after oil producers Norway and Mexico.⁶ Econometric estimates reported in Annex 1.A1 suggest that the terms of trade boost to the corporate tax share, compared to its long-run historical average, could be as much as $1\frac{1}{2}$ per cent of GDP in fiscal year 2005/06, which is reassuringly similar in magnitude to the transient component of tax revenues calculated using the real income gap. There may, however, be other factors which have been boosting corporate taxes. An internal review⁷ by the Treasury concluded, without quantifying their contribution, that these comprise: the privatisation of major government business enterprises; growth in capital

Box 1.3. The medium-term fiscal strategy

The primary objective of the central government's fiscal strategy, introduced in 1996, has been to maintain the budget in balance, on average, over the economic cycle. The fiscal strategy also includes a number of secondary objectives, including:

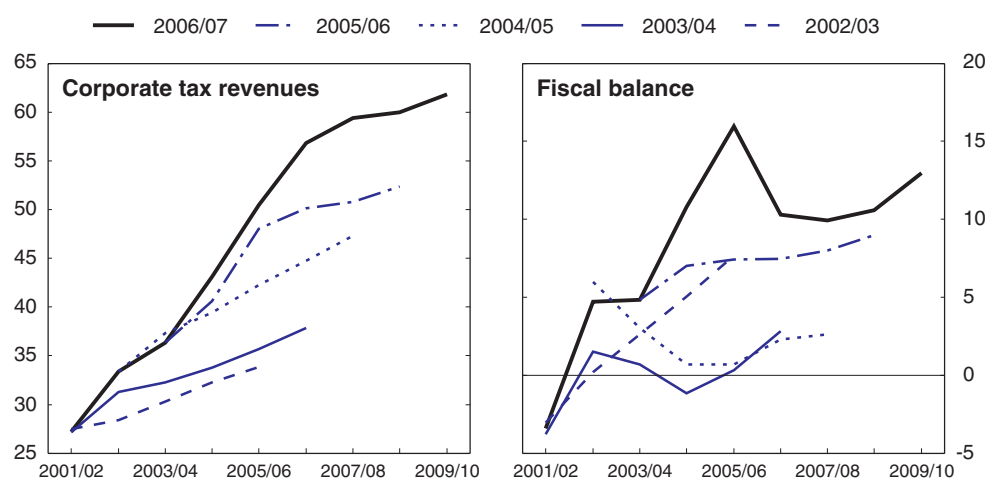
- Maintaining budget surpluses over the immediate 2-year projection period while growth prospects are sound.
- Not increasing the overall tax burden from 1996/97 levels to ensure that budget balance is achieved through a disciplined approach to expenditure rather than by recourse to increasing the tax burden.
- And improving central government net worth.

A feature of the Australian fiscal strategy in comparison with that in many other OECD countries is that it allows for considerable discretion. For example, there is no attempt to precisely date the economic cycle (as for example in the United Kingdom) nor is there any precise definition of "sound" growth prospects. While there is a high degree of discretion there is also a high degree of transparency. The *Charter of Budget Honesty* imposes a number of reporting requirements on the government to ensure transparency, including the requirement to publish a pre-election economic and fiscal outlook report once a federal election has been called, and an *Intergenerational Report* every five years to assess the long-term sustainability of current government policies.

Source: Australian Government (2005), *Budget Paper No. 1: Budget Strategy and Outlook 2005-06*, Australian Government, Canberra.

Figure 1.14. **Fiscal surprises have been repeatedly positive**

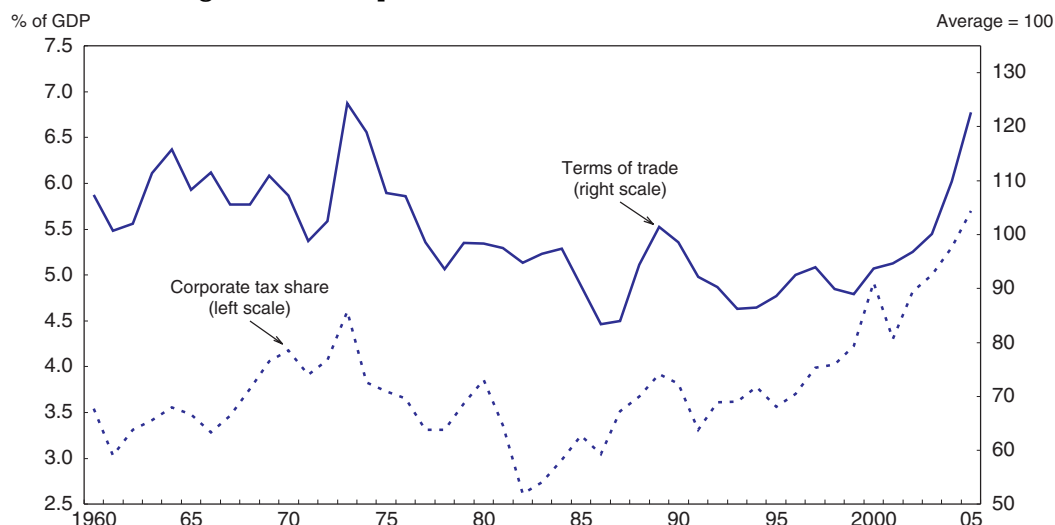
Successive budget projections, in billion AUD



Source: Australian Government, *Budget Papers* from various years, www.budget.gov.au.

gains made by companies; the long period of economic expansion which has reduced the stock of carried-forward losses to offset tax payable; more effective tax compliance activities of the Australian Taxation Office; and increased incentives to pay tax.

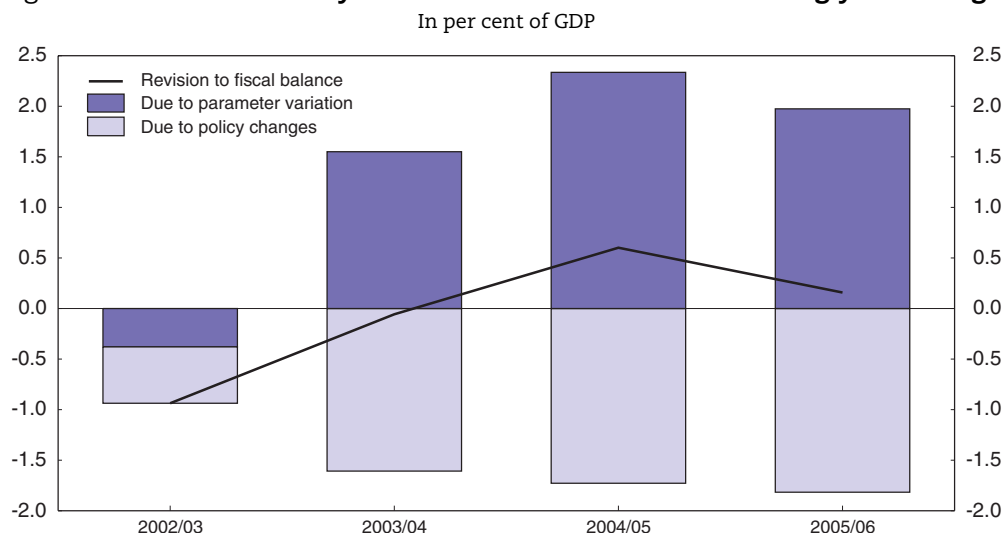
While most of these initial tax revenue surprises have been reflected in a similar upward revision to the fiscal balance for the immediate year, the upward revisions have been much smaller at longer horizons. Based on the analysis provided in the budgets, the projected change in the fiscal balance compared to the previous budget can be

Figure 1.15. **Corporate tax share and the terms of trade**

Source: OECD Economic Outlook 79 database.

decomposed into two components: *policy changes*, such as increased discretionary public expenditure or tax cuts; and *parameter variation*, resulting from unanticipated changes in the tax base or benefit expenditures due to unexpected changes in activity. Over the last three budgets the implied upward revisions to the 4-year ahead fiscal surplus resulting from *parameter variation*, in practice overwhelmingly greater tax revenue buoyancy, have ranged between 1 and 2% of GDP (Figure 1.16). However, the actual revision to the 4-year ahead fiscal surplus has never exceeded 0.9 per cent of GDP because the additional revenue buoyancy has been mostly offset by policy changes, which for the 2005/06 and 2006/07 Budgets have mainly been in the form of tax cuts (Boxes 1.4 and 1.5).

The fiscal stance implied by the latest budget projections is moderately expansionary and coincides closely with the latest OECD projections. Projected GDP growth is in line with

Figure 1.16. **Revision to 4-year ahead fiscal balance in following year's budget**

Source: Australian Government, *Budget Papers* from various years, www.budget.gov.au.

Box 1.4. The 2005/06 Budget measures

Between the 2004/05 and 2005/06 Budgets, policy decisions were introduced costing an estimated 1% of GDP in 2005/06 and about 1½ per cent of GDP in subsequent years, with personal income tax cuts accounting for about 40% of the fiscal costs beyond the first year (Table 1.3).

Table 1.3. Policy changes with major fiscal implications in the 2005/06 Budget¹

Estimated cost, in per cent of GDP

	2005/06	2006/07	2007/08
Revenue reductions			
Personal income tax cuts	0.3	0.6	0.6
Superannuation surcharge abolition	..	0.1	0.1
Other revenue changes	0.1	0.2	0.1
<i>Total revenue (A)</i>	<i>0.4</i>	<i>0.8</i>	<i>0.8</i>
Expenditure increases			
Current expenditure (B)	0.5	0.6	0.6
Net capital expenditure (C)	0.0	0.0	0.0
Total effect on surplus (= A – B – C)	–0.9	–1.4	–1.4

1. Changes include all those policy decisions since the 2004/05 Budget up to and including the 2005/06 Budget, although in practice most of the policy decisions were announced in the latter.

Source: Australian Government, Budget 2005-06, various *Budget Papers*, www.budget.gov.au/2005-06.

Personal income tax cuts to be implemented in two stages were decided as follows:

- From July 2005, the 17% rate was reduced to 15%, the 42% threshold was increased from AUD 58 001 to 63 001 and the 47% threshold was increased from AUD 70 001 to 95 001 (compared with AUD 80 001 announced in the 2004/05 Budget).
- From July 2006, the 42% threshold was to be further increased to AUD 70 001 and the 47% threshold was to be further increased to AUD 125 001.

The surcharge on superannuation contributions is abolished which will increase incentives to make additional contributions.

The tariff applying to imported business inputs was removed with effect from May 2005.

most estimates of potential growth with the federal budget surplus expected to fall from 1¾ per cent of GDP in 2005/06 to 1% of GDP in 2006/07, remaining at this level to 2009/10 with both spending and revenue stable as a share of GDP.

Critical assumptions underlying the medium-term projections are those regarding commodity prices, the terms of trade and the implications for corporate profits and taxes. The budget projections assume that current high commodity prices elicit a global supply response so that export commodity price levels (and the terms of trade) stabilise and do not increase through 2006/07, and thereafter fall back in 2008/09. Nevertheless, the terms of trade is assumed to remain 14% above their long-run average level. As a consequence, the growth of corporate tax revenues slows substantially over the projection, but as a share of GDP only falls by 0.3% of GDP from the peak of 2006/07, compared with the increase of nearly 2% of GDP over the previous five years (Figure 1.17). The high level of commodity prices, as previously discussed, is not the only explanation for the current buoyancy in

Box 1.5. The 2006/07 Budget measures

Between the 2005/06 and 2006/07 Budgets policy decisions were introduced costing an estimated 1.3% of GDP in 2005/06 and about 1¼ per cent of GDP in subsequent years, with the largest cost accounted for by cuts in personal income tax (Table 1.4).

Table 1.4. Policy changes with major fiscal implications in the 2006/07 Budget¹

Estimated cost, in per cent of GDP

	2006/07	2007/08	2008/09
Revenue reductions			
Personal income tax cuts	0.6	0.9	0.9
Business tax cuts	0.0	0.1	0.1
Other revenue changes	0.0	0.0	0.0
<i>Total revenue (A)</i>	<i>0.7</i>	<i>1.0</i>	<i>1.0</i>
Expenditure increases			
Current expenditure (B)	0.5	0.6	0.6
Net capital expenditure (C)	0.1	0.0	0.1
Simplifying taxation of superannuation ² (D)	..	0.2	0.2
Total effect on surplus (= - A - B - C - D)	-1.3	-1.7	-1.8

1. Changes include all those policy decisions since the 2005/06 Budget up to and including the 2006/07 Budget although in practice most of the policy decisions were announced in the latter.

2. Because the simplification of the taxation of superannuation is a proposal rather than an actual measure costings are allowed for centrally rather than reflected in portfolio budget statements.

Source: Australian Government, Budget 2006-07, various *Budget Papers*, www.budget.gov.au.

Personal income tax cuts

Income tax thresholds are increased for low and middle-income earners and the top tax rates are lowered for higher income tax earners. Specifically:

- The 30% threshold increases from AUD 21 601 to 25 001 (from about 40 to 46% of average full-time earnings).
- The 42% marginal tax rate is cut to 40% and the threshold increases from AUD 63 001 to 75 001 (from about 117 to 139% of average full-time earnings).
- The top marginal tax rate is cut from 47 to 45% and the threshold increases from AUD 95 001 to 150 001 (from about 176 to 278% of average full-time earnings).

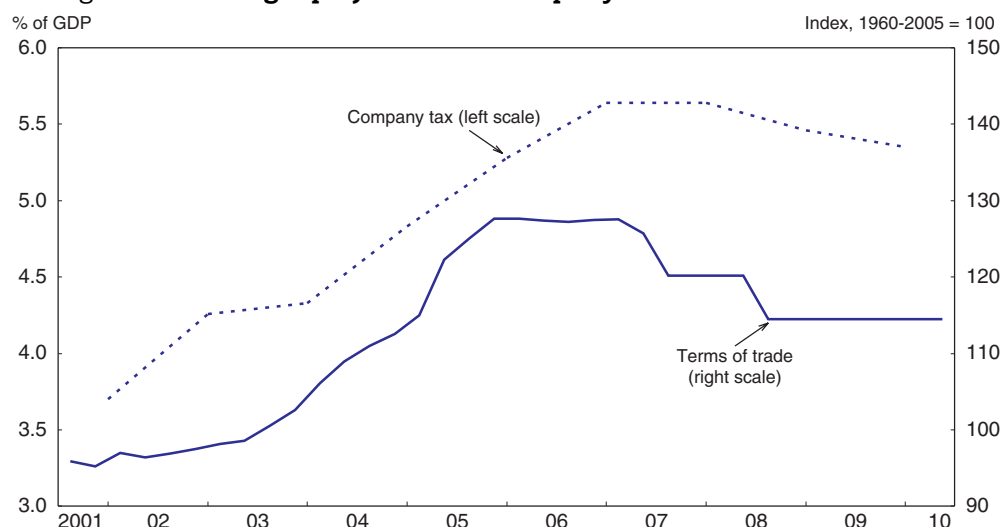
Following these changes more than 80% of taxpayers face a marginal income tax rate of 30% or less. The increase in the top marginal tax rate threshold to AUD 150 001 will mean that around 2% of taxpayers will be subject to a marginal tax rate of 45%, but will only reach this threshold if they earn about three times average full-time earnings.

Business taxes

The diminishing value rate for determining depreciation deductions will be increased from 150 to 200% (referred to as a “double declining balance”). This measure is intended to improve resource allocation by aligning depreciation deductions for tax purposes more closely with the actual decline in the economic value of assets.

Simplifying pensions

Following recommendations by the *Taskforce on Reducing Regulatory Burdens in Business* (2006) the government announced a plan to simplify and streamline superannuation which includes a number of proposals to simplify the tax arrangements and restrictions that apply to superannuation benefits, with the objective of encouraging higher retirement savings and improving incentives to work.

Figure 1.17. **Budget projections of company taxes and terms of trade**¹

1. Data from 2005/06 onwards are forecasts from the 2006/07 Budget.

Source: Australian Government (2006), *Budget Paper No. 1: Budget Strategy and Outlook 2006-07*, Australian Government, Canberra; The Treasury, Australian Government.

corporate taxes. But even so, there is a risk that other factors supporting corporate tax buoyancy also prove to be transient (such as strong financial sector profits), although other factors may be more permanent (such as improved tax compliance). Nevertheless, there is a risk that the eventual fall in the corporate tax share is greater than envisaged in the budget projections. The loss in the share of corporate taxes in the budget projections is more than counterbalanced by a rise in the share of personal income taxes resulting from fiscal drag (i.e. bracket creep) which, as discussed below, is greater than for most other OECD countries.

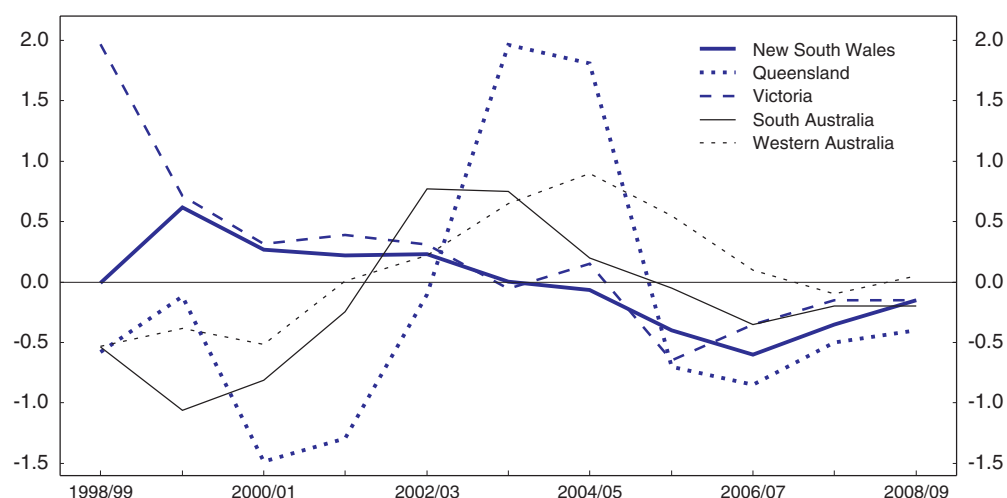
The states' fiscal position

In aggregate, the states eliminated net debt in 2001/02 and up to 2004/05 had run fiscal surpluses in six of the previous seven years. The strong fiscal performance at the state level is partly due to the widespread adoption of medium-term fiscal policy frameworks. Most of these frameworks have explicit objectives which usually include some combination of: an explicit objective for net debt or net worth; maintaining a triple-A credit rating; and either an objective to run a sustained fiscal surplus or else a substantial operating surplus (i.e. excluding net capital outlays).

Prior to the 1990s many state governments had targeted a cash "current" account in balance or surplus reflecting the traditionally central role of the states in infrastructure provision (Robinson, 2002). The recession in the early 1990s – combined with chronic deficits and sizeable debt – led to rating downgrades, motivating sub-national governments to adopt rules requiring balanced budgets and medium-term debt reduction. The medium-term orientation of fiscal policy and the introduction by all Australian governments of accrual accounting reduced the risk of fiscal slippage and improved short-term stability (Sutherland et al., 2005).

The aggregate government balance of the states is, however, expected to move from a surplus of $\frac{1}{2}$ per cent of GDP in 2004/05 to an estimated deficit of about $\frac{1}{2}$ per cent of GDP in 2005/06 which is also projected for 2006/07, with all of the large states, except Western Australia, expected to be in deficit (Figure 1.18). Both Western Australia and Queensland,

Figure 1.18. **State general government fiscal balances**
Per cent of gross state product



Source: ABS (2005), *Australian National Accounts: State Accounts, 2004-05* (cat. No. 5220.0); ABS (2006), *Government Finance Statistics, Australia, 2004-05* (cat. No. 5512.0); Australian Government (2006), *Budget Paper No. 3: Federal Financial Relations 2006-07*, Australian Government, Canberra.

the two large states most directly benefiting from the commodities boom, have previously been running surpluses. They benefit most directly from royalty income related to mining activities; in Western Australia this has increased from just over 1% of gross state product (GSP) in 2003/04 to 1¾ per cent in 2005/06; in Queensland royalties and land rent have increased from ½ per cent to 0.8% of GSP over the same period. However the buoyancy of the states' tax base (which is mainly payroll and property taxes) in general is less closely related to the commodities boom than corporate taxes which are owed to the federal government. Conversely, in most states, but particularly in New South Wales, revenues have under-shot expectations reflecting the impact of a softer housing market on property-related taxes. The states are, however, generally forecasting an improvement in their fiscal balances by 2008/09 with net debt levels remaining low as a share of output.

Progress in implementing tax reform

The tax system has been substantially reformed since 2000 (OECD, 2004). In particular, a *New Tax System* was introduced, replacing narrowly-based indirect taxes with a broadly-based Goods and Services Tax (GST). In addition a series of changes to business taxes were implemented in response to recommendations of the *Ralph Committee*. Nevertheless, the issue of further tax reform has continued to receive political and media attention, in part fostered by the recent series of positive fiscal surprises. Against this background the government commissioned a report to compare the Australian tax system with that in other countries (Hendy and Warburton, 2006). Although comparisons were drawn with many countries, a subset of nine OECD countries was selected as a focus comparator group, being chosen because the tax-to-GDP ratio is broadly similar to the Australian. Together with Australia they are referred to in the report as the OECD-10. Australia is a relatively low tax country with a total tax burden in 2003 of 31½ per cent of GDP compared with the OECD average of over 36%. The following discussion reviews the main findings of the report in the context of the ongoing tax reform debate, past OECD Survey recommendations as well as recent tax changes.

The taxation of wages

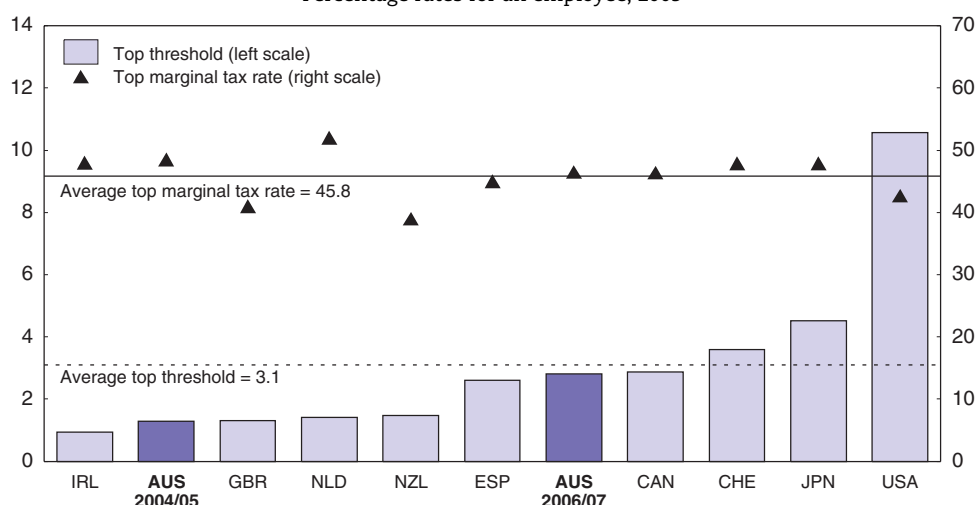
The Australian tax benefit system is highly progressive. Comparing the tax wedge for an individual with no dependent on 67% and 167% of average wages, Australia has the second most progressive tax benefit system among the OECD-10. Strong progressivity inevitably gives rise to high average levels of taxation for higher income earners. Two issues of concern were highlighted in the previous Survey: firstly, the large gap between the top personal marginal income and the corporate tax rate may encourage tax avoidance via the redefinition of personal income as company income; secondly, the top marginal tax rate bites at a relatively low income level and so may encourage migration of skilled workers. While taxation can be an important factor at the margin in shaping the economic decisions of individuals on where to work, it is only one of a range of considerations. Of the top 10 countries which highly-skilled Australians emigrate to, Australia experiences positive net migration of highly-skilled persons from all except for Hong Kong, despite the fact that all of these countries have top marginal tax rates lower than Australia's.

In 2004/05 Australia's top marginal tax rate of 48.5% (including the 1.5% Medicare levy) was the second highest among the OECD-10, and it applied to incomes equivalent to around 1.4 times average wages, which was the third lowest among the OECD-10 (when social security contributions are also included). Following the tax changes introduced in the 2006/07 Budget (Box 1.5) the top marginal tax rate will fall to 46.5% (including the 1.5% Medicare levy) and more significantly the top rate will apply to incomes around 2.8 times average wages (the fifth highest among the OECD-10). Indeed, the widening of the tax brackets implies a fall in the *average* tax rate for a single person on twice average wages of more than 2 percentage points and for those on three times average earnings by nearly 4 percentage points (Figure 1.19). However, in percentage terms, the 2006/07 Budget delivered even greater tax cuts to low income earners. From 2006/07, the low income tax offset (LITO) will increase from AUD 235 to 600. The LITO will begin to phase-out from AUD 25 000 (up from AUD 21 600) and will provide tax relief up to AUD 40 000 (up from AUD 27 475). Those eligible for the full LITO will not pay tax until their annual income exceeds AUD 10 000. Combined with the increase in the 30% threshold to AUD 25 001 from 1 July 2006, and the reduction in the lowest income tax rate from 17 to 15% that was announced in the 2005/06 Budget, this will improve the rewards from working for low income earners. Overall, the extent of the changes in the 2006/07 Budget suggest that the priority for future tax cuts should now be to reduce the high effective marginal tax rates faced by many households in the lower income deciles since they may now have a greater effect on overall labour supply, as discussed further in Chapter 6.

The extent of the changes in the 2006/07 Budget appear all the more extensive when contrasted with the relative stability of the average effective income tax rate between 2000/01 and 2005/06 once the tax rate is normalised on average nominal wages (Figure 1.20). This relative stability has arisen, despite a series of tax cuts, due to continuing strong growth in nominal incomes and the tendency for taxpayers to move into higher tax thresholds as nominal income increases – fiscal drag. At least four of the OECD-10 countries analysed in the International Comparison of Australia's Taxes automatically index their tax thresholds to inflation each year (Canada, Netherlands, United Kingdom and United States). In addition, Switzerland makes an adjustment after the price level has risen by at least 7% since the last adjustment and Spain indexes its tax thresholds at 2%. There is thus a precedent for Australia adopting some default indexation of tax thresholds as a means of making changes to the tax system more transparent. It would also imply a more reasonable baseline

Figure 1.19. **Comparison of top tax thresholds¹**

Percentage rates for an employee, 2005

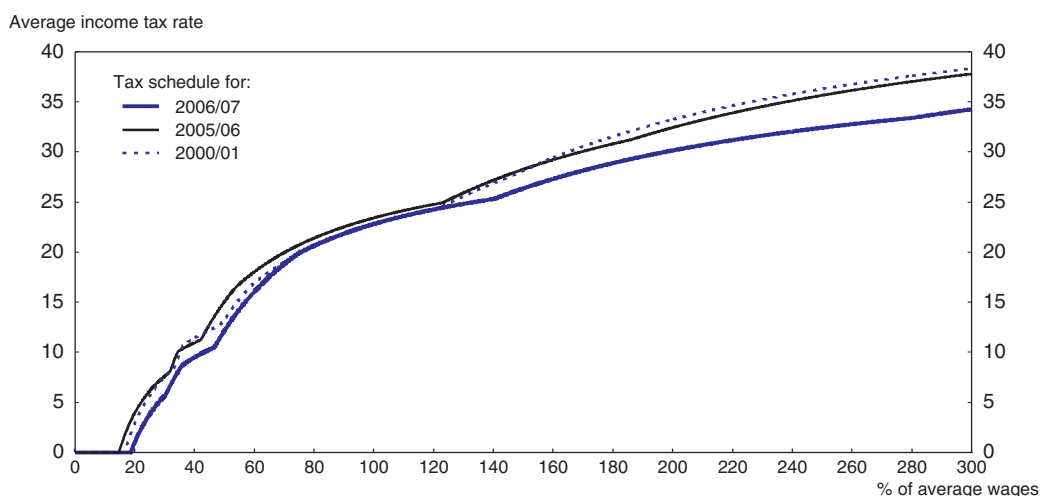


1. The top marginal tax rate is calculated as the additional central and sub-central government personal income tax (combined rate), plus employee social security contribution (all-in rate), resulting from a unit increase in gross wage earnings. The threshold is the level of gross wage earnings (in multiples of the average wage) at which the top marginal combined personal income tax rate is reached.

Source: Preliminary data from the OECD Tax database, May 2006.

Figure 1.20. **Average income tax rate for a single person¹**

At different wage levels, per cent



1. Average tax rate includes Medicare levy.

Source: OECD calculations and ABS (2006), *Average Weekly Earnings, Australia* (cat. No. 6302.0).

forecasting assumption for the budget projections. Otherwise the implicit assumption is that beyond any tax cuts for the current year, the income tax burden will rise over the remainder of the 4-year projection horizon. It is noted, however, that the government's current approach of making periodic changes to the tax scales provides greater fiscal flexibility to undertake further tax reform and that since 1995/96 personal tax cuts exceeded those that would have arisen as a result of indexing tax thresholds for inflation.

The government commissioned Taskforce report "Rethinking Regulation" noted that attention could be given to further simplification of the tax system to reduce compliance

costs. The government announced a range of measures in the 2006/07 Budget that will reduce the complexity of the tax law and reduce compliance costs for taxpayers. Of note is the proposal to end benefit taxation for most individuals aged 60 or over in receipt of superannuation income. The change to the treatment of end benefits will significantly reduce the complexity in this area of the law. Other recently announced or introduced measures that serve to reduce complexity and compliance costs are the alignment of small business thresholds; increases to certain thresholds in the administration of fringe benefits tax and the introduction of a bill to remove inoperative provisions from the income tax law. The government should continue to seek opportunities to simplify the tax law. One option which might be considered is to allow taxpayers a standard minimum deduction. While this would be contrary to the general principle that taxpayers should be able to deduct only expenses actually incurred, in some other countries this approach has effectively removed the need for taxpayers with simple affairs to lodge tax returns.

Taxation of goods and services

The tax take from value added and sales taxes at 4¼ per cent of GDP is broadly in line with the OECD-10 average, but mainly because both the United States and Japan have an exceptionally low share of about 2%. Compared with all OECD countries, it is the fifth lowest. Similarly, the 10% statutory GST rate is the fourth lowest among all OECD countries and is significantly below the OECD (unweighted) average of 17½ per cent. This suggests that one option would be to shift more of the overall tax burden to the GST, although this does raise issues at the heart of fiscal federalism (Chapter 3).

Corporate tax

As for skilled workers, the relative tax burden is one factor among many influencing the location decision of multinational companies, but nevertheless one which needs to be continually monitored given the increasing mobility of firms. The share of corporate taxes in GDP is relatively high; in 2003 Australia had the highest corporate tax burden of the OECD-10 at 5.3% of GDP, 2 percentage points above average. However it is likely that much of this difference is due the commodities boom, rather than being explained by a more onerous corporate tax regime. The 30% statutory corporate tax rate is slightly below the OECD-10 average. However, Australia does have the lowest value of depreciation allowances of the OECD-10 countries if the value is measured as the present value of depreciation as a proportion of initial purchase price. The changes introduced in the 2006/07 Budget to make depreciation deductions more generous (Box 1.5) will bring Australia closer to the generosity of regimes in other OECD-10 countries.

Property and transaction taxes

Virtually all property and transaction taxes in Australia are levied by the state, territory, and local governments. Australia's reliance on property and transaction taxes is broadly in line with the average of the OECD-10. However, the tax burden from taxes on immovable property is below the average of the OECD-10, but Australia has the highest financial and capital transaction tax burden. In particular, Australia's top rate for stamp duty on conveyances of 7% is the second highest of the OECD-10. There is international evidence that such stamp duties have a strong distortionary effect on transactions and hence labour mobility (van Ommeren and van Leuvensteijn, 2003). In addition to stamp duty on conveyances, the Australian states and territories also levy a number of other

Box 1.6. Recommendations concerning fiscal policy and taxation**Fiscal policy**

- In the short-term if there were to be further increases in commodity prices, it would be desirable to save any resulting positive surprises to tax revenues rather than being used for permanent tax cuts or spending initiatives.
- In the event of a pronounced fall in the terms of trade and a downturn in the global economy, it will be important to allow the automatic stabilisers to work, including, to allow at least temporarily modest fiscal deficits if that downturn were severe.

Taxation

- Recent cuts in the higher rates of personal income tax and the widening of thresholds are to be welcomed. However, the extent of changes in the 2006/07 Budget suggests that the focus of any future tax cuts should switch to reducing high effective marginal tax rates faced by many households in the lower income deciles.
- Remaining financial and capital transactions taxes, mostly levied at the state level, should be phased out quickly.
- The government should continue to seek opportunities to reduce the complexity of the tax law. One option which might be considered is to allow taxpayers a standard minimum deduction. While this would be contrary to the general principle that taxpayers should be able to deduct only expenses actually incurred, in some other countries this approach has effectively removed the need for taxpayers with simple affairs to lodge tax returns. The possibility of raising the GST tax take, primarily via a base broadening, should be considered. Revenue from this measure could be used to reduce the direct tax burden on labour and further address vertical fiscal imbalance. However, such a change in the tax base would require the agreement of all state governments and would also require significant changes to the financial arrangements between the federal and state government.

financial transaction taxes, including stamp duties on mortgages, leases, shares and rental arrangements. The Goods and Services Tax was intended to replace a number of financial and capital transactions taxes. The Australian Government has recently reached an agreement with all states and territories on timetables for the abolition of the majority of the taxes that the GST was intended to replace, including a range of business stamp duties.

Taxation of retirement savings

Pension savings are, as in other OECD countries, tax-favoured compared with the treatment of other savings. Yoo and de Serres (2004) find that pension savings in Australia are the 8th most tax-favoured among all OECD countries and the 4th among the OECD-10. But another aspect of the taxation of retirement savings stands out clearly in international comparison, namely its complexity. Pensions are taxed at three points; contributions, earnings on accumulated assets and benefit payments. This can confuse retirement decisions and incentives to invest in pensions as well as imposing additional costs, not least because of the need to obtain specialised financial advice. The report of the Taskforce on Reducing Regulatory Burdens on Business (2006) recommended giving high priority to a major simplification of the rules relating to pensions. In response to these concerns the government announced in the 2006/07 Budget (Box 1.5) a plan to sweep away a raft of

complex tax arrangements that apply to pension benefits, because this is the area where complexity is greatest.

Under this plan, those aged 60 and over who have already paid tax on their superannuation contributions and earnings would not pay tax on their superannuation benefits from July 2007. As superannuation benefits would no longer be assessable income, there would be an incentive to continue to work while drawing down on superannuation as less tax will be paid on work income. Superannuation benefits can still be accessed before the age of 60, although they would be taxed under new simplified rules. As part of the superannuation reform there will also be a reform of the pension assets test taper rate which would reduce from AUD 3 to 1.50 per fortnight for every AUD 1 000 of assets above the free area with effect from September 2007.

The removal of the benefits tax should assist people in planning for their retirement, including whether to make additional contributions, by simplifying the pension system. It will also increase retirement incomes and encourage pre-retirement savings: for a person earning AUD 1 000 per week over 40 years, assuming employer contributions of 9%, the projected retirement income as a result of the planned change is increased from AUD 798 to 934 and the increase in average retirement income period with additional savings of AUD 50 per week would be an increased retirement income of AUD 192. With pension benefits tax-free from age 60 there will also be an incentive to remain in the workforce longer.

Notes

1. Recent estimates by the Reserve Bank suggest that foreign ownership of the resources sector is around 50% and is probably higher than in previous resource booms (RBA, 2005).
2. There is no unambiguous statistical evidence in favour of one measure of core inflation over another. A comparison of various measures, including statistical measures and exclusion-based measures, shows that statistical measures in particular provide less noisy measures of inflation. Most measures also have predictive power for the CPI over a long sample, but over the most recent period of inflation targeting (when headline inflation has been very stable) there is more modest evidence that they predict headline inflation (Roberts, 2005).
3. The real income gap is calculated as $[(\text{real domestic income}/\text{potential output}) - 1 - \alpha]$, where potential output is the OECD measure of potential output (OECD, 2006) and α is a constant calculated to ensure that the average real income gap is equal to the average real output gap over history.
4. Arguably the elasticity between nominal GDP and aggregate tax revenue is probably greater than unity due to fiscal drag, which in Australia may be particularly large, as discussed further below.
5. The calculations are based on the most recent *Economic Outlook* projection which assumes the terms of trade remains close to recent levels until the end of 2007.
6. The three OECD countries – Australia, Canada and Norway – for which there is a statistically significant (at the 5% level) positive correlation between the terms of trade and the corporate tax share over the last three decades are unsurprisingly all major commodity producers.
7. See Box 1 on pages 5-7 of Australian Government (2005).

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ANNEX 1.A1

Treasury model simulations of a terms of trade shock

This annex reports a model simulation by the Australian Treasury's TRYM large-scale macro model as an additional method of assessing the fiscal implications of a terms of trade shock. The TRYM simulation suggests that a shock to the terms of trade of 7%, caused by an increase in world commodity prices, would raise the fiscal balance by about ½ per cent of GDP over the first 2 years (Table 1.A1.1). An interesting feature of the simulation results is that the initial effect on GDP and employment is negative, due to the loss in competitiveness of non-resource exports as the exchange rate appreciates, but that there are strong positive effects on the volume of gross national expenditure. An implication of the initial adverse GDP effect is that conventional cyclical measures of the budget balance, which are related to movements in the level of GDP away from trend, might (erroneously) impute a negative transitory fiscal effect of the terms of trade shock.

Table 1.A1.1. **Treasury model simulation of a shock to the terms of trade**¹

	Units ²	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Terms of trade	%	7.16	7.23	7.14	7.10	7.11	7.15
Real exchange rate	%	5.90	5.54	5.19	4.88	4.64	4.48
GDP growth	% points pa	-0.80	0.17	0.37	0.38	0.37	0.34
GNE growth ³	% points pa	0.08	0.34	0.45	0.42	0.36	0.35
Employment growth	% points pa	-0.21	0.06	0.24	0.27	0.26	0.23
Inflation – consumption deflator	% points pa	-2.02	-2.04	-1.87	-1.57	-1.18	-0.74
Government borrowing	% points of GDP	-0.61	-0.50	-0.38	-0.32	-0.30	-0.29
Current account balance	% points of GDP	0.51	0.45	0.25	0.09	0.05	0.04

1. Shock to the terms of trade occurs through an increase in the price of commodity exports.

2. pa: per annum.

3. Gross national expenditure growth.

Source: The Treasury, Australian Government.

ANNEX 1.A2

Sensitivity of corporate taxes to the terms of trade

To examine the sensitivity of corporate taxes to both cyclical conditions and the terms of trade, corporate taxes as a share of GDP (CTSH) are regressed on the (logged) terms of trade (TT) and the OECD's measure of the output gap (GAP) using annual data. All data are taken from the OECD's Analytical Database (ADB). The equation also includes a linear time trend (TIME). The final preferred equation is:

$$\begin{aligned} \Delta \text{CTSH} = & 1.031 - 0.403 \text{CTSH}_{-1} + 0.103 \Delta \text{GAP} + 0.049 \text{GAP}_{-1} + \\ & (2.0) \quad (-2.5) \quad (3.1) \quad (1.3) \\ & 3.672 \Delta \log - 2.420 \Delta \log \text{TT}_{-1} + 2.342 \log \text{TT}_{-1} + 0.027 \text{TIME} \\ & (4.4) \quad (-2.6) \quad (2.4) \quad (3.2) \end{aligned}$$

where t-ratios are shown in brackets, Δ is the first difference operator.

Estimation period 1971-2005

Adjusted R-squared = 0.56

SE of regression = 0.24.

The equation easily passes standard diagnostics for serial correlation, heteroscedasticity and normality of residuals at conventional significance levels.

The long-run solution to this equation implies that an output gap of 1% boosts the corporate tax share by 0.12 percentage point of GDP whereas a 10% increase in the terms of trade raises the corporate tax share by 0.58 percentage point. This implies a much greater sensitivity of the corporate tax share to the terms of trade than to the output gap given that the standard deviation of the output gap is 1¼ percentage points, whereas the standard deviation of the (logged) terms of trade is 10½ per cent. An increase in the terms of trade by 30% – the difference between the level of the terms of trade projected for 2006 in *Economic Outlook* No. 79 and its long-run average since 1960 – is therefore estimated to raise the share of corporate taxes in GDP by 1¾ percentage points.

Chapter 2

Long-term structural challenges

Judged in terms of GDP per capita, Australia's ranking among the OECD countries has steadily improved since the beginning of the 1990s. It has now surpassed all G7 countries except the United States. This chapter reviews the main challenges that policy-makers need to address to sustain this strong performance. In framing policy responses it is important to recognise the over-arching framework of fiscal federalism which is of key importance in many areas which are crucial in determining long-run performance. In common with most other OECD countries, population ageing threatens to slow the growth in living standards over coming decades. To offset the adverse effect it will be important to pursue policies that underpin swift productivity growth and raise labour utilisation. International benchmarking is used to evaluate recent performance and to highlight weaknesses which need to be addressed by policy. With respect to productivity the most obvious areas which need addressing are improving product market competition in terms of infrastructure services, and raising labour market flexibility through streamlining industrial relations and improving workforce skills. There is scope for increasing labour supply from lone parents, women with families, the disabled and those aged over 55. Australia is better placed than most to deal with the fiscal pressures from ageing given a strong starting point and relatively modest growth in public pension liabilities. The main spending pressures are instead expected to come from health spending.

The political context of reform: getting the most out of fiscal federalism

The special chapter in this Survey examines the operation of fiscal federalism because it permeates many areas that are vital for determining long-run economic performance. The Council of Australian Governments (COAG) has recently endorsed a *National Reform Agenda* that, building on earlier arrangements, focuses not only on competition and regulatory issues, but also includes human capital issues such as health, education, training and work incentives. The relatively high degree of joint inter-governmental responsibilities in major functional areas, such as health care and education, makes co-operation and the setting of clearly-defined roles and responsibilities among the different levels of government essential for cost-effectiveness (Chapter 3). Moreover, regulating network industries is often the joint responsibility of the states and Commonwealth. Much progress has been made in this area, but infrastructure issues have again come to the fore, with infrastructure bottlenecks allegedly holding back exports (Chapter 4). Industrial relations are also guided by federal and state systems, though the recent WorkChoices legislation moves towards a simpler, national system (Chapter 5).

The major long-term challenge: responding to ageing

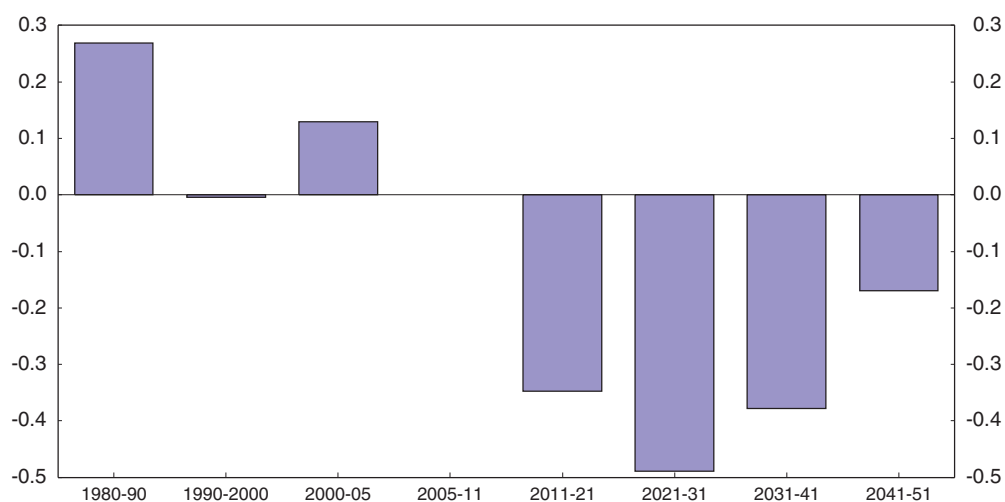
The extent of ageing, as summarised by the rise in the old-age dependency ratio to mid-century, is about the same as the average across all OECD countries. This change is substantial, with one quarter of the population expected to be over 65 in 40 years time, roughly double the present proportion. The order of magnitude of the possible effect on the growth in living standards can be gauged by splitting GDP per capita into three components:

$$\text{GDP per capita} = \text{output per head} \times \text{employment rate} \times \frac{\text{population of working age}}{\text{total population}}$$

The population of working age has generally grown slightly faster than the total population so the “demographic dependency effect”, the third term in the identity above, has mostly been positive over recent history. However, based on the most recent official demographic projection,¹ it is likely to subtract between 0.3 and 0.5% per annum from the growth in living standards over coming decades (Figure 2.1).

Ageing will further slow the growth of living standards as the working age population gets older, as the employment rates tend to decline markedly from the age of about 55. Recent projections by the Productivity Commission (2005) suggest that the aggregate labour force participation rate could fall by 7 percentage points over the next four decades, which if translated into a similar decline in employment rates would subtract on average an additional 0.3 percentage point per annum from the growth in living standards. Slightly more dated OECD projections suggest that the effect of the decline in the participation rate could be much larger (Burniaux *et al.*, 2004).² To offset the adverse effect on the growth in living standards it is important to pursue policies to raise productivity growth and labour utilisation. The remainder of this chapter begins by evaluating recent performance in an

Figure 2.1. **The demographic contribution to per capita income growth**¹
Per cent per annum



1. The demographic contribution to per capita income growth is here measured as the average annual percentage change in the ratio of the population of working age to the total population.

Source: ABS (2005), *Population Projections Australia* (cat. No. 3222.0) and OECD calculations.

international context, before using benchmarking to highlight weaknesses which need to be addressed by policy. Finally, the fiscal pressures that arise from ageing are also considered.

Benchmarking performance against other OECD countries

In terms of GDP per capita, Australia currently ranks 8th among all OECD countries, having surpassed all G7 countries except the United States (Figure 2.2). Progress both in absolute terms and relative to other countries was most rapid during the second half of

Figure 2.2. **Decomposition of the gap in GDP per capita**¹
Percentage point differences with respect to Australia, 2004



1. GDP based on 2004 purchasing power parities.

2. Based on total number of hours worked per capita.

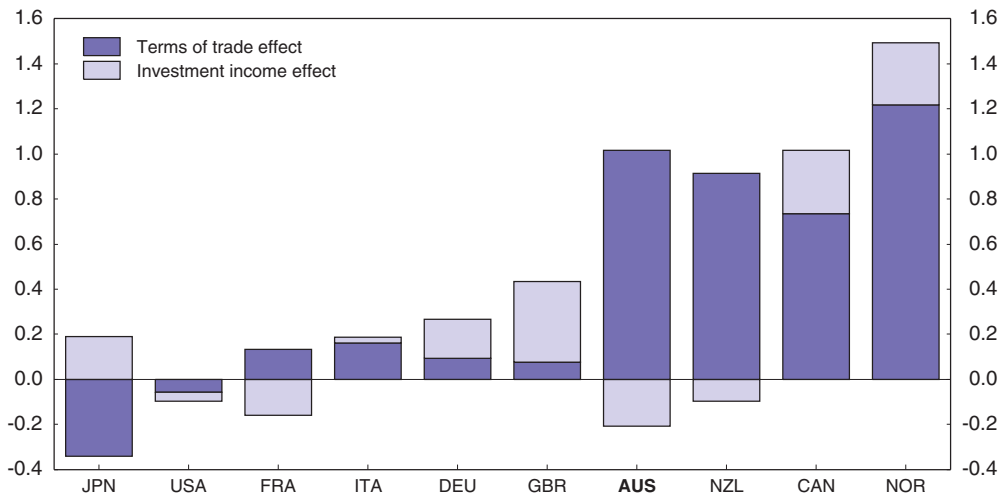
Source: OECD, Productivity database, January 2006.

the 1990s when growth on this measure was about 2¾ per cent per annum, but since the turn of the decade this has fallen back to 2%.

If, however, allowance is made for changes in the terms of trade to reflect increases in the purchasing power of residents, corresponding to a measure of real gross domestic income (GDI) rather than GDP, Australia's recent performance improves considerably. The terms of trade effect adds more than 1% per annum to the growth in living standards, which is a larger effect than for any other OECD country except Norway (Figure 2.3). Whether such an adjustment is appropriate to compare the performance of countries is debatable. Arguably the improvement in the terms of trade resulting from the recent global commodities boom does not represent a structural improvement in economic performance in the same way as an improvement in labour productivity or labour utilisation does. Alternatively, if the main purpose of economic activity is ultimately to improve consumption possibilities then at an aggregate level the changes ought to be considered to be similar. Perhaps a more difficult issue is judging how permanent the change in the terms of trade is likely to be. Recent research has suggested that over most of the period since 1960 the change in the terms of trade has had relatively little impact on domestic welfare, as improvements in one period tend to be offset by losses in another (Diewert and Lawrence, 2006). If it is entirely transitory, then real GDI would be a volatile benchmark with which to compare the performance of countries. On the other hand, if allowance is made for the increase in the investment income deficit since 2000, consistent with a measure of gross national income (GNI), then this would subtract 0.2 percentage point per annum from real income growth since 2000 (Figure 2.3).

Figure 2.3. **Additional real income growth effects**¹

Percentage points per annum, 2000-05



1. The terms of trade effect measures the difference between growth rates of real GDP and real gross domestic income (GDI), the investment income effect the difference between real GDI and real gross national income (GNI).

Source: OECD Economic Outlook 79 database.

Closing the productivity gap

The gap in GDP per capita with the United States is essentially explained by productivity (Figure 2.2), although this gap has narrowed since 1990. While cross-country comparisons are fraught with measurement problems³ and also reflect important differences in endowments and geography (Box 2.1) of the economies compared, they

Box 2.1. The effect of geographical remoteness on productivity

The degree of geographical remoteness is a factor in determining the degree of trade openness and is therefore also likely to matter for productivity growth. There is much evidence to suggest that openness to international competition is an important factor in encouraging firms to be more efficient and to innovate.

Ewing and Battersby (2005) construct a measure of remoteness by constructing a weighted average of distance from each partner country, where the weight reflects the GDP of the partner country. Among all OECD countries, Australia is more remote than every country except New Zealand. For example it is 3 to 4 times more remote than any of the major European economies. Nevertheless, particularly because of the growing importance of Asia, between 1950 and 1998 this measure of remoteness fell by around 13%, although the largest fall was for Korea by 29%, whereas all European countries became more remote, on average by around 20%. Although there was a slight increase in remoteness in 1998, related to the impact of the Asian crisis, it is likely that the downward trend has resumed, perhaps even more strongly, with the increasing importance of China in the global economy. Between 1999 and 2004 China has grown from being Australia's 6th most important destination for exports (by value) to its second (after Japan) with China's share of Australian exports rising to over 9% from under 5% in 1999.

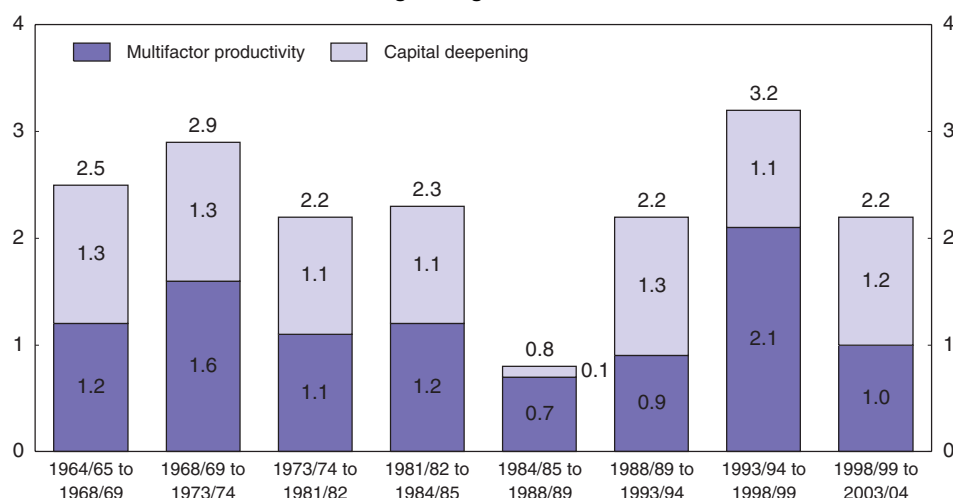
Battersby (2006) investigates further the link between geographical remoteness and productivity by estimating a simple labour productivity equation for individual states of the United States and Australia which includes an indicator measuring the proximity of the state to world output. This indicator is significant in the regression analysis and suggests that Australia's isolation from world economic activity accounts for as much as 45% of the gap in labour productivity between Australia and the United States.

nevertheless suggest that there still is considerable room for further gains in income and productivity levels.

The scope from further product market reforms

There was a marked surge in multi-factor productivity (MFP) growth from the early to the late 1990s. However, over the most recent cycle ending in 2003/04 both labour productivity and MFP growth would appear to have reverted to their respective long-run trends (Figure 2.4). A similar picture emerges from international comparisons; over the second half of the 1990s, productivity growth exceeded all G7 countries by a significant margin, but since the turn of the decade it has fallen behind the United States and appears unexceptional in comparison with other G7 countries. The reasons for the slowdown cannot be readily attributed to a changes in the rate of growth of physical or human capital, nor changes in industrial composition (Dolman *et al.*, 2005). The previous Survey argued that strengthened competitive pressures in the economy from the progressive implementation of the National Competition Policy (NCP) since the 1990s played a key role in the surge in productivity, together with other micro and macroeconomic reforms. This appears consistent with the finding that the aggregate productivity movements are present across a range of industries as well as OECD cross-country empirical evidence that increased competition boosts MFP (Nicoletti and Scarpetta, 2005). Thus, past reforms may have been realised in mainly one-off gains to the level of productivity. If this is indeed the case then it underlines the importance of completing the unfinished business on the NCP

Figure 2.4. **Growth in labour productivity over productivity cycles**¹
Percentage changes at annual rates



1. Market sector. Productivity cycles are the intervals between productivity peaks, as identified by the Australian Bureau of Statistics.

Source: ABS (2005), Australian System of National Accounts, 2004-05 (cat. No. 5204.0).

agenda, and as argued in Chapter 4, particularly further improving the efficiency in essential areas such as electricity, water, road and rail transport.

An alternative explanation for the strong performance over the second half of the 1990s is that the economy avoided a recession over this period, so that what was observed as a productivity surge might really be an unmeasured increase in hours worked (Quiggin, 2001). On the other hand measures of capacity utilisation, such as the OECD's measure of the output gap, suggest that the economy has been operating at a high level of utilisation over most of the last decade, including the period since 2000. Indeed, it seems more likely that a further payoff from the competition reforms has been an improvement in the resilience of the economy as resources can more readily flow between sectors and firms. Empirical support for this view is provided by Kent *et al.* (2005) who find a role for product and labour market flexibility in explaining a decline in aggregate output volatility among a panel of 20 OECD countries. On this view, an additional benefit of further reforms to improve competition would be enhanced resilience of the economy to withstand future shocks.

The scope from further labour market reforms

The Australian labour market ranks highly among OECD countries in many aspects of flexibility. Kongsrud and Wanner (2005) construct composite policy indicators of labour market regulation and find that Australia is among the most flexible of all OECD countries and that that this corresponds with a higher capacity for the labour market to adjust (as proxied by a range of measures including regional dispersion of unemployment, outflows from unemployment, incidence of long-term unemployment, etc.). One area where there has been considerable change is in the industrial relations arrangements, which have evolved gradually from a prescriptive, complex, set of rules, largely set by a judicial body, to a much more flexible system, with many enterprise and individual agreements. Nevertheless there is still scope for fostering greater flexibility. Further changes have been introduced with the WorkChoices Act, which will shape the setting of working conditions

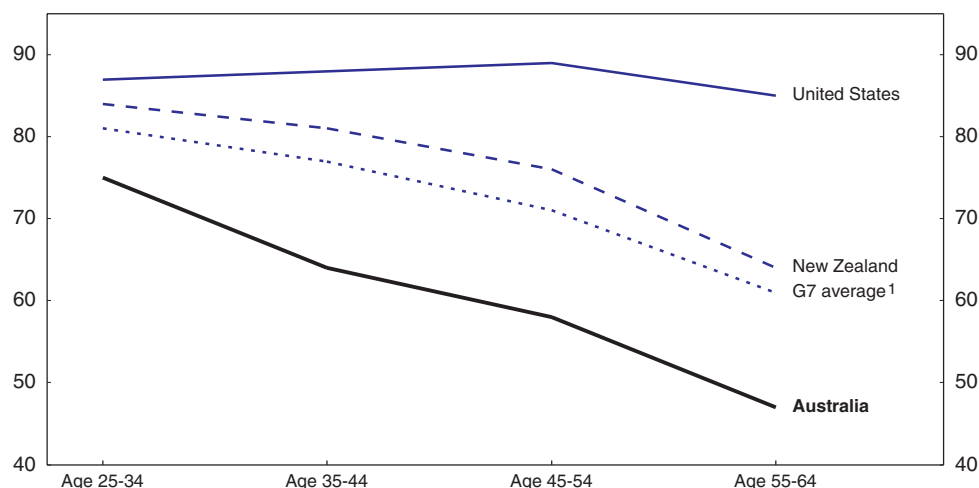
including wage determination, the setting of minimum wages and employment protection legislation. These changes are assessed in Chapter 5.

The scope from raising educational performance

The OECD *Growth Study* (OECD, 2003) highlighted the importance of human capital in explaining differences in growth performance among OECD countries. Using measures of educational attainment as a proxy for human capital, Australia compares poorly with the United States and other G7 countries, particularly in terms of the proportion of the population that has not attained at least upper secondary education (Figure 2.5). Applying the results from the *Growth Study* suggests that raising human capital (as proxied by the average years of schooling) to the level of the United States could raise GDP per capita by between 4 and 7½ per cent.⁴ This is in line with the estimate by Dowrick (2003) who finds that a rise in the average years of schooling by one year (which was roughly the difference with the United States in 2003) would eventually raise GDP by 8%. As older age cohorts are relatively less educated in comparison with many other leading OECD countries, the contribution which differences in human capital make to the productivity gap with other countries should decline over time. However, it is also important that the level of education attainment and the quality of education are appropriate to the needs of the country having regard to that country's stage of advancement, otherwise the expansion of education may not yield the gains (see, for example Wolf, 2004). Nevertheless, because the proportion of the youngest cohort who completes at least upper secondary education is still much lower than in the United States and most other G7 countries, the educational attainment of 25 to 34 year-olds should be monitored in the future. The educational attainment of the youngest cohort in future years is difficult to project, and it will depend on the education and training experiences of current and future 15 to 24 year-olds. Vocational training and educational attainment are also considered in Chapter 5.

Figure 2.5. Educational attainment by age

Population that has attained at least upper secondary education, per cent, 2003



1. Unweighted average.

Source: OECD (2005), *Education at a Glance*.

The scope from raising innovation performance

On a number of conventional indicators – especially research and development (R&D) intensity and patenting – innovation performance appears mediocre in comparison with the best performing OECD countries (OECD, 2006). A number of cross-country empirical studies, including the OECD *Growth Study*, have found an empirical link between various measures of innovation and growth or productivity performance. On the other hand, recent empirical work focussed on Australia has failed to find any robust relationship between R&D spending and productivity (Shanks and Zheng, 2006). Moreover, even on the basis of cross-country evidence, there is no straightforward empirical link from policy levers, through to innovation indicators and broader economic performance. For example, the size of the tax subsidy for private R&D investment is relatively modest in Australia compared with some OECD countries, but those countries (Mexico, Spain and Portugal) that subsidise R&D the most have an even lower R&D intensity, whereas many of the countries with the highest R&D intensity (including Finland, Germany, Sweden and Switzerland) do not provide any tax subsidy to R&D at all (OECD, 2006). Furthermore, some differences in innovation indicators are explained by factors such as industry structure; Davis and Tunny (2005) show that even if Australia had the same R&D intensities in 15 sub-industries as the United States (or Japan), the industry mix in Australia would still leave aggregate R&D spending (as a percentage of GDP) in these sub-industries at less than half the level of the United States (or Japan). On the other hand framework conditions and especially the degree of product market competition, which are found to be important in promoting R&D in cross country empirical work (Jaumotte and Pain, 2005), are among the most favourable in the OECD.

One aspect of innovation where Australia does rank highly among OECD countries is as a user of information and communication technology (ICT); investment in ICT as a share of gross fixed capital formation is among the highest in the OECD, exceeded only by the United States, Finland and Sweden (OECD, 2005a). Arguably, this is one of the most important measures of innovation performance because, given the trend decline in ICT prices, the benefits of innovation may increasingly accrue to the users rather than producers of ICT (Bayoumi and Haacker, 2002). Given that the industry structure explains much of the relatively low R&D intensity, that framework conditions appear favourable and that Australia is a strong user of ICT, innovation is not considered in a separate chapter in the remainder of this *Survey*.

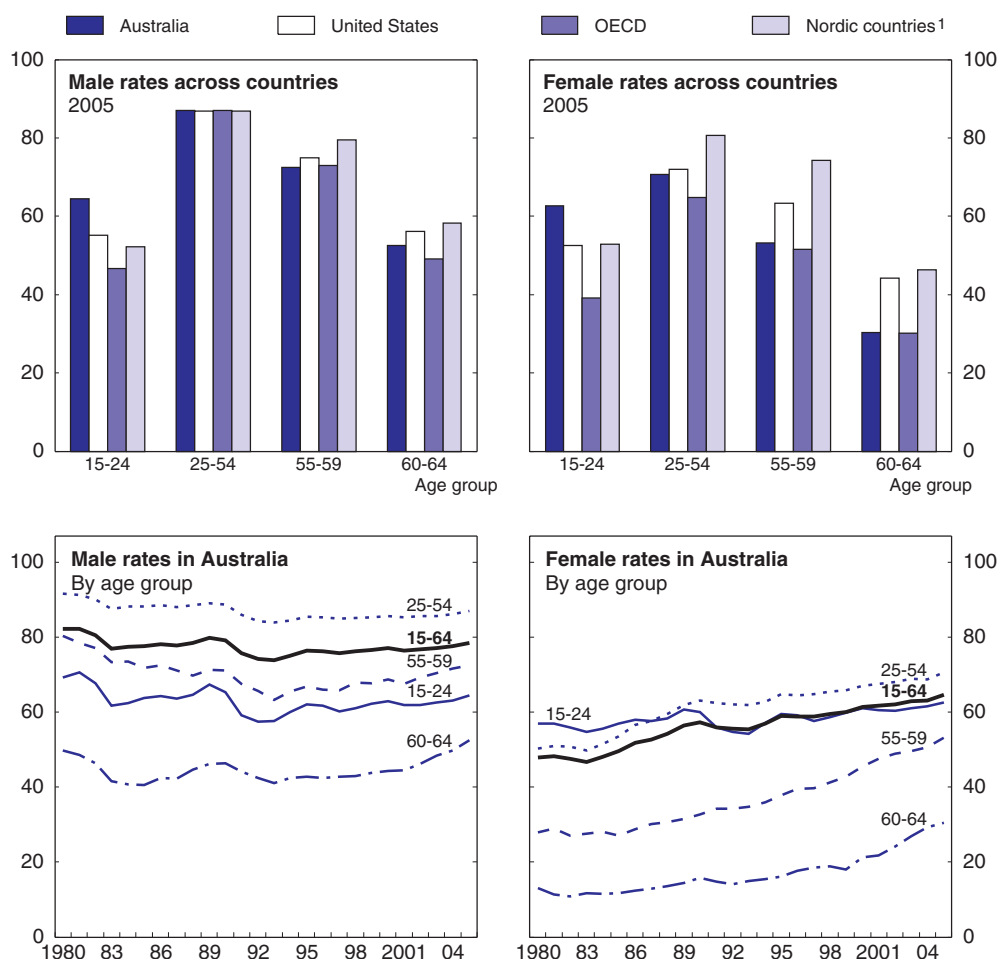
Raising labour utilisation

Overall labour utilisation is high in international comparison. However comparing employment rates with the strongest performers, including the United States and the Nordic countries, suggests scope for raising the employment rate, especially among those aged over 55 and among women of all ages (Figure 2.6, upper two panels).

These are, however, also the groups where recent progress has been made (Figure 2.6, lower two panels). Female employment rates, especially for older age groups, have been rising since the 1980s and have been primarily driven by females aged 25 to 54 years. The ageing of this cohort has been gradually increasing the employment rates of older female age groups. Nevertheless, the gap in employment rates for prime age women between those who have children and those who do not is among the highest in the OECD. Moreover, there is a high prevalence of part-time work. This raises a number of policy issues: firstly, whether high effective marginal tax rates (resulting from the interaction of

Figure 2.6. **Employment rates**

Employment as a percentage of population in the same age group



1. Denmark, Finland, Iceland, Norway and Sweden.

Source: OECD, Labour Force Statistics database, July 2006.

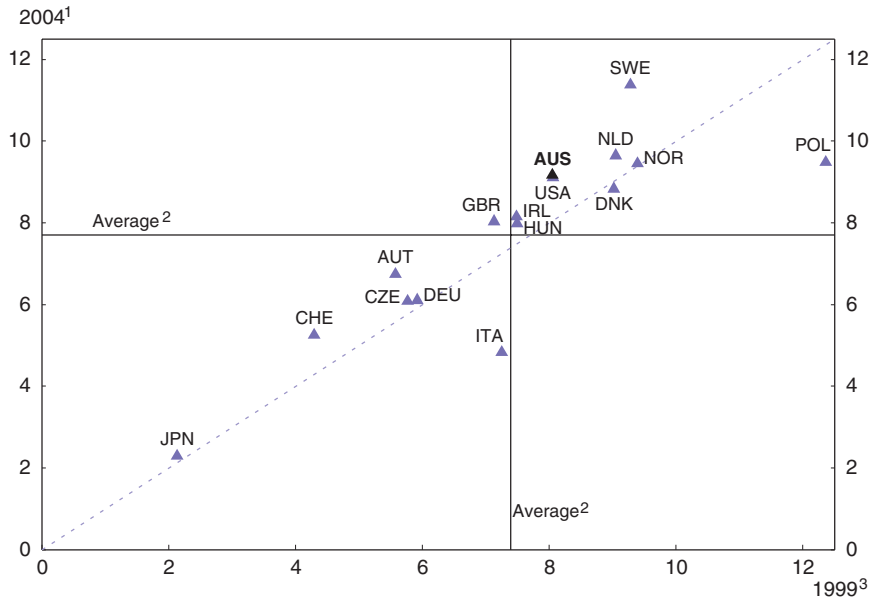
benefit withdrawal and marginal tax rates) are deterring women from entering the labour market or decreasing the number of hours they work; and secondly, whether public support for child care facilities is adequate.

There has also been a more modest turnaround in male employment rates. After falling over the 1980s and the early 1990s, the employment rates of older males began increasing – a development that has been observed in a number of OECD countries. Much of the increase may be related to the fact that the cohorts of older men most affected by poor labour market conditions in the early 1990s, as well as structural changes to the economy throughout the 1980s and 1990s, are now increasingly aged over 65.

While these developments are encouraging, the average effective age of retirement of both men and women is still well below the best performers in the OECD and also well below the official age of retirement at which the Age Pension can be drawn. While retirement decisions reflect choices by individuals, such choices may be distorted by policy settings. Of particular concern in this respect, has been the continued growth in the number of people on the *Disability Support Pension* (Figure 2.7), which appears to have been

Figure 2.7. Disability rates have worsened

Ratio of disability benefit recipients to working age population (age 20-64), per cent



1. 2003 for Czech Republic, Germany and Italy.

2. Unweighted average.

3. 2000 for Czech Republic.

Source: OECD calculations based on data from Labour ministries.

increasingly used as a pathway to early retirement. However, the number of disability pensioners has begun to level out, with growth of 0.9% between March 2005 and March 2006 which is the lowest in 20 years.

Child care, disability pensions and old age pensions are all areas where there has been much recent policy action under the government's *Welfare to Work* programme. These changes are reviewed in Chapter 6 and the case for further policy reforms is considered.

The long-term fiscal challenge from ageing

An important innovation in raising public awareness about the future fiscal pressures resulting from ageing was the publication in 2002 of the first *Intergenerational Report (IGR)*.⁵ The Productivity Commission (2005) published its own analysis more recently and came to broadly similar findings as regards the future fiscal pressure from ageing. The Productivity Commission's estimates for all levels of government showed that over the next four decades age-related public spending could rise by 6½ per cent of GDP (Table 2.1). These projections highlight that Australia differs from the typical OECD country as fiscal pressures come predominantly from increased health expenditure rather than pensions.

Pension outlays are less sensitive to ageing than in most other OECD countries because the public (first pillar) pension system, the *Age Pension*, is flat rate, means-tested, with a comparatively low replacement rate, aiming to prevent poverty. Moreover, an increasing share of the elderly will rely on incomes from occupational pensions. This is a consequence of the introduction of the *Superannuation Guarantee* in 1992, which, with few exceptions requires employers to provide a minimum level of pension contributions, currently set at 9%, for all employees earning above a (low) threshold level of wages.⁶

Table 2.1. **Fiscal pressures from ageing at all levels of government**

Age-related government spending, in per cent of GDP

	2003/04	2044/45	Difference (% points)
Health care	5.7	10.3	4.5
Aged care and carers	1.1	2.4	1.4
Pensions	2.9	4.6	1.7
Other social safety net	3.8	3.1	-0.6
Education	5.2	4.7	-0.5
Total	18.7	25.2	6.5

Source: Productivity Commission (2005), "Economic Implications of an Ageing Australia", *Productivity Commission Research Report*, March.

The Future Fund

The government has an objective to pre-fund public sector employee superannuation liabilities currently estimated to be AUD 96 billion (about 10% of GDP), representing the largest liability on the Australian government's balance sheet. This will be realised through the *Future Fund* (Box 2.2) which was established in 2005/06 with seed capital of AUD 18 billion, with further contributions to be sourced from future budget surpluses and asset sales. Fund earnings will be retained within the Fund and hence are not available for government spending and are excluded from the calculation of the "underlying cash balance". This means that fiscal policy will be tighter over future years than would otherwise be the case, initially by about 0.1 to 0.2% of GDP but eventually by perhaps about ½ per cent of GDP. The aim of the Future Fund is to fully offset the government's public sector superannuation liabilities by around 2020, thereby allowing the budget to cater for the increased fiscal pressures arising from the ageing of the population.

The Future Fund provides a framework to accrue financial assets while maintaining a government bond market. The explicit quarantining of the Future Fund separately from other medium-term objectives is laudable and will make an important contribution to pre-funding the fiscal costs of ageing its own employees. In particular, it should be seen in the light of cross-country evidence that attempts to pre-fund public pension liabilities by accumulation in social security systems can, without a high degree of explicit separation, be largely offset within the government sector by larger deficits in other budget accounts. Bosworth and Burtless (2004) find that when there is a high degree of separation between public employee pension funds and non-pension budgets (as is typical of US state governments) the accumulation of exceptionally large pension fund reserves does not lead the government to act as though the funds are available to finance non-pension outlays or tax cuts. Conversely, their examination of the experience of national governments that have attempted to pre-fund a portion of their public pension liabilities suggests that a large proportion (60 to 100%) of the fund accumulation in national social insurance systems is typically offset within the government sector by larger deficits in other budgetary accounts.

Pressures on health spending

The biggest pressure on public finances is expected to come from public health and long-term care spending, which accounts for about 70% of all health spending. Across Australian health services, average annual spending per person on those aged 65 to 74 is around four times higher than for those aged 15-34, and rises to around six times more for the those aged over 85 (Productivity Commission, 2005). There is a strong age-related

Box 2.2. The Future Fund

The prospect of Australian government net debt being eliminated raised the question of whether to maintain the government bond market and how to allocate the improving net position. In response to the outcome of a public review, the government announced in May 2003 its decision to keep the government bond market because of the important role that the market plays in the efficient management of interest-rate risks. In addition, as a positive step towards meeting imminent fiscal pressures of an ageing population, the government announced its intention to channel future surpluses into a Future Fund to ensure the funding of future unfunded superannuation liabilities.

Public sector employee superannuation entitlements are the largest financial liability on the federal government's balance sheet. This liability relates to past and current public sector employees. It is currently valued at around AUD 96 billion (about 10% of GDP) and is estimated to grow to around AUD 140 billion by 2020. The government has never fully funded its superannuation liability. However, in 1990 and 2005 the government closed the main civilian superannuation schemes to new members. From 2005 the government began paying the superannuation liability for new civilians employed as they accrue, rather than growing the superannuation liability further. Despite this, the existing superannuation liability is expected to continue to grow, largely due to growth in the military superannuation schemes and continued growth of entitlements accruing to existing members of the closed civilian schemes.

The Future Fund will be invested in a broad range of financial assets and be managed by an independent statutory agency governed by an appropriately qualified board – the Future Fund Board of Guardians (the Board). Further contributions to the Future Fund will be made from future realised budget surpluses and asset sales. The 2006/07 Budget estimates have been constructed assuming the full sale of the government's remaining shares in Telstra in 2006/07. The estimates also assume that the sale proceeds will be transferred to the Future Fund. However, the government has not made final decisions in relation to the sale, including the structure of the sale.

profile in other developed countries, although comparisons are difficult given different data definitions. In addition, and possibly more importantly, there will be growing demand for health services induced by the emergence and diffusion of new medical technologies, which interact with the ageing effect and may be compounded by the high income elasticity of demand for health care. Although some of the new technologies may lower the cost of health services, long-term trends suggest that this is by far outweighed by the overall expansion of treatment and rising unit costs of some technologies. Such effects are explicitly built into both IGR and Productivity Commission projections. To do otherwise might imply that “Australia could move from being a country that takes up new medical technology relatively quickly to one with a slow uptake” (Productivity Commission, 2005).

The Productivity Commission (2005) projects a rise in health and long-term care expenditure by as much as 6 percentage points of GDP to the middle of the century. There are four major categories of health expenditure: hospital care, medical services (Medicare), pharmaceutical and other expenditure, and the effects of population ageing vary across these components. They are strongest for hospitals and pharmaceuticals because these services have cost profiles that rise most steeply with age: average public expenditure costs per person for a male aged 65-74 on pharmaceuticals are more than 18 times those for a male aged 15-24 and hospital costs follow a similarly steep age-profile.

These projections suggest there is a premium on boosting efficiency of public spending on health and other key areas which are currently subject to complex patterns of joint government involvement that can lead to inefficiencies, as discussed in Chapter 3. Fragmented decision making and funding arrangements are particularly notable in the areas of hospital services and old-age care, creating incentives for cost and blame-shifting between government levels. States have responsibility for funding public hospitals, while the Commonwealth funds private medical services under Medicare and is responsible for old-age care.

One of the pressures highlighted in both the 2002 *Intergenerational Report* and the Productivity Commission projections is the continuing high rates of growth in the cost of the Pharmaceutical Benefit Scheme (PBS) (Box 2.3), reflecting the increased availability of new and more expensive drugs, which increase the total volume of prescriptions and cost to the government per prescription. Expenditure on pharmaceuticals per capita in 2003 was close to the OECD average and less than half of that in the United States (OECD, 2005b). However, the growth rate of real annual spending on pharmaceuticals between 1997 and 2003 was over 9% per annum compared with an OECD average of 5½ per cent, and was only just exceeded by the United States. According to the Productivity Commission projections PBS spending will rise from 0.7% of GDP currently to around 2.6% of GDP in 2044/45.

The *Pharmaceutical Benefits Scheme* has considerable advantages in keeping the cost of drugs low in international comparison while also allowing many new and innovative drugs to be made available if they pass a rigorous cost-effectiveness analysis. The use of co-payments, with differentials for the general population compared with concessional beneficiaries, is an important feature of the system to keep costs down. The system has evolved so that more patients are covered by concessional co-payments (either directly or through the operation of a safety net). In 2004/05 only 13% of all subsidised prescriptions were for the general patients (i.e. not covered by either the safety net or concessions) compared with a share of about half in the early 1980s. The fall in this share is explained by growth in the number of drugs which are priced below the general co-payment level (and hence do not attract a subsidy when dispensed to general patients), as well as growth in the share of pensioners, the extension of concessions to other welfare recipients and the introduction of the safety net facility. The size of the co-payment is a fixed nominal amount regardless of the prescription cost. Even after a recent 20% increase in the value of the co-payment, which initially caused much political controversy, concessional patients only pay about 10% of the average prescription cost of all concessional patients. Moreover, this share has generally fallen over time, as co-payments have generally been indexed to the consumer price index (CPI) which tends to rise more slowly than average prescription costs (Figure 2.8).

While growth in PBS outlays has recently slowed, historically strong growth in PBS outlays, as well as their projected growth in both the *Intergenerational Report* and Productivity Commission fiscal projections suggests options to constrain expenditure by increasing co-payments should be considered. A difficulty with any such increase is that the heaviest burden will be on low income earners, and there is also a risk that if patients go without necessary medication then other medical costs, such as for hospital care, may increase by more than any savings on pharmaceuticals. On the other hand, given that a rationale for co-payments is to promote consumer awareness of underlying costs it would be better to explore alternative indexation arrangements for PBS co-payments. Under the present system, whereby the level of co-payments is normally up-rated annually in line with the CPI, there will be a tendency for co-payments to continuously fall as a share of

Box 2.3. The Pharmaceutical Benefits Scheme

The Pharmaceutical Benefits Scheme (PBS) is an integral part of the health system in providing access to medicines at an affordable price. However, it has been the subject of increasing scrutiny as the cost of providing subsidised medicines has escalated.

In order to receive a pharmaceutical benefit under the PBS, a consumer must be prescribed a drug listed in the schedule of pharmaceutical benefits. The subsidy is automatically applied when the drug is dispensed at a pharmacy and the cost to the patient is no greater than the patient co-payment contribution rather than the full cost of the medication.

The cost of a medication is negotiated between the Australian government, through the Pharmaceutical Benefits Pricing Authority, and the supplier of the drug. To this agreed price mark-ups are added together with a dispensing fee. These are negotiated between the Australian government and the Pharmacy Guild of Australia under the Community Pharmacy Agreement. Due to the exercise of monopsony power the price of drugs are kept relatively low in international comparison (Productivity Commission, 2001): manufacturers' prices for Australia's top-selling pharmaceuticals were 160% higher in the United States, about 50% higher in the United Kingdom, Canada and Sweden and similar to prices in France, Spain and New Zealand; manufacturers' prices for top-selling new innovative pharmaceuticals were similar to those in all the comparison countries, except the United States and United Kingdom where they were about 100% and 50% higher, respectively.

Patient co-payment and safety net

When purchasing a medication under the PBS the maximum price a consumer pays is generally the patient co-payment which, as of January 2006 was AUD 29.50 for general patients, compared with the average full cost prescription of AUD 59 in 2004/05 (although it should be noted that this average excludes prescriptions that cost less than the co-payment and hence which are privately paid). For concessionary patients (low-income earners, welfare recipients including all pensioners, health care card holders, etc.) the co-payment was AUD 4.70 compared with an average dispensed price of a prescription for this group of about AUD 33 in 2004/05. Patient co-payments are indexed to movements in the consumer price index each year.

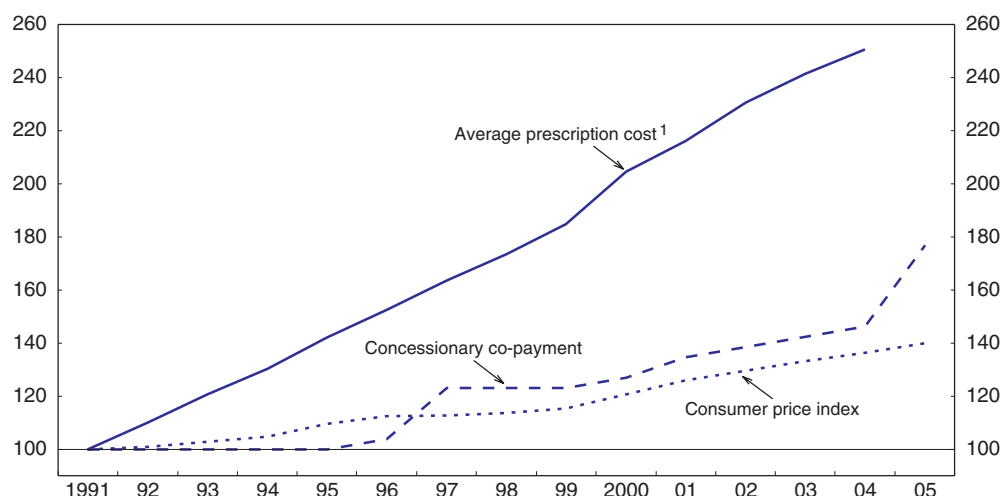
There are safety net provisions for a reduction in the patient co-payment contribution once a family has exceeded a certain amount on PBS subsidised medications in a calendar year. General patients are entitled to PBS medications at the concession price for the remainder of the year, while concession patients are entitled to PBS medications at no cost for the remainder of the year. In 2006, the safety net thresholds are AUD 960 (general) and AUD 254 (concession). In 2004/05 only 16% of all government expenditure subsidised general patients and 84% subsidised concessionary payments or prescriptions under the safety net scheme.

Brand premium and generic medicines

The government allows manufacturers to charge *brand premiums* on medications where cheaper generic brands are available. The brand premium is usually the price difference between the innovator brand and the generic brand. If the patient elects to purchase a brand with a brand premium rather than a cheaper generic brand, the patient must pay this brand premium in addition to the normal patient co-payment. The brand premium paid does not count toward the safety net threshold.

Figure 2.8. **Prescription costs and co-payments for concessionary patients**

Index, 1991 = 100



1. On a fiscal year basis: 1991/92 to 2004/05.

Source: Department of Health and Ageing (2005), "Expenditure and Prescriptions, Twelve Months to 30 June 2005", Pharmaceutical Benefits Branch and OECD Economic Outlook 79 database.

prescription costs or for the government to be required to implement large increases at discrete intervals which may be controversial – as the most recent increase in 2004/05 demonstrates. One option is to differentially index co-payment categories (general and concessional) and tie indexation to wages growth or average subsidy paid under the PBS. Another option would be to set a minimum absolute co-payment, but above this threshold the co-payment would be a percentage of prescription costs rather than a fixed nominal amount as at present. All such options would need to take account of the existing safety net arrangements and the need to maintain access to very high cost pharmaceuticals. In addition, an increased focus should be placed on preventative health measures to minimise future growth in health care costs and reduce long-term fiscal pressures.

Notes

1. The central projection of the Australian Bureau of Statistics, catalogue reference 3222.0.
2. In a baseline scenario, Burniaux *et al.* (2004) project a decline in labour force participation (based on the standard definition of the working age population) by an average 0.3 percentage point per annum between 2000 and 2025 and by 0.6 percentage point per annum between 2025 and 2050.
3. It should be taken into account that in a number of European countries in particular, high productivity levels also reflect the fact that low-skilled workers have been priced out of the market, due to collective bargaining arrangements, the interaction of tax and benefit systems and employment protection, with a corresponding chronic lack of employment opportunities for low-skilled workers.
4. The *Growth Study* results (OECD, 2003) suggest that a 10% increase in the stock of human capital (proxied by the average years of schooling) raises per-capita GDP by between 4 and 7%, whereas in 2003 the average years of schooling in Australia was 12.9 compared to 13.8 in the United States (OECD, 2005c).
5. Under the conditions of the Charter for Fiscal Honesty section 20(1)(b), an updated Intergenerational Report is publicly released and tabled within five years of the public release of the preceding report, that is, not later than May 2007.
6. For further details and discussion of Australia's pension system see OECD (2005d).

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ANNEX 2.A1

Progress in structural reform

This annex reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

Recommendations	Action taken since the previous <i>Survey</i> (February 2005)
Product market competition	
Enhance competition:	
<ul style="list-style-type: none"> Make the Australian Competition and Consumer Commission more accountable through the establishment of a formal process for reviewing proposed mergers. 	<p>The Dawson Bill introduces a formal merger clearance system, to operate in parallel with the existing informal clearance system. Under the formal system, decisions of the Australian Competition and Consumer Commission can be reviewed by the Australian Competition Tribunal.</p> <p>Under the formal clearance system, the ACCC will have 40 days to make a decision on the proposed merger. This 40 day limit can be extended at the applicant's request.</p> <p>The Dawson Bill is awaiting reintroduction in the House of Representatives following amendments passed by the Senate.</p>
<ul style="list-style-type: none"> Introduce new legislation to reduce uncertainty in the current law on the control of abuses of a dominant position of firms and to avoid overly legalistic analysis of the significance of market power. 	<p>Section 46 of the Trade Practices Act prohibits the misuse of substantial market power. The Trade Practices Legislation Amendment Bill (No. 1) 2006 amends section 46 to ensure that:</p> <ul style="list-style-type: none"> In predatory pricing cases, courts can consider both below cost pricing and recoupment in determining whether a corporation has misused its market power. Anti-competitive leveraging of market power from one market to another is prohibited. Market power derived from contracts, arrangements or understandings can be taken into account in assessing a corporation's degree of market power. <p>The Trade Practices Legislation Amendment Bill 2006 will be introduced in Parliament in 2006.</p>
<ul style="list-style-type: none"> The federal government should explore ways of ensuring cost-effective and timely investment decisions in regulated network sectors that operate across several jurisdictions. 	<p>Under the new National Reform Agenda (NRA), the Australian government will work with the states to implement a simpler and consistent national system of rail access regulation for interstate and some major intra-state rail tracks.</p> <p>All governments, through the Ministerial Council on Energy (MCE), are developing a national framework for energy market regulation. These reforms will incorporate the MCE's response to an independent review of the national gas access regime, including important operational improvements (<i>e.g.</i> new regulatory incentives for gas pipeline investment).</p>

Recommendations	Action taken since the previous Survey (February 2005)
<p>Increase competition in specific sectors:</p> <ul style="list-style-type: none"> Stronger efforts should be devoted to the implementation of a fully competitive national electricity market, including full retail contestability. Australian governments should seek to establish an integrated reform agenda with a co-operative framework covering all elements of land and shipping transport. Competition in fixed-line telecommunications and postal services should be promoted. The water reform agenda should be completed: rural water reform needs to be accelerated; the security of water access entitlements be improved and the water markets and trading be encouraged; and cross-subsidisation of water usage should be phased out. Address the unfinished business of the current NCP agenda, reinvigorate the commitment to reform, and extend competition and efficiency enhancing reforms to appropriate new areas, including social policy. 	<p>Retail contestability was achieved in all states, except Queensland. A single national regulator (AER) and an agency to manage the national market (AEMC) were established. Under the NRA, all governments have agreed to review key aspects of the national electricity market and make proposals to achieve a national transmission grid, address market structure issues impacting on competition and efficiency.</p> <p>Under the NRA, Australian governments have agreed to a range of transport-related reforms that encompass road, rail, ports and other export-related infrastructure, significant infrastructure facilities, and urban transport.</p> <p>A series of changes was implemented to the telecommunications regulatory framework to promote competition and enhance the adequacy of services for consumers, including the operational separation of Telstra.</p> <p>Tasmania and Western Australia signed the National Water Initiative (NWI), making it a nationwide agreement. Most governments have drawn up NWI implementation plans and there is progress in water trading, national water accounting standards and nationally compatible registers for water access entitlements.</p> <p>A new National Reform Agenda was endorsed in February 2006 by the Council of Australian Governments (COAG) that focuses not only on competition and regulatory issues, but also on human capital issues (health, education and training, and work incentives).</p>
Labour markets	
<p>Raise the employment of second earners, older workers, the disabled and lone parents:</p> <ul style="list-style-type: none"> Reduce further high effective marginal tax rates for low income families. Tighten the eligibility criteria for Disability Support Pension receipt. Extend the mutual obligation requirements to all working age income support recipients, including older workers, combined with a close monitoring and strict enforcement of activity tests. 	<p>The <i>Welfare to Work</i> package, announced in the 2005 Budget, entailed: an easing of the income test for the Newstart Allowance; reductions in the lowest marginal tax rate; and increased family assistance. The May 2006 Budget boosted further family assistance and introduced a restructuring of the tax scale, with the greatest tax cuts as a percentage of tax paid being provided to low income earners. This builds upon the 2004 Budget "More Help for Families" package which reduced the first FTB(A) taper from 30 to 20% and the FTB(B) taper was reduced from 30 to 20% and the income threshold increased from AUD 1 825 to 4 000.</p> <p>The <i>Welfare to Work</i> package has tightened the eligibility criteria for new claimants of disability support pensions (DSP). Applicants for DSP who are assessed as being capable of working 15 hours or more per week at award wages are no longer eligible for support after 1 July 2006, but will receive the Newstart Allowance instead.</p> <p>The <i>Welfare to Work</i> package aligned the participation requirements for older people on unemployment benefit closer to those for younger recipients; extended part-time participation requirements to new income support claimants who have a partial capacity to work, and extended part time participation requirements to principal carer parent and to parenting payment recipients (existing and new applicants) with school age children. Moreover, the reform package introduced a new suspension-based compliance framework.</p>
<p>Reform industrial relations:</p> <ul style="list-style-type: none"> Ease regulatory requirements for collective and individual agreements. Reduce the number of allowable award matters. Take the employability of low-skilled workers into account when setting award wage increases. Harmonise state and federal industrial relations arrangements. Contain the cost of dismissal procedures. 	<p>The <i>WorkChoices Act</i>, which came into effect in March 2006, moves industrial relation arrangements towards a nationwide system and simplifies the requirements for collective and individual workplace agreements. The number of allowable award matters has been reduced and the newly-created Fair Pay Commission will set a federal minimum wage, taking into account the employability of the low skilled. Businesses with up to 100 employees are exempted from unfair dismissal laws.</p>

Recommendations	Action taken since the previous Survey (February 2005)
Education and training	
Broaden the secondary school curriculum to reduce the risk of early school leaving and better integrate with the vocational education and training sector.	The 2005/06 Budget funded the establishment of technical colleges to enable year 11 and 12 students to undertake flexible school based apprenticeships.
Improve educational outcomes and opportunities to facilitate the school to work transition.	The 2005/06 Budget established a national network of industry career advisors to support young people through school and in making the transition from school to work. This initiative is to be developed further by the national network of industry career specialists announced in 2006.
Training and up-skilling of persons already in work, particularly older workers.	Recognition of prior learning is being improved through the COAG. This will bolster the ability of the VET system to recognise prior learning and hence the ability of students to progress through the system more easily. Ongoing support is provided to mature age workers from disadvantaged backgrounds to commence apprenticeships, through the New Apprenticeships Incentives Programme.
Improve the quality of higher education to keep the sector internationally competitive, particularly the quality of teaching and learning as well as governance and workplace relations in universities.	The Learning and Teaching Performance Fund commenced funding in 2006. It offers incentives to universities to improve the quality of learning and teaching. The Workplace Productivity Programme will receive funding from 2006-08. It aims to promote flexible working arrangements and improve productivity in the higher education sector. This programme will review or reform financial arrangements, operational management and human resource practices within universities. The 2006/07 Budget provided additional funding to expand by 50% the Capital Development Pool which assists higher education providers with capital projects.
Increase the responsiveness of higher education to labour market needs.	The 2006/07 Budget provided an increase in the FEE-HELP limit to assist full-fee paying students to meet the cost of their course with the support of an income contingent loan. This will enable more students to gain labour market skills and higher education institutions to offer such courses.
Aggregate fiscal policy	
The Australian government should aim for small surpluses when the economy is operating at or close to potential.	The Australian government has run budget surpluses of around 1% of GDP since 2002/03, which is projected to continue over the next four years.
Taxation	
Lower high marginal tax rates.	The May 2006 Budget reduced the top two marginal tax rates of personal income tax by 2 percentage points.
Raise the threshold at which the maximum marginal income tax rate cuts in.	Recent reforms have raised the threshold at which the top maximum marginal income tax rate cuts in to AUD 150 000, which is 2.7 times the average full-time wage.
Abolish distortionary state taxes and reform the payroll tax.	The Australian government has reached an agreement with all states on a timetable for the abolition of most business-related state taxes listed for review in the IGA, such as stamp duty on mortgages, leases, and credit and rental arrangements. In its response to the <i>Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business</i> , the Australian government supported the recommendation to progress, through COAG, with the harmonisation of the payroll tax base and administrative arrangements across the states and territories.

Chapter 3

Fiscal relations across levels of government

Key areas of public service provision are subject to complex patterns of joint government involvement that can lead to inefficiencies. Clarifying government roles and responsibilities is likely to have a significant potential for improving public sector efficiency. Fragmentation of decision making and funding arrangements, particularly in the areas of hospital services and old-age care, creates incentives for cost and blame-shifting between government levels. A collaborative approach between government levels to overcome some of these problems, as recently initiated by the Council of Australian Governments, would help to develop better governance arrangements and improve spending assignments. A less complex system of inter-governmental transfers would also contribute to a more effective specification of spending responsibilities. Stronger revenue-raising capacity of the states, through a further improvement in the efficiency of the state tax system, would raise the ability of sub-national governments to meet expenditure responsibilities and be better prepared for coping with demographic change.

The Australian federation was set up in 1901 and is among the world's oldest, after the United States (1789), Switzerland (1848) and Canada (1867). It is characterised by: i) widespread joint government involvement in most functional areas; ii) the presence of a vertical fiscal imbalance (i.e. disparities between the powers to raise revenue and to finance service delivery at different levels of government), which is addressed by federal transfers to the sub-central governments; iii) a comprehensive system of horizontal fiscal equalisation, aimed at eliminating disparities between the revenue-raising capacity and spending needs of the sub-central jurisdictions; and iv) a co-operative approach to fiscal management, with borrowing at all levels of government under the oversight of the Loan Council.

The relatively high degree of joint inter-governmental responsibilities in major functional areas, such as health care and education, makes co-operation among the different levels of government particularly vital for cost-effectiveness. Building on earlier arrangements, the Council of Australian Governments (COAG) has recently endorsed a National Reform Agenda that focuses not only on competition and regulatory issues, but also includes human capital issues (health, education and training and work incentives). Setting clearly-defined roles and responsibilities, especially in the key area of health care and related services where there is much overlap, is imperative for enhancing the accountability of the various government levels and improving service delivery. In relation to the physical infrastructure aspects of the National Reform Agenda, an unusual feature is that regulating network industries is often the joint responsibility of the states and Commonwealth. Much progress has been made in this area, but infrastructure issues have again come to the fore, with infrastructure bottlenecks allegedly holding back exports (Chapter 4). Industrial relations are also guided by federal and state systems, though the recent WorkChoices legislation implies a move towards a simpler national system (Chapter 5).

The presence of vertical imbalances, with the states relying on transfers from the Commonwealth, leads to design issues concerning the inter-governmental transfer arrangements to bridge the vertical fiscal gap – although such imbalances are not, by themselves, indicative of a problem (Productivity Commission, 2005a). Concerns include the potential for: undermining accountability to taxpayers for expenditure decisions; creating duplication and overlap in the provision of services; constraining beneficial tax competition across jurisdictions; and weakening incentives for tax and microeconomic reform. Raising the states' revenue mobilisation capacity would be a step towards reducing the vertical fiscal gap.

Horizontal balance issues raise questions regarding the appropriateness of the current equalisation mechanism in terms of the equity it achieves against the potential efficiency losses and the cost of institutional complexity it entails. Concerns arise about the usefulness of extensive interstate fiscal equalisation given the relatively low pre-equalisation disparities.

Finally, benefits would arise from the strengthening of government financial reporting and the further improvement of the existing benchmarking framework.

The need for an efficient delivery of government services is heightened by the growing spending needs associated with population ageing which are projected by the Productivity Commission (2005b) to add aggregate spending of around 6.5% of GDP by 2044/45, in the absence of policy changes. The bulk of this fiscal pressure is expected to fall on the Commonwealth which is the main provider of health and aged care services and of old-age pensions. But demographic changes will also put pressure on state expenditure in the area of health-related services, and in particular hospital services. The overall fiscal burden is projected to be less severe than for the Commonwealth, however, because the states provide education services where expenditure pressures should recede.¹ Specific purpose payments (SPPs) are important in terms of how the future fiscal burden will be distributed among the government levels, with the Commonwealth's share being highest if SPPs grow with service needs.²

This chapter discusses areas of fiscal relations across levels of government that warrant further reform efforts and lays out policy options for improvement. The issues identified are common to all federations and finding a solution is a difficult challenge. What characterises Australia is the relatively high level of co-operation through the Council of Australian Governments that provides a mechanism to deal with problems when they are perceived to be serious. The first section provides background information on the key features of Australian federalism. It focuses on revenue and expenditure assignment and inter-governmental fiscal relations. The following sections present the main issues related to current spending, funding assignments and instruments to secure fiscal discipline. The last section provides some concluding remarks and a set of policy recommendations.

Australian federalism: the main features

The structure of government and division of power

Australia's federal system is three-tiered. It comprises the central government (the Australian government, formerly referred to as the Commonwealth government), the states (six states and two territories with state-type powers)³ and local governments (currently around 720) (Table 3.1). The Constitution recognises the Commonwealth and the states. Local governments, which are governed by state legislation, play a very small role relative to other OECD countries, confined to services such as waste management, town planning, water supply and local roads.

Throughout the history of the federation there has been a general trend towards greater centralisation. The constitutional powers and responsibilities of the central and state governments are presented in Box 3.1. The increase in responsibilities at the Commonwealth level resulted from High Court decisions (for example, upholding the ability of the federal government to make grants to states contingent on them not utilising their income taxing powers, and the ban on the states levying a sales tax),⁴ referenda (as on indigenous population affairs) and referral of state powers (as with corporate law), as well as through the Commonwealth's constitutional right to make grants to the states conditional on its policy priorities and objectives. The creation of the modern welfare state by the central government,⁵ along with the more recent need to develop national approaches in response to greater competition arising from globalisation

Table 3.1. **Australian states: summary statistics**
In per cent of total

	Population ¹	Land area	GDP per capita ²
New South Wales	33.3	10.4	103
Victoria	24.7	3.0	101
Queensland	19.6	22.5	92
South Australia	7.6	12.8	88
Western Australia	9.9	32.9	115
Tasmania	2.4	0.9	75
Northern Territory	1.0	17.5	117
Australian Capital Territory	1.6	0.03	128
Australia	100.0	100.0	100

1. Estimated resident population in 2005.

2. GDP for 2004/05 in current prices. The GDP of the states is known as gross state product (GSP) in Australia.

Source: ABS (2005), *Australian Demographic Statistics* (cat. No. 3101.0) and *Australian National Accounts: State Accounts* 2004-05 (cat. No. 5220.0); ABS (2006), *Year Book Australia: 2006* (cat. No. 1301.0).

Box 3.1. The division of powers

The Constitution adopted in 1901 confers on the Commonwealth only a few *exclusive* powers, such as the power of setting the rates of customs and excise duties, and coinage. However, it provides for a large number of areas where the Commonwealth can exercise powers *concurrently* with the state governments, although the central government has legislative supremacy in the case of inconsistency. These powers include taxation, social welfare, postal services and telecommunications, banking and insurance and industrial disputes that extend over state borders.

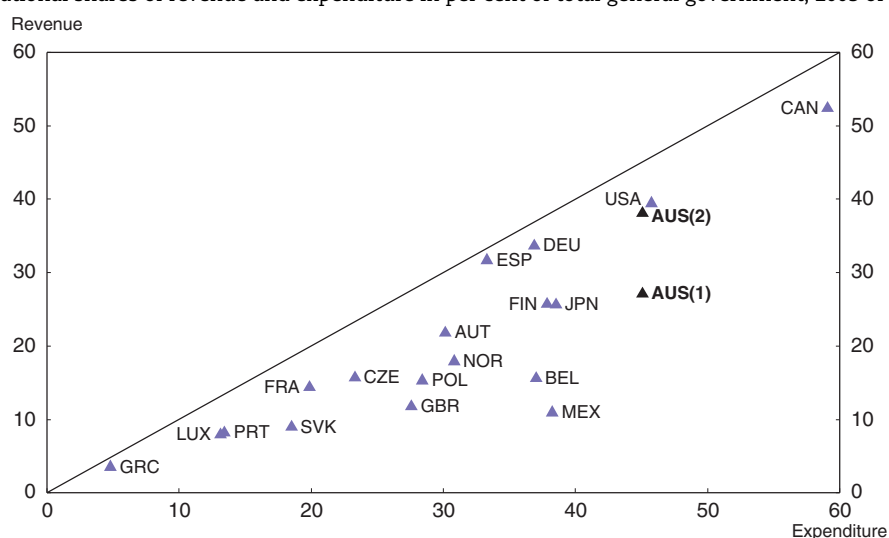
The state governments have (exclusive) responsibility over all other service areas, including housing and urban development, law and order, energy, rail and road transport, and health care and education. However, the Commonwealth can be involved in areas of state responsibility through the granting of financial assistance on terms and conditions it deems appropriate, as, for instance, in the health care and education areas.

Source: Craig (1997); Productivity Commission (2005a).

and the fact that the Constitution provides for the concurrent exercise – rather than for a clear separation – of powers between the states and the Commonwealth have also contributed to the drift towards a more centralised system (Keating and Wanna, 2000). These developments, and especially the growth in conditional transfers in response to the greater taxation power of the Commonwealth, have led to the emergence of major functional areas of joint government responsibility and a complex pattern of expenditure.

Spending and revenue assignments

Judged on the basis of their relative spending and revenue shares Australian sub-national governments are large in international comparison (Figure 3.1). They have considerable autonomy to set the level and composition of their expenditure, though there are some important exceptions,⁶ especially with regards to the matching requirements for tied grants (see below). Social and welfare spending is the largest Commonwealth own-purpose expenditure item (*i.e.* excluding earmarked grants to the sub-national governments), followed by health care and defence (Figure 3.2). The states have major responsibilities for education, accounting, along with health care, for over half of their

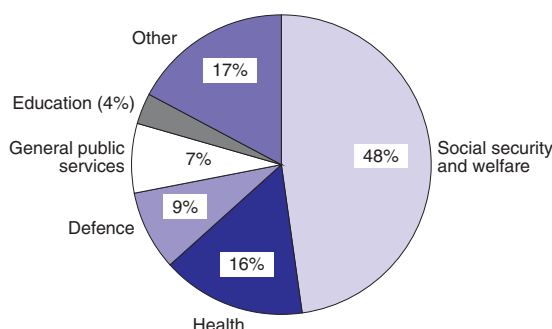
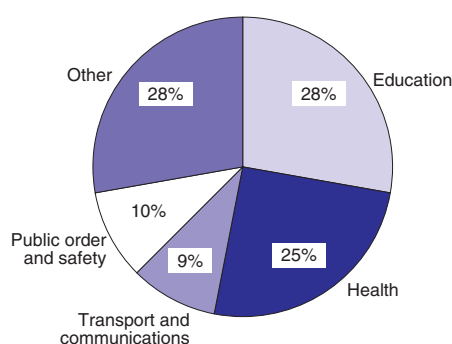
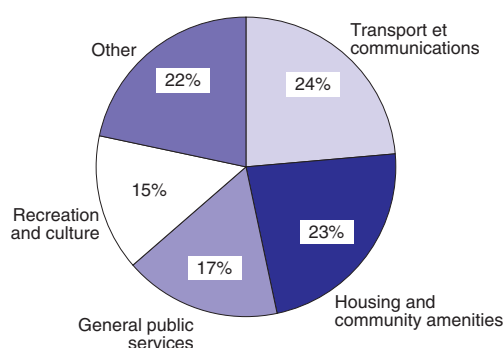
Figure 3.1. **Indicators of decentralisation: an international comparison**Sub-national shares of revenue and expenditure in per cent of total general government, 2003 or 2004¹

1. 2002 for Mexico. Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments. Transfers between government levels are netted out. The two data points for Australia show: 1) the Goods and Services Tax (GST) considered as a grant, and 2) GST considered as a state tax. For Norway data exclude revenues from oil production.

Source: OECD Annual National Accounts database, May 2006; Belgostat; Statistics Canada; Statistics Norway; US Bureau of Economic Analysis; ABS (2006), *Government Finance Statistics 2004-05* (cat. No. 5512.0).

spending. Local government outlays are concentrated on transport services, housing and community services, followed by general public services and recreational and cultural facilities, but amount to only 6% of public expenditure. The sub-national employment share is high, at approximately 84% of total public sector wage and salary earners and around 14% of all wage and salary earners, reflecting the state and local governments' responsibilities for service delivery in the areas of education, health care, transport and public order and safety (Australian Government, 2006).

In contrast to the sharing of responsibilities on several spending categories, there is no co-occupancy of tax bases by the different levels of government. One exception is land property, a tax base which both the state and local governments share. The Commonwealth has control over some of the broadest tax bases, including personal and corporate income, customs and excises (Figure 3.3). It collects the revenue of the Goods and Services Tax (GST), implemented in July 2000, but transfers it entirely to the states. The statistical treatment of GST as a Commonwealth or state tax is therefore a matter of some controversy (Box 3.2). Sub-national governments have full autonomy to set their own tax rates and bases, with the major exception of the GST, for which changes in the base or rate require the unanimous support of the state governments, the endorsement of the Commonwealth and both houses of the Federal Parliament. Taxes on property (immovable property and financial and capital transactions) and payroll taxes account for a major share of total state tax revenue. At the local level, land taxes (known as rates) on property comprised around 40% of total revenue in 2003/04.

Figure 3.2. **Decomposition of public expenditure by function and government level**Own purpose expenditure, 2004/05¹**Australian Government (Commonwealth)**
AUD 170 billion**State government**
AUD 122 billion**Local government**
AUD 19 billion

1. Australian Government excludes specific purpose payments (SPPs), state government includes SPPs to the states but excludes SPPs through the states to local government, local government includes SPPs.

Source: The Treasury, Australian Government and ABS (2006), *Government Finance Statistics 2004-05* (cat. No. 5512.0).

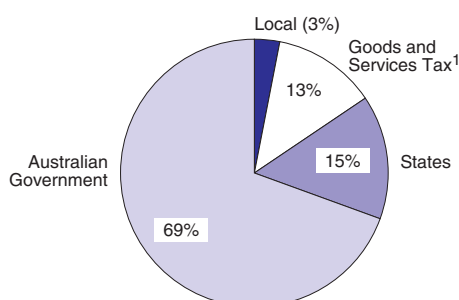
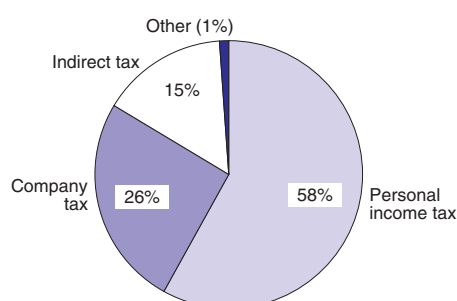
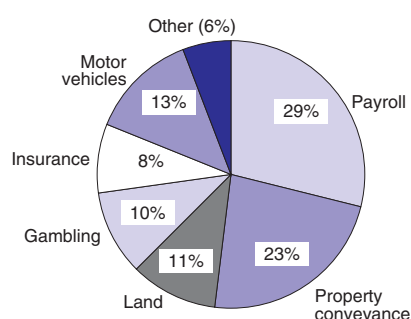
Inter-governmental financial arrangements

Financing fiscal imbalances

Because the largest tax bases are assigned to the Commonwealth, while expenditure responsibilities are significantly more decentralized, a vertical fiscal imbalance emerges in Australia's inter-governmental fiscal relations (Figure 3.4). The exact magnitude of the fiscal gap from 2000 onwards depends on the statistical treatment of GST as a state or a Commonwealth tax, as discussed above. But there also exist horizontal fiscal imbalances, reflecting differences in revenue raising capacity and delivery costs among the states. The Commonwealth Grants Commission (CGC) estimates that the revenue-raising capacity of the states ranges between 75 and 114% of the national average on a per capita basis, largely due to differences in tax bases. Cost differences are assessed to be within 10% of the national average, excluding the Northern Territory (Searle, 2002). Vertical and horizontal fiscal gaps also arise at the local government level, especially between rural and metropolitan councils.⁷

Figure 3.3. **Sources of tax revenue**

Per cent of total, 2004/05

Total taxation revenue
AUD 278 billion**Australian Government (Commonwealth)**
AUD 194 billion²**States**
AUD 42 billion³

1. All Goods and Services Tax (GST) revenue goes to the states to spend according to their own budgetary priorities. Whilst the GST is collected by the Australian Tax Office (ATO), it does so as an agent for the states with the states paying the ATO for the cost of collecting the GST.
2. Excluding GST revenue.
3. The GST raised AUD 35 billion in 2004/05, taking total state revenues to AUD 77 billion, but is excluded from this pie chart.

Source: ABS (2006), *Taxation Revenue Australia* (cat. No. 5506.0) and national authorities.

Bridging fiscal imbalances requires comprehensive inter-governmental revenue sharing through grants and transfers. Specific purpose payments (SPPs)⁸ to the states and local governments made up around 13% of Commonwealth expenditure in 2005/06 and cover a wide range of functions, especially health care and education (Figure 3.5). While most SPPs are paid to and spent by the states, SPPs are also assigned to some non-government bodies (for example, private schools) and to the local governments directly or through the states.⁹ SPPs are granted in pursuit of the Commonwealth's own policy objectives on the basis of presumed deficiencies in service delivery (which may occur where part of the benefit of certain spending accrued outside a state border), as well as in response to demands for a national approach in key functional areas. Most SPPs therefore are "tied" – that is they are subject to conditions designed to ensure that national objectives are achieved (Box 3.3).

There are also other grants. These include national competition policy payments (NCPPs) to the states in return for implementing National Competition Policy and related

Box 3.2. The Goods and Services Tax: a Commonwealth or a state tax?

According to the Australian Bureau of Statistics, there are two broad treatments that could apply to Goods and Services Tax (GST) revenue according to the Government Finance Statistics (GFS) reporting framework, reflecting a “constitutional” or an “agency” approach.

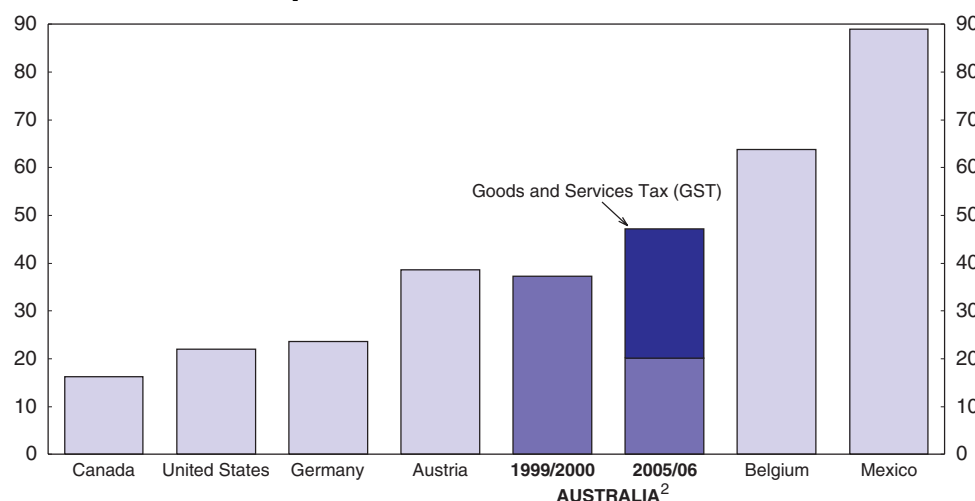
The Commonwealth considers the GST to be a state tax, as all its revenue is transferred to the states. The Commonwealth acts as a *collection agent* for the states, and the states reimburse the Commonwealth for the cost of collecting the GST. GST payments to the states are therefore not treated as a Commonwealth transfer. The Commonwealth also justifies its statistical treatment of GST revenue on the grounds that the tax base and rate cannot be changed without the unanimous support of the state governments, which implies that it is not a Commonwealth tax.

The Australian Bureau of Statistics (ABS, 2000), on the other hand, treats the GST as a Commonwealth tax because the Commonwealth exercises “... considerable influence and discretion over the setting of the GST and the distribution of its proceeds ... [and that] ... individually the states do not have sufficient influence or discretion over the setting of the GST and the distribution of its proceeds”. On these grounds, the ABS considers the distribution of GST to the states as a grant, treating its payment as Commonwealth spending.

As shown in Figure 3.4, the statistical treatment of GST has implications for the magnitude of the vertical fiscal imbalance (VFI), with the share of federal payments from the Commonwealth in state revenue having declined, in 2005/06, to approximately 20% or hovering around 47% – compared with a pre-GST level of around 37% in 1999/2000 – depending on whether the GST is treated as a state or federal tax.

Figure 3.4. The vertical fiscal imbalance: a comparison with other federations

In per cent of total sub-national revenue, 2003¹

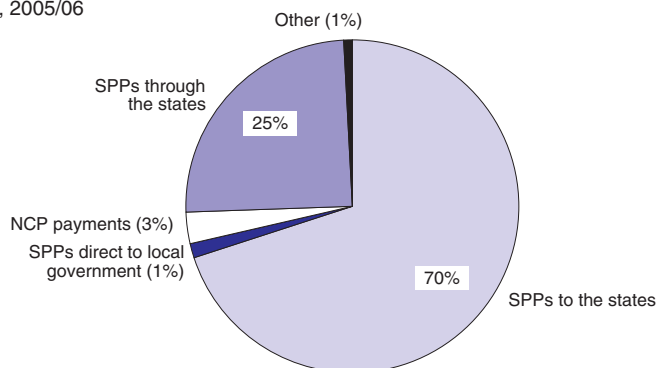


1. Provincial government level only for Canada. The vertical fiscal imbalance (VFI) is defined as the total of federal payments to total sub-national revenue.
2. For Australia, VFI is the share of Commonwealth payments in total state revenue. The GST – levied on a value added basis at a single rate of 10% – was introduced in July 2000 and replaced the Commonwealth wholesale sales tax and a range of inefficient state taxes, including financial institutions duties, accommodation taxes, stamp duties on marketable securities and debit taxes. The states have further adjusted their gambling taxes to take account of the GST impact on gambling operators.

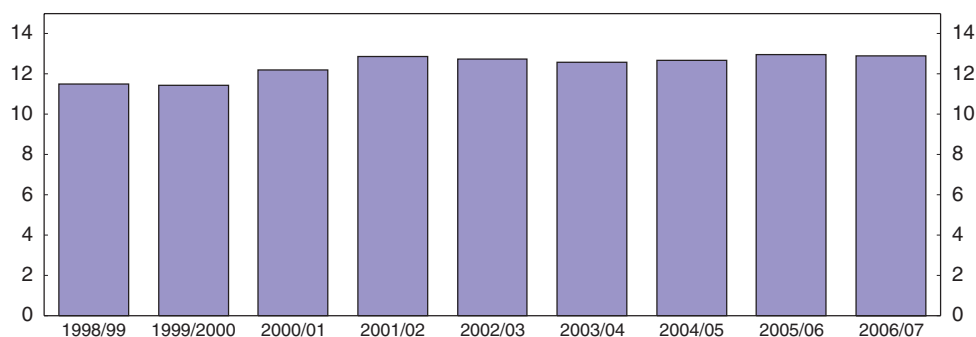
Source: International Monetary Fund (2005), *Government Finance Statistics Yearbook*; US Bureau of Economic Analysis; OECD (2005), *OECD Economic Surveys: Mexico*; Australian national authorities.

Figure 3.5. **Australian Government payments to sub-national governments**¹**Composition of payments**²

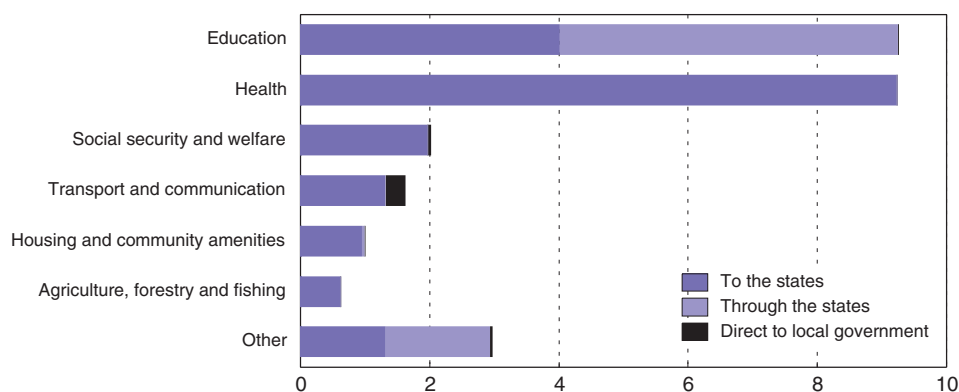
AUD 27.7 billion, 2005/06

**Evolution of SPPs**³

In per cent of Commonwealth general government expenditure

**Allocation of SPPs by functional area**

In billion AUD, 2005/06



1. Data from 2005/06 onwards are estimates.

2. NCP: National competition policy.

3. Specific purpose payments (SPPs) for current and capital purposes.

Source: Australian Government (2006), *Budget Paper No. 3: Federal Financial Relations 2006-07* and *Final Budget Outcome* papers for earlier years, Australian Government, Canberra.

Box 3.3. Specific purpose payments

In general, the conditions attached to SPPs cover various different arrangements : i) general policy conditions (e.g. that the states provide free public hospital access for Medicare patients in return for funding under the Health Care Agreements); ii) expenditure conditions (e.g. SPPs for schools may be spent on teacher salaries and curriculum development); iii) input control requirements, in the form of “maintenance of effort” and “matching funding” arrangements (i.e. the states are required to maintain funding levels and/or match the federal funding in a programme area); iv) a requirement for states to report performance and financial information; and v) due recognition conditions (i.e. the states are required to publicly acknowledge the Commonwealth’s funding) (Australian Government, 2005).

Specific purpose payments are based on individual agreements between the Commonwealth and state governments. These agreements are not legally binding, but the recipients are required to demonstrate that allocations are spent in accordance with the agreement’s terms and conditions. Penalties and sanctions may apply for the untimely reporting of financial and performance information (as specified in the SPP agreement).

There are different indexation arrangements built into SPP agreements, based either on broad economy-wide indices (such as the various wage cost indices and the consumer price index), or population, or a combination of both. Moreover, in some cases funding increases according to the demand for the services provided by SPPs, while some SPPs have their own specific indexation arrangements (such as particular percentage growth rates).

reforms, with the 2005/06 NCPPs being the final payments under the current arrangements.¹⁰ The policy includes a commitment by the states to review legislation that restricts competition and to enact specific reforms in electricity, gas, water and road transport. The competition payments are assigned to the states on a per capita basis and are indexed annually to maintain their real value over time. Receipt of NCPPs is subject to recommendations from the National Competition Council’s assessment of progress in the implementation of reform commitments, with the potential for penalties to be recommended.¹¹ The Australian government also considered, in 2005/06, for the first time, recommendations from the National Water Commission in relation to states’ progress on water reform (Australian Government, 2006). The actual amount of payments received by the states is determined by the Treasurer.¹²

The equalisation scheme

The distribution of GST revenue among the states is guided by horizontal fiscal equalisation (HFE), based on *per capita relativities* recommended by the Commonwealth Grants Commission, an independent advisory body established in 1933 (Box 3.4).¹³ The assignment of general purpose assistance to local government is also guided by horizontal equalisation. Each state government maintains a separate grants commission to determine the allocation of these grants to the councils within their jurisdiction.

Box 3.4. Horizontal fiscal equalisation: main features

In applying horizontal fiscal equalisation, the Commonwealth Grants Commission (CGC) distributes the GST pool (GST revenue and Health Care Grants) to the states such that, “if each state made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the *capacity* to provide public services at the same standard” (CGC, 2004).

Equalisation rests on “three pillars”: i) the fiscal capacity of the states, rather than the performance or outcomes they achieve, are equalised – the CGCs recommendations pertain to untied general revenue grants, so that each state may spend its GST revenue according to its own priorities; ii) the states are equalised to average standard – no judgment is made by the Commission on the level of service that might be appropriate or about appropriate benchmarks; and iii) equalisation is “policy neutral” – a state’s own policies or choices should not directly influence its share of GST revenue.

The assessment procedures by the CGC are based on a complex methodology that takes account of differences in per capita revenue-raising capacity and differences in spending “needs” (i.e. the per capita amounts required to be spent by the states in providing an average standard of government services). The procedure culminates in the calculation of the “relativities”: an index of relative needs which, when weighted by the population in each state, provides a basis for the distribution of the GST pool.* The CGC updates the relativities each financial year, and undertakes broader reviews of its methodology every five years. The next major review is currently underway, and is due to report in early 2010. In assessing a state’s relative needs, and thereby the allocation of the GST revenue, the CGC takes into account only factors that are beyond a state’s control (referred to as “disabilities”), including population size and structure, wages, rental and electricity costs, and tax bases (such as payroll tax). If actual spending and revenue were used instead, a state could influence its share in GST revenue through its policy choices.

Since the CGC is responsible for taking account of all sources of state revenue in its equalisation procedure, specific purpose payment (SPP) receipts need to be treated as revenue when calculating the relativities. However, some SPPs are “quarantined” by the Commonwealth in its terms of reference given to the Commission, and are not taken into account. Others are considered “out of scope” by the CGC (that is, they are not relevant because they do not fund state services or they do not have a direct impact on state budgets), whereas all the remaining SPPs are “treated by inclusion”, reducing a state’s need for GST funds. The inclusion of SPPs in the equalisation process is an issue of debate, as discussed later.

* The national average relativity is set to one. The states assessed to have relativities above one require more than the national average per capita amount of the GST pool to deliver services at the national average level, while the opposite is true for those with a relativity below one (CGC, 2006).

Source: Craig (1997); Australian Government (1999, 2005); CGC (2004, 2006); Garnaut and FitzGerald (2002a); Webb (2002a) and Williams (2005a, 2005b).

Issues concerning the allocation of spending responsibilities

Joint government involvement in key functional areas

The Commonwealth and the states are involved in almost every functional spending area. The Commonwealth justifies its involvement on the grounds of promoting national standards, ensuring policy coordination and attainment of national objectives, achieving economies of scale and scope, and dealing with inter-jurisdictional spillovers. However, shared responsibilities can pose difficulties, including on how to avoid the inefficiencies

which may emerge – as a result, usually, of a blurring of government responsibilities – from cost and blame-shifting among government levels, wasteful duplication of effort or under-provision of services, and a lack of effective policy co-ordination. Some overlap arising from vertical competition may be beneficial, however, if it provides greater choice or better services (Australian Government, 2005; Productivity Commission, 2005a).

There is little evidence on the extent of overlap, duplication and cost-shifting. But the complexity of the underlying arrangements for joint provision of health care and related services (Box 3.5), in particular in the areas of hospital services and care for the elderly, creates incentives for cost and blame-shifting¹⁴ between government levels (Productivity Commission, 2005c). With the states having responsibility for funding public hospitals, and the Commonwealth for subsidising private medical services under Medicare, there is an incentive for public hospitals to refer patients being discharged to their general practitioner (GP), rather than providing post-hospital services directly. On the other hand, difficulties in accessing GPs may cause patients to resort to emergency wards of public hospitals for primary care services. Moreover, in areas where there are shortages in Commonwealth-funded nursing homes, public hospital beds may be unnecessarily occupied on a long-term basis by patients requiring old-age care (Garnaut and FitzGerald, 2002a; Allen Consulting, 2004; Williams, 2005b).

The health and old-age care systems were a key agenda item in the June 2005 meeting of the Council of Australian Governments – which recognised the need for clarifying government roles and responsibilities to improve their functioning. The Productivity Commission (2005c) estimated that an efficiency improvement of 10% in the health care sector service delivery would provide cost savings equivalent to around 1% of GDP at present and 2% by 2050. The Hogan review for aged care (Hogan, 2004) recommended longer-term options for improving consumer choice and competition, including the establishment of a contracting agency to act on behalf of the federal government to negotiate prices and conditions for residents. The Commonwealth indicated that it would consult widely on these proposals.¹⁵

The potential for cost and blame-shifting between government levels seems to be lower in the education than in the health care sector (Productivity Commission, 2005c) due to a generally less complex institutional framework in the former sector (Box 3.5). There are areas however where a more co-ordinated approach is needed. Concerning vocational education and training (VET), in particular, COAG pointed out that “there is scope for further whole-of-government actions”, arguing that the creation of a “genuinely” national approach to apprenticeships and training is vital to reduce skill shortages. Issues also arise at the tertiary education level, relating, for instance, to the cross-jurisdictional variations in the recognition of universities and accreditation courses and providers,¹⁶ and to differences in funding arrangements for VET, which is mainly state-funded, and universities, which are funded almost exclusively by the Commonwealth. The fact that students enrolled in the VET sector cannot defer payment of tuition charges but undergraduate university students are able to do so, even though VET tuition fees are lower than those of universities, may distort student choice. Costs and other inefficiencies also arise due to differences in schooling among the states (*e.g.* entry and minimum leaving age, curriculum design), although there are plans for introducing a common entry age across jurisdictions by 2010 and an Australian Certificate of Education for grade 12 (Banks, 2005; Productivity Commission, 2005c).

Box 3.5. **Division of government responsibilities in health care, education and training**

Health care

Spending on health care reached 9.7% of GDP in 2003/04, with public expenditure accounting for 68% of the total. Approximately two-thirds of public expenditure on health care is funded by the Commonwealth, and the remainder by the states. The main features of the current funding arrangements are as follows:

- Under the Medicare system, the Commonwealth provides access to medical, pharmaceutical and hospital services for all Australians through: i) The *Medicare Benefits Scheme* rebates for listed medical services; ii) the *Pharmaceutical Benefits Scheme* of subsidies for listed prescription drugs; and iii) the *Australian Health Care Agreements* with the states, ensuring access to free public hospital services based on clinical need. Moreover, the Commonwealth provides a rebate of between 30 to 40% for private health insurance holders.
- The largest source of funds for residential and community old-age care comes from the Commonwealth, which also has responsibility for regulating residential old-age care.
- The states are responsible for most acute and psychiatric hospital services. They also provide and fund the majority of community health care services and public health care activities, including school dental services, child and maternal health care services, disability support, disease control and various inspection functions.
- Local governments may also provide residential and community old-age care services, home care and personal preventive services, such as pre-school immunisation clinics.
- Private providers deliver a significant proportion of primary, specialist and allied health care through general practitioners, specialists, pharmacists, physiotherapists and dentists. They are funded by a combination of user charges, Medicare and private health insurance.

Education and training sector

Public expenditure on education was approximately 5.4% of GDP in 2003/04, with states accounting for the most part. Private expenditure on education stood at around 1.6% of GDP.

The states' responsibilities include:

- Providing schooling to all children of school age.
- Providing major funding for government school education and contributing funds to non-government schools.
- Regulating school activities and policies, and setting curricula, course accreditation, student assessment and awards for both government and non-government schools.
- Administering and providing major funding for vocational education and training (VET).
- Regulating and accreditation of higher-education courses.

The Commonwealth's responsibilities include:

- Providing the majority of funding for non-government schools and being principally responsible for the funding of higher education institutions.
- Providing supplementary funding for government schools and VET. Starting in 2006, 25 federally-funded Australian Technical Colleges will be located in regions suffering from skill shortages and high unemployment.
- Providing financial assistance for specific educational programmes and categories of students.
- Promoting national consistency and coherence in the provision of education and training.

Both government levels are responsible for planning and monitoring the performance of education services and evaluating outcomes.

Recent cooperative efforts

A broad range of inter-governmental agreements have been put in place since the early 1990s, including the harmonisation of regulations, the adoption of national standards and the re-assessment of roles and responsibilities. These were driven by pressure to improve the international competitiveness of the economy, as well as to deal with inter-jurisdictional spillovers and ensure effective policy outcomes in key functional areas (Productivity Commission, 2005a). The option of ceding responsibility to one level of government would provide a permanent boundary between the functions of each tier of government, establishing clearer lines of accountability. However, it would be very difficult to implement in practice as the states or the Commonwealth would have to cede responsibilities and it would call for a reform of the existing funding arrangements. There are also benefits arising from joint government involvement. The Australian government has a clear role in national aspects, but the state/local governments are best situated to respond to local needs (Allen Consulting, 2004). Enhanced co-operation, however, unavoidably raises issues about clarification of roles and responsibilities and the appropriate mechanisms for collaboration, and for monitoring policy implementation and performance.

In February 2006, COAG agreed to collaborate on the implementation of a new National Reform Agenda to enhance productivity and labour force participation so that Australia is better placed to meet rising demographic pressures and intensified international competition. The reform agenda is broad-based. Its main innovation is the inclusion of a human capital agenda (health, education and training and work incentives), in addition to the traditional areas of competition and regulatory reform. The focus in the health care area is on preventing chronic disease, integrating delivery and ensuring that the incentives created by payment structures are consistent with better health outcomes. In education, the focus is on early childhood development and on improving the transition from school to work or further study, with apprenticeship and vocational training playing significant roles. A new organisation, the COAG Reform Council,¹⁷ will monitor the progress in implementing the agreed programmes and report annually to COAG.

The COAG process represents a step towards clarifying the allocation of roles and responsibilities between government levels in the health and aged care sectors. An agreement has been reached that health SPPs will be reviewed prior to renegotiation to determine whether elements could be changed to contribute to better health outcomes, and for implementing the key recommendations of the Productivity Commission in the *Australia's Health Workforce Report*, calling for a reform of the overly complex funding and payment regime underpinning the system in order to improve workforce performance and health quality and outcomes (Productivity Commission, 2006).

Earmarked grants

The current SPP arrangements, and in particular the conditions attached to such payments, are often criticised by the states for constraining budget flexibility; imposing restrictive input controls, via effort conditions and matching requirements, rather than focusing on outputs; and creating duplication and administrative costs, especially when federal funds are provided to the states through a large number of "small" SPPs (State and Territory Treasuries, 1999; Garnaut and FitzGerald, 2002a). On the other hand, there are some benefits arising from conditionality, including, in the federal government's view, increased accountability of state spending and the potential for enhancing cost-efficiency

in situations where grants are provided to deal with inter-jurisdictional spillovers or to set national standards.

The state treasuries have developed a set of *Best Practices*, aimed at overcoming some of the problems outlined above.¹⁸ While not endorsing these principles, the Commonwealth has indicated its willingness to move towards a new framework for SPP accountability that involves the clarification of objectives and assignment of responsibilities for SPPs, and reporting by the states on agreed financial information and performance indicators. This approach has been progressively adopted as SPPs have been renegotiated. A positive initiative in this respect is the requirement that state governments have to meet a number of new performance conditions in order to obtain federal funding for education over the period 2005-08. While the new approach represents a step towards an outcome accountability framework, funding for SPPs will continue to be input-based as, in the Commonwealth's view, input controls remain the best way to protect the federal government against financial risks associated with service delivery, which is the responsibility of the states. Input controls are further seen by the Commonwealth as a means of ensuring that state sub-national governments do not shift responsibility for service provision over time to the central level.

Benefits could arise, however, from funding SPPs on an outcome/output rather than an input basis. These include an improved use of state resources, through granting states greater flexibility on the allocation of federal funds, and incentives to service providers to raise efficiency. Moreover, a focus on outcomes could enhance transparency and accountability. Nevertheless, drawing on the experience of the United Kingdom, which is at the forefront of applying quantitative outcome-focussed performance targets in the public sector, the targets should be simple to quantify and audit, if they are to enhance operational efficiency. In the Australian context, as a step on the way to an ultimate move towards the funding of SPPs on an outcome/output basis, further effort could be put into developing outcome/output performance and reporting frameworks, where the challenge is to develop measures of service delivery that are clearly defined, measurable and enforceable. Progress will be easier with some SPPs than others. For example, targets for educational achievement would provide better performance indicators for learning outcomes than clinical outcomes would do for health care, given the measuring difficulties and depth of information required for the latter. Nevertheless, even in cases where there is sufficient information for the government to set outcome targets, these can be implemented effectively only if they provide performance incentives (OECD, 2004). Financial incentives, for example in the form of rewards for early achievement of the targets, could motivate service providers. That said, it would also be advisable to impose financial penalties, or adopt a "naming and shaming approach",¹⁹ for non-compliance. In a different context, competition payments played a very important role in the implementation of National Competition Policy reforms, and demonstrate the potential for financial incentives to underpin progress of the new national reform agenda (Productivity Commission, 2005c).

The use of broad-banding, where a number of small SPPs are combined into a larger pool, should be considered, as it is likely to have the potential for enhancing the efficiency of funding through increased flexibility and reduced administrative costs – although such an approach could hamper the objectives of the SPPs, insofar as these are aimed at internalising spillover effects associated with individual policy areas. In their 2002 Review of *Commonwealth-State Funding* (commissioned by New South Wales, Victoria and Western Australia), Garnaut and FitzGerald recommended that SPPs be rationalised into three major

programmes: a health and aged care programme, an education and training programme (both to be administered by the states), and an indigenous population programme (to be administered by the Commonwealth). This proposal received no support from the Commonwealth. It saw disadvantages including the loss of control over how its money is spent by the states, resulting in possible under-spending on capital programmes, and the difficulty of monitoring states' financial contributions across several functions. Reviewing the funding arrangements prior to their renegotiation, as recently agreed by COAG for health care payments, is a welcome initiative. Finally, a more rules based approach for setting SPPs would ensure greater transparency.

Issues in funding arrangements for sub-national governments

Given the significant spending responsibilities of the sub-national governments, an important challenge on the funding side is to provide lower-tier governments with sufficient revenue-raising autonomy to make them accountable to local citizens.

Vertical fiscal imbalances

The question of whether it is desirable to reduce vertical imbalances remains open (Box 3.6). The presence of a vertical imbalance is not, by itself, necessarily indicating a problem. However, specific features of the transfer system to fill the vertical fiscal gap have given rise to a number of concerns (Productivity Commission, 2005a). There has been growing attention over Australia's VFI since the 2000 reforms, in view of the replacement of taxes over which the states had full control by the GST (Collins, 2001 and 2004; Searle, 2002). The outcome of this debate should depend on the assessment of the economies of scale that can be exploited in centralising tax collection and the costs associated with increased co-ordination and the loss of the capacity by the lower tiers of the government to engage in efficiency-enhancing horizontal competition.

The debate over VFI raises the question of which taxing responsibilities should be assigned to different levels of government. This is a complex issue and no consensus has so far been reached. Major changes in the taxing powers of the states seem unlikely as the High Court has precluded the states from introducing broad-based consumption taxes, such as the GST. One option for increasing the revenue-capacity of the sub-national governments would be to allow them to "piggyback" on the personal income tax levied by the Commonwealth. This would call for the centre to make "tax room" by lowering its personal income tax so that the states can impose a surcharge on the federal personal income tax. Each state could be allowed to set the surcharge rate and, for the reform to be revenue-neutral, they would be required to give up part of the federal transfers received.²⁰ This option would encourage tax competition among the states. An advantage of the personal income tax surcharge option is that it would not significantly raise tax administration costs, if the tax base is unchanged and identical across the states and with the Commonwealth, since it would still be administered and collected by the Commonwealth. However, a difficulty with this option is that its introduction would require a fundamental adjustment of Commonwealth-state financial arrangements which would require agreement of all jurisdictions.

The existing state tax mix

The most direct solution if some increase in the revenue-raising capacity of the states to meet their expenditure responsibilities were considered warranted would involve

Box 3.6. The controversy over the vertical fiscal imbalance

Critics often consider VFI as the root cause of the problems in the inter-governmental relations, including reduced accountability, duplication and overlap in the provision of services, excessive conditionality of federal transfers, distortion of public expenditure towards items that receive earmarked grants (“fly-paper” effect),¹ and the creation of “fiscal illusion”, as governments and voters fail to consider more than the own-revenue costs of state government spending. Moreover, VFI is often regarded as reducing the scope for beneficial tax competition across jurisdictions and weakening the incentives for tax and microeconomic reforms (Madden, 2002).

The case against VFI is by no means uncontroversial. The scope for “fly-paper” and “fiscal illusion” effects has been called into question by some commentators.² As for interstate tax competition, evidence by the Productivity Commission (1996) suggests that this often involves special exemptions and concessions on businesses to attract labour and capital, thus questioning positive effects from competition. Some fiscal gap could also be considered beneficial on the ground that it: i) provides leverage for the Commonwealth to undertake important national reforms that require state government involvement; and ii) helps smoothing economic cycles by enabling the central government to influence the allocation of resources in the economy through its spending and revenue decision. In addition it is possible that some vertical fiscal imbalance may constrain the size of government as the central government is exposed to the political costs associated with increasing taxes. This cost is only partially offset by the political benefits of expenditure programmes given that many of these are funded by the central government, but delivered by sub-national governments.

1. The flypaper effect – described as “money sticks where it hits” – refers to situations where grants tend to be used by the recipient government for service provision, and will not be passed to taxpayers in the form of lower taxes. This is likely to lead to over-provision.
2. For a discussion see Hancock and Smith (2001). In particular, the authors question the existence of failed public choice mechanisms as the empirical evidence is not conclusive.

broadening the states’ land property and payroll tax bases. In any event, the efficiency of the state tax system should be raised (Table 3.2). There is no doubt that the 1999 *Intergovernmental Agreement (IGA) on the Reform of Commonwealth-State Financial Relations* created more efficient tax arrangements by replacing a number of narrowly-based, distorting indirect taxes and the Financial Assistance Grants by the GST. But the remaining distortionary state stamp duties should also be abolished. As a positive step the Australian government has now reached agreement with all states on a schedule for the abolition of most taxes listed for review in the IGA, including stamp duty on mortgages, leases, and credit and rental arrangements. The abolition of these taxes is estimated by the government to save taxpayers approximately AUD 4.4 billion over the four years from 1 July 2006 (Australian Government, 2006). If the land tax were to be broadened, consideration should be given to the abolition of conveyances duties on the transfer of real property – though the abolition of the business conveyancing duty is to be considered in the future.²¹

Property taxation

The ratio of property tax revenue to GDP is above the OECD average. However, there is still scope for greater reliance on this tax base (Figure 3.6). The land property tax base could be broadened. This would require addressing administrative issues, including the need to keep property valuations up to date, and reducing exemptions, which are estimated to

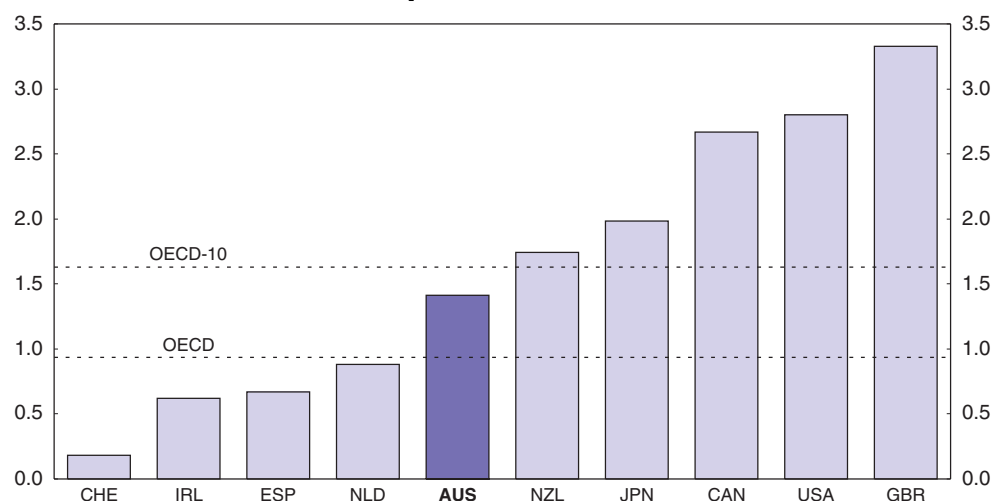
Table 3.2. Mix of state and local government taxes¹
In per cent of total tax revenue, 2004/05

	New South Wales	Victoria	Queensland	South Australia	Western Australia	Tasmania	Northern Territory	Australian Capital Territory	Total
On employers payroll	27	24	19	20	24	21	30	26	24
On property	46	46	53	50	55	51	40	50	49
Immovable property	24	25	26	30	26	30	16	26	25
Land	9	7	5	7	6	5	..	8	7
Municipal rates (local government)	14	17	18	20	16	23	16	0	16
Financial and capital transactions	22	21	27	20	29	20	25	24	23
Stamp duties on conveyances	18	19	20	15	26	15	20	21	19
On the provision of goods and services	16	19	14	19	8	15	19	12	16
Gambling	8	11	9	11	3	9	13	7	9
Insurance	8	8	4	8	6	6	6	5	7
On use of goods and performance of activities	11	10	13	10	13	14	10	12	12
Motor vehicles	10	10	12	10	13	14	10	12	11
<i>Memorandum items:</i>									
Total tax receipts (billion AUD)	17.9	12.6	8.6	3.7	5.2	0.9	0.4	0.7	49.8
Per capita (thousand AUD)	2.6	2.5	2.2	2.4	2.6	1.8	1.8	2.2	2.5

1. Excluding revenue from the Goods and Services Tax.

Source: ABS (2006), *Taxation Revenue, Australia 2004-05* (cat. No. 5506.0).

Figure 3.6. Recurrent taxes on immovable property¹
In per cent of GDP, 2004²



1. Taxes levied regularly on proprietors and tenants in respect of the use or ownership of land and buildings.

2. Provisional data, 2003 for Australia. The OECD aggregates are unweighted averages; the OECD-10 are the ten countries shown in the chart and are chosen because they have a similar overall level of aggregate tax pressure to Australia.

Source: OECD (2005), *Revenue Statistics*.

reduce the potential tax base by at least 50% (Freebairn, 2002). Owner-occupied residential land constitutes the main exemption, with others including primary production land and land held by charities and religious bodies. Moreover, tax free thresholds apply to small and low value holdings of land used for industrial and commercial purposes and for rental houses, exempting them from paying land tax. The current exemptions may encourage land to be devoted to activities that are exempted, leading to efficiency losses. The

different treatment of land property for owner-occupied housing, as opposed to rental, provides a clear example. The existence of an exemption threshold, in the cases mentioned above, may also provide an incentive to landholders to sub-divide their property to reduce the tax liability (Gabbitas and Eldridge, 1998; Freebairn, 2002). If the land tax were to be broadened, for example to include owner-occupied housing, then consideration should be given to the abolition of the conveyance duties levied on the transfer of real property. Reduced reliance on conveyance fees (levied on the sale or transfer of title of business and residential property) would be welcome as this tax is both inefficient and inequitable.

Payroll taxation

Australia is among the few OECD countries (along with Austria, Canada and Mexico) that have a payroll tax at the sub-national level. The main advantages of payroll taxes are their relatively broad and stable base, and low administrative costs. However, the payroll tax base has been narrowed over time, reflecting the increased use of exemptions by the states, with a resulting loss of efficiency. Approximately half of the potential tax base lies outside the tax net due to the small firm exemption (Freebairn, 2002). There are also exemptions for firms engaged in particular activities (such as charitable and other non-for-profit organisations), as well as those granted by the states to specific firms to attract them to set up operations in their jurisdiction. The Productivity Commission further sees ample room for reducing the high compliance costs through an increased harmonisation among the states (Gabbitas and Eldridge, 1998). Additional inefficiencies associated with the payroll tax arise from its incomplete coverage of all forms of remuneration,²² as well as its potential discouragement effects on innovation (by imposing a heavy burden on newly-created companies with little or no profits), and by adding to the cost of hiring workers. The payroll tax may, however, be at least partly shifted onto wages, thus mitigating these last two disadvantages.

Tax competition

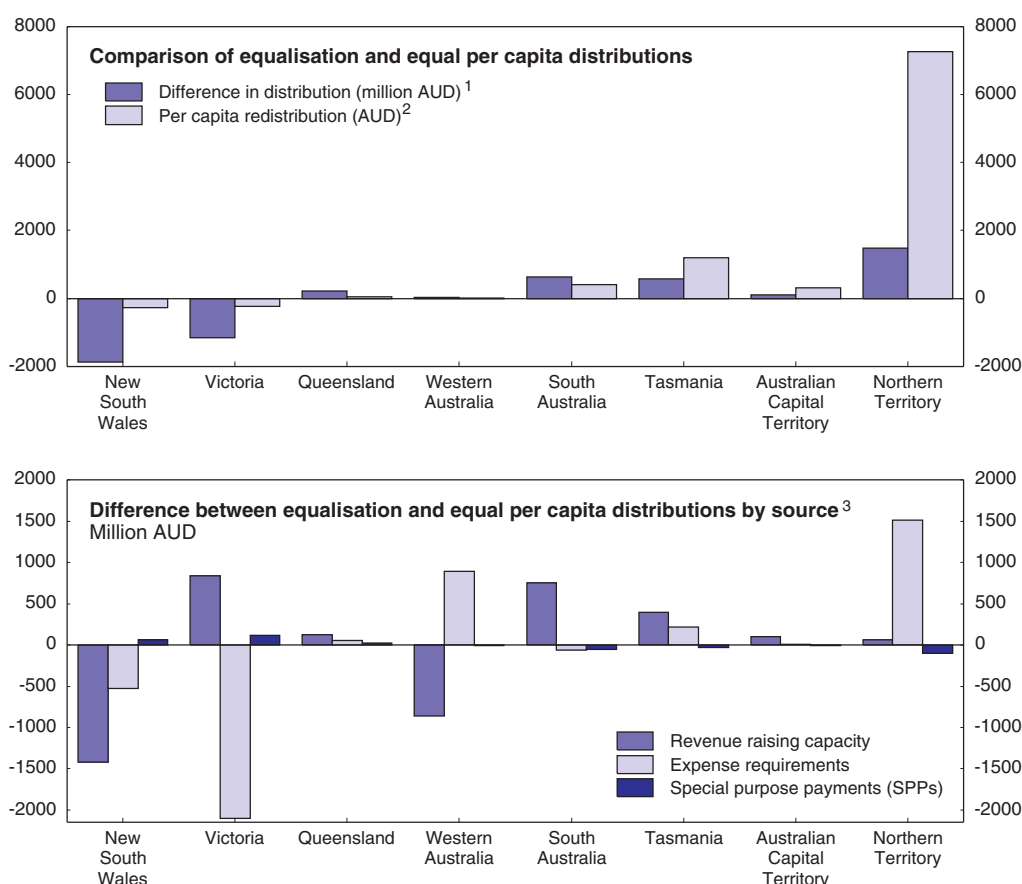
The tax mix varies noticeably between the Australian jurisdictions. To some extent, this variation is the result of tax competition across the states, often originated from the smaller states, in an attempt to “compensate” for natural or institutional weaknesses not apparent in the larger states.²³ According to the Productivity Commission, tax competition seems to have spread to “less obvious forms” in recent years, having taken increasingly the form of specific exemptions, and to a lesser extent, *general* exemptions (Gabbitas and Eldridge, 1998). Predatory tax competition²⁴ among the states is unlikely to be sustainable, as the associated revenue losses need to be balanced against other fiscal priorities, such as maintaining a balanced budget in the longer term. As a step towards mitigating this problem, an agreement was signed recently by the states (except Queensland) to restrict the use of selective assistance to attract investment.

Horizontal fiscal equalisation

Horizontal fiscal equalisation results in a redistribution of funds away from the larger states (New South Wales and Victoria), benefiting mainly South Australia, Tasmania and the Northern Territory (Figure 3.7). This reflects the Commonwealth Grants Commission’s assessment that “donor” states have greater revenue capacities and/or less significant expenditure disabilities than other states. Expenditure assessments, in total, redistribute

Figure 3.7. **The impact of horizontal fiscal equalisation**

2005/06



1. Difference between a state's distribution of the Goods and Services Tax (GST) revenue/health care grants pool using the Commonwealth Grants Commission's relativities with a notional distribution on a per capita basis.
2. Difference in distribution divided by population.
3. Negative amounts indicate that a state has an above average capacity to raise revenue for its own sources, or below average costs for providing services, or that it receives above average per capita amounts of SPPs from the Australian Government.

Source: Australian Government (2006), *Report on State Revenue Sharing Relativities: 2006 Update*, Commonwealth Grants Commission, Australian Government, Canberra.

more than revenue assessments. Australia stands out as the only country in Pelouquin and Chong's (2002) set of federations that attempts to fully equalise the revenue-raising capacity and expenditure needs of its states, despite having the lowest pre-equalisation fiscal disparities.²⁵

The appropriateness of the extent of interstate fiscal equalisation, in light of the relatively small pre-equalisation disparities, has been questioned by Garnaut and FitzGerald (2002a). The authors consider, in particular, the current system as being "too comprehensive", arguing for equalising access solely to education, health care, and indigenous community development. In contrast, the defenders of the current system believe that the comprehensive approach to equalisation is a reflection of the desire to ensure that each state has the capacity to provide a standard level of services to its citizens.

The equalisation principle employed by the Commonwealth Grants Commission (CGC) has come under great scrutiny. The debate focuses on the measures used in the CGC's

calculation of per capita relativities,²⁶ which are often criticized for being based on a complex methodology, with the CGC sometimes lacking the data needed. Another issue of controversy arises from the inclusion of specific purpose payments in state revenues, unless “quarantined” by the Commonwealth, which reduces the state’s implied share of the GST revenue pool. As such, the CGC methodology could reduce the incentive for the states to enter into agreements with the Commonwealth for transfers in the form of SPPs. However, it is also argued that the consequences of the SPP treatment on the distribution of the pool of GST revenue come through with a time lag, because of the averaging provisions used in calculating the allocation of the pool to the states (Williams, 2005b).

The debate over whether the equalisation system discourages efficient resource allocation is inconclusive (Box 3.7). Empirical evidence suggests that the impact on efficiency is not large. Dixon *et al.* (2005) concluded that the welfare gain from changing the current framework and distributing the GST on an equal per capita basis would be about 0.3% of total federal payments to the states.²⁷ Moreover, estimates by Ramakrishnan and Cerisola (2004) suggest that the structure of federal transfers to the states did not have a significant impact on output growth across states in the 1990s, although empirical analysis of the dynamic efficiency disadvantages could be affected by a reverse causality between growth and equalisation payments, in addition to major difficulties regarding unmeasurable counterfactuals.

The main elements of the present equalisation system are unlikely to undergo radical changes. But this does not preclude incremental reforms to maintain the relevance and responsiveness of the system. The next major review, due to be implemented in early 2010, will include proposals for simplification of the methodology used by the CGC to determine the GST relativities. It should be currently easier to pursue reforms, as the larger states are all bunched around one on their relativity, with only Tasmania and the Northern Territory way above. In addition to enhancing transparency, greater methodological simplicity would reduce the set of information required from the states. More generally, the debate about the desirability and sustainability of the equalisation system usually tends to lead to extreme suggestions: either no reform or the phasing out of the current equalisation system, at least for the large states – as recently proposed by New South Wales.

Strategies to secure fiscal discipline

The Australian government does not impose fiscal rules on the states. The Australian Loan Council is the means by which public-sector borrowing is co-ordinated and monitored. This co-operative approach offers several advantages, including the creation of a political forum for discussions. It also has the potential for strengthening political commitments, and hence fiscal discipline, through consensus-building, and for raising local awareness of the macroeconomic implications of policy choices. On the other hand, this approach requires agreement on common fiscal policy targets, which may be difficult to secure, and lacks adequate mechanisms for enforcement (Journard and Kongsrud, 2003).

The Loan Council

The Loan Council is made up of representatives of central and sub-central governments. It reviews borrowing plans, taking into consideration each jurisdiction’s fiscal position and infrastructure requirements. Jurisdictions may be requested to make adjustments, if their policies are perceived as being at odds with the Council’s macroeconomic objectives. The Council publishes each jurisdiction’s agreed financing

Box 3.7. Horizontal fiscal equalisation and economic efficiency: main issues

The debate over the impact of equalisation payments on economic efficiency revolves around the following main issues.

Some authors argue that horizontal equalisation transfers may *discourage labour from moving to jurisdictions where its marginal product is highest*. Such criticism arises mainly from equalisation on the cost side, and in particular, with regards to the location-specific disabilities (including factors such as scale of delivery, urban transit and population dispersion), which tend to lead to a redistribution of revenue in favour of the less populous states.

Critics further argue that, by focusing on average levels of service, the CGC methodology creates *disincentive for state governments to improve efficiency*. States embarking on cost-reducing reforms are “penalised”, while inefficient states are “rewarded” for under-performance. As a result, heavily subsidised states may undertake spending initiatives with low payoffs. In addition, the current equalization arrangements may hamper growth-enhancing reforms, if the states anticipate that the gains from reforms will be equalised away. As Webb (2002b) points out, however, there is no agreement on how to integrate incentives that reward efficiency into equalisation assessments.

Moreover, it has been suggested that the current system of inter-governmental transfers creates *deadweight losses* estimated at AUD 150-280 million per year (Garnaut and FitzGerald, 2002b). These are static costs. The authors also express the view that the dynamic efficiency costs are potentially higher, but difficult to quantify.

Opponents of the argument, that equalising transfers may *discourage labour from moving to jurisdictions where its marginal product is highest*, contend that fiscal equalisation can correct for the inefficiencies arising, for example, from interstate differences in the distribution of capital returns, fiscal incentives (that is, differences in state taxes, service levels and costs), congestion and demographic factors. It is further argued that equalisation simply brings decentralised fiscal outcomes closer to those that would prevail under unitary decision-making. Within-boundaries equalisation is already practiced by the Commonwealth and the states, as they do not impose higher taxes in higher-cost areas or provide a lower level of services in remote areas. Hence, if equalisation among the states was reduced or even eliminated, the effect would be felt state-wide and not just in high-cost remote areas. In other words, there would be an incentive to move from the rural areas or smaller state capitals to the already large metropolitan areas of Sydney and Melbourne, with no clear gains derived in a highly urbanised society as Australia.

In its latest report, the CGC counters criticisms that its practices undermine efficiency (or even penalise it) on the grounds that differences in efficiency across states play no role in the derivation of relative needs of the states (as these are calculated on the basis of average expenses and revenues, adjusted for influences beyond state government control), and hence in the calculation of the grant shares. In this context, CGC points out that states that are more efficient than average can use the proceeds as they see appropriate, while those below average must compensate for the difference by a lower quality of services, higher taxes or an increase in borrowing, all of which might induce such states to seek efficiency improvements.

Source: Craig (1997); Rye and Searle (1997); Collins (2004); CGC (2006); Dixon et al. (2005); Garnaut and FitzGerald (2002a, 2002b); Madden (2002); McLean (2002); Ramakrishnan and Cerisola (2004); Webb (2002a).

requirement and can request jurisdictions to provide an explanation for breaching a tolerance limit (Sutherland et al., 2005).

The Loan Council has undergone a number of significant changes over time (Box 3.8). The current arrangements focus on fostering transparency and accountability. Emphasis

Box 3.8. Australian Loan Council: main features and reforms

The Loan Council was set up informally in 1923 and given formal status in 1927, under the Financial Agreement between the Commonwealth and the states. It has undergone a number of significant reforms over time. Under the initial arrangements, state borrowing was controlled by the Commonwealth, with the states being only able to borrow from overseas markets with unanimous Loan Council approval. The states have always been free to determine how borrowed funds would be used. These arrangements worked well until the 1970s, when the states began to use non-conventional borrowing instruments, such as leasing and deferred payment schemes, circumventing the effective control of the Council. Financial de-regulation in the 1980s also reduced the Council's ability to effectively control sub-central borrowing. The *Global Borrowing Limits Approach* of 1984 constrained the level of new borrowing (conventional and unconventional) by the Commonwealth and the state governments. Though successful at the start, by 1993/94 it had become apparent that these arrangements did not reflect the total impact of public sector financing on financial markets, as it did not take into account reserves, and that borrowing did not necessarily mirror the needs or fiscal positions of the states, as the limits were based on historical amounts. This led to the implementation of the current arrangements. By focusing on net, rather than global, borrowing, the current arrangements removed the Commonwealth's explicit power to borrow on behalf of the states and allowed them to issue their own securities.

The current system requires nominations by the states jurisdictions for their total call on financial markets with no requirement for specific project details. Emphasis is put on credible budgetary processes and more comprehensive data reporting requirements to make governments more accountable to the market. Specifically, the Commonwealth and each state government are required to submit to the Loan Council their net financing requirements for the coming year. These so-called *Loan Council Allocations* comprise estimates of the sum of general government and public non-financial corporations' surplus or deficit, net cash flows from investment in financial assets for policy purposes and some memorandum items.

The Loan Council considers a state jurisdiction's nomination with regard to the jurisdiction's fiscal position, infrastructure needs and the macroeconomic implications of borrowing. If the submission of a particular jurisdiction raises concern, the Council has the right to request comprehensive justification for the nomination, as well as an amendment of the fiscal strategy, if needed. However, there has been little controversy or dispute arising from Loan Council decisions. To ensure that credible nominations are put forward, each jurisdiction is subject to a 2% tolerance limit for deviations. In the event that this limit is exceeded, a jurisdiction is required to publicly report the breach.

Source: National submission; Craig (1997); Institute on Governance (1998); Webb (2002b).

has been put on setting credible budgetary processes and facilitating financial market scrutiny over proposed borrowing through uniform and more comprehensive information reporting requirements. These arrangements have not been put to the test, as yet, since the Loan Council has operated through a period of improving state finances, with continuing operating surpluses and sharp declines in debt, and also at a time when the federal government has accumulated large budget surpluses.

Complementing the role of the Loan Council, financial markets and rating agencies seem to have been effective in disciplining sub-central fiscal behaviour. The experience of Victoria in the 1990s is instructive. Following a period of deficits and rising debt and a

subsequent rating agency downgrade, the Victorian government set an explicit long-term objective to reduce debt and debt-servicing ratios to levels consistent with restoration of the state's former triple A credit rating. Maintaining an AAA credit rating is currently an explicit objective of the fiscal strategy in a number of states.

Improving transparency

The strengthening of government financial reporting would enhance fiscal policy transparency. The current reporting system entails multiple sets of financial statements, which differ across jurisdictions, reducing comparability.²⁸ Efforts underway to harmonise the existing requirements and presentation framework are welcome, given the potential implications of such a reform in assessing fiscal policy outcomes.²⁹

There is also scope for further improving the existing benchmarking frameworks, published annually in the *Report on Government Services*, through completing the process of developing indicators and establishing relevant data sets.³⁰ This would facilitate comparisons of equity, cost-effectiveness and efficiency in service delivery across jurisdictions. The focus of the recent COAG-agreed National Reform Agenda on long-term outcomes and measures underlines the need to improve the assessment of relative performance across jurisdictions.

Concluding remarks and policy recommendations

The Australian federal system has evolved considerably over time, moving towards a model where the Commonwealth and the states have joint responsibility for a large number of functions and governments collaborate in key policy areas. The states, however, have considerable room to set the level and composition of their expenditure, although there are some important limitations. The current pattern of widespread shared government involvement increases the necessity to clearly define roles and responsibilities, and for a simpler and more flexible system of SPP arrangements to minimise duplication and cost shifting, particularly in key areas such as health and related services. The recently-endorsed COAG National Reform Agenda – focusing on human capital issues, in addition to the traditional areas of competition and regulation – is a welcome step towards achieving a more effective delivery of public services. A close co-operation among the Commonwealth and states for the timely implementation of the COAG reform agenda is imperative, especially in light of pressures arising from demographic changes.

The presence of vertical and horizontal imbalances also raises issues. Whereas there is little agreement over the desirable degree of governmental centralisation, the states' reliance on revenue transfers from the Commonwealth draws attention to the design of the inter-governmental transfer arrangements needed to bridge the fiscal gap. Important in this context is a further improvement in the state tax mix, with a broadening of the base of more efficient taxes as compensation for the abolition of the remaining stamp duties. As for the current comprehensive horizontal fiscal equalisation mechanism, conflicts between the long-term “donor” states and “recipient” states in a pool-based equalisation system are to be expected. However, consideration could be given to implementing the simplification of the overly complex and detailed CGC methodology even earlier than 2010 – the year targeted by the current reform programme. Finally, benefits would arise, in terms of ensuring fiscal discipline across government levels, from further enhancing the transparency of public spending through an improvement in the reporting and benchmarking frameworks. Ongoing efforts towards this direction are welcome.

Box 3.9. Recommendations for improving fiscal relations across levels of government

The allocation of spending responsibilities:

- The complex patterns of joint government involvement in key areas of public service provision should be simplified, through a clarification of government roles and responsibilities, to reduce cost and blame-shifting, and duplication or gaps in service delivery. Emphasis should be put on effectively clarifying spending assignments in the health care and related services, and in particular in the areas of hospital services and aged care.
- The specific-purpose payments should become less complex and inflexible. A first step would be to develop an outcome/output performance and reporting framework for each SPP. This is an ambitious task as outcome/output measures of service delivery are difficult to clearly define, measure and enforce in a robust way. Nevertheless, such frameworks could ultimately lead to a move towards the funding of such payments on an outcome/output basis in certain areas, such as education.
- The Commonwealth and state governments should co-operate closely to ensure the timely implementation of the 2006 COAG National Reform Agenda, focusing not only on competition and regulation, but also on human capital issues (health care, education, and training and work incentives).

Funding arrangements for sub-national governments:

- Broaden the land property tax base through addressing administrative issues such as keeping property valuations up to date, and reducing exemptions, in particular that of land property for owner-occupied housing.
- Further improve the efficiency of the existing state tax mix, by implementing rigorously the agreed schedule for the abolition of most business stamp duties. If the land tax were to be broadened, for example to include owner-occupied housing, then consideration should be given to the abolition of the conveyance duties levied on the transfer of real property.
- Broaden the base of the current narrowly-based payroll tax system (mainly by extending it to smaller firms), and streamline compliance procedures.
- If some increase in the revenue-raising capacity of the states to meet their expenditure responsibilities were considered warranted, a less direct option would be to allow states to “piggyback” on the personal income tax levied by the Commonwealth, with the centre making “tax room” by lowering its personal income tax. A difficulty with this option is that its introduction would require a fundamental adjustment of Commonwealth-state financial arrangements which would require agreement of all jurisdictions.
- Consider simplifying the overly complicated and detailed system of horizontal equalisation, even before the year 2010 targeted by the current reform programme.

Ensuring fiscal discipline:

- Improve the transparency of fiscal policy through the strengthening of government financial reporting. Efforts towards harmonising the existing frameworks and preparing a single set of government reports are welcome and should continue.
- Further enhance the existing benchmarking framework by completing the process of developing indicators and establishing relevant data sets for those indicators.

Notes

1. In particular, with the Commonwealth being a major provider of funding of private schools – which are growing more rapidly than state-funded public schools – the states face less expenditure pressure in the context of a gradually declining share of the population of school age.
2. In its report, *The Economic Implications of an Ageing Australia*, the Productivity Commission projects that if SPPs grow with service needs, 90% (5.7% of GDP) of the total fiscal pressure (6.5% of GDP) will fall on the Commonwealth and the remainder on states. The Commonwealth's share falls to around 80% if SPPs grow with GDP and to 60% if SPPs grow with inflation and population (Productivity Commission, 2005b).
3. The term “states” is used in the chapter to encompass the activities of both states and territories.
4. Examples include the High Court's decision in the second uniform income case (1957), effectively confirming the 1942 judgment that the Commonwealth's exclusive power over the income tax base (constitutionally a shared base) could continue after the war; and the Court's broad interpretation of “excise duties” to incorporate all taxes on manufacture, distribution, and sale of goods, barring states from levying taxes on the sales taxes of goods (although they retained their ability to tax services) (Keating and Wanna, 2000; Madden, 2002; and Williams, 2005a).
5. The Constitution was amended in 1946 to give the Commonwealth legislative power with respect to “pharmaceutical, sickness and hospital benefits, medical and dental service”. The only Commonwealth power in relation to health prior to this amendment was over quarantine matters.
6. In addition to the matching requirements for tied grants, these limitations arise from the Constitution itself (especially in relation to the federal government's role in defence and external affairs); state legislation (as it relates to defining the role of local government); and citizen's preferences with regard to public goods provided by the sub-national governments.
7. According to the authorities, many councils have inadequate financial governance or long-term financial planning practices. Many do not make adequate provision for depreciating infrastructure and do not borrow to replace infrastructure, while providing increased community services without ensuring that there are adequate resources to do so. Local government considers that its functions and responsibilities have increased and that it should be provided with a corresponding increase in financial resources, while the states and territories do not see the need for increased funding of local government.
8. Since the early 1990s the federal government has used over 90 different SPPs to transfer funds to the states, although the total number of the programmes may surpass 500, if different sub-programmes are also taken into account (Searle, 2002).
9. These include financial assistance grants to local governments for roads and other services. Assistance is paid in the form of general purpose assistance and untied local road funding – both of which can be spent according to the priorities of local authorities. The annual increase in funding is granted on the basis of an escalation factor, determined by the Australian Treasurer with reference to population growth and the consumer price index (Australian Government, 2005).
10. The Agreement to Implement the National Competition Policy and Related Reforms (1995) and the November 2000 COAG Communiqué (containing changes to the NCP arrangements) provided for the Australian Government to make competition policy payments to the states up to and including 2005/06. Hence, the 2005/06 NCPPs are the final payments under the current arrangements. As part of the new National Reform Agenda, agreed by COAG in February 2006, the Commonwealth will provide funding to the states and territories on a case-by-case basis, once specific implementation plans have been developed if funding is needed to ensure a fair sharing of the costs and benefits of reform (Australian Government, 2006).
11. These penalties may take the form of a permanent deduction, specific suspension (until pre-determined conditions are met) and pool suspension (applying to a range of outstanding legislation review and reform compliance failure, which are reassessed in subsequent assessments).
12. On the basis of the 2006/07 Budget, the Australian Government decided to deduct permanently AUD 40.7 million and suspend AUD 32.9 million of the estimated maximum level of payments of AUD 777.9 million in 2005/06, and reimburse AUD 100.5 million of 2004/05 suspensions. The National Competition Council indicated that it would recommend the lifting or reduction of 2005/06 suspensions subject to the satisfactory assessment of implementation of reform commitments in 2007 (Australian Government, 2006).
13. According to the CGC's terminology, a relativity is defined as “a per capita weight assessed by the Commission for use by the Australian Treasury in calculating the share of the GST pool that a state

- requires to achieve horizontal fiscal equalisation” (CGC, 2006). The decisions of the CGC are not legally binding. The federal government, however, usually implements its recommendations.
14. When responsibilities of various government levels overlap, as for example in the case of health care, each level of government can blame the other for not doing its part, leading to under-provision of some services and poor cost-efficiency of public expenditure programmes (Journard, 2005).
 15. The Australian government addressed all of the immediate, and most of the medium-term recommendations in the Hogan Review, providing AUD 2.2 billion for various initiatives.
 16. Recent debate has focused on the possibility of rationalising responsibilities for universities. While the Commonwealth has significant financial and policy responsibility for higher education, the states retain major legislative responsibilities.
 17. The Reform Council will be an independent body, which will replace the National Competition Council that has played a vital role in implementing the NCP reforms since 1996 (COAG, 2006).
 18. The key principles include: simple administrative accounting and reporting arrangements; an outcome/output focus; non-legalistic wording and the use only of those provisions that give effect to the main policy intent; flexibility to allow the states and territories to decide delivery mechanisms; and clearly defined allocation of funds, processes and dates for renewal.
 19. This could be achieved through the publication of reports by the overseeing authority which set out details of how a state had failed to comply.
 20. For a discussion of this option see Collins (2004). Going back, the Commonwealth passed legislation, in 1978, to allow the states to impose an income tax surcharge, but the initiative failed partly because the Commonwealth government did not make “tax room” by cutting personal tax rates. If a state government wanted to levy an income tax surcharge, it would have had to impose that on top of the existing federal rates, which none was willing to do. Moreover the surcharge was portrayed in a number of states as double taxation, while states are also quite comfortable receiving grants from the Commonwealth, rather than raising revenues on their own (James, 1997).
 21. Unlike stamp duty on business conveyances of real property, the abolition of which is to be considered in the future, stamp duty on residential conveyances was not listed in the Intergovernmental Agreement and has therefore not been a part of this agreement between the Australian government and the states.
 22. The legal incidence of payroll tax is on employers, and is based on wages paid or payable to employees (which in most states includes non-cash fringe benefits). Labour income paid by the federal and local government, as well as that earned by the self-employed are untaxed. Moreover, the tax base does not include sub-contractors and certain types of fringe benefits, and in two states – Queensland and the Northern Territory – employer superannuation contributions (Gabbittas and Eldridge, 1998).
 23. In addition to horizontal tax competition, the observed variation in the state tax mix also reflects differences in the ability of the states to raise revenue from a particular tax base and interstate differences in abolishing outdated and inefficient taxes. Historically, the abolition of other taxes has been led by the larger states, with the other states following suit (Gabbittas and Eldridge, 1998).
 24. The elimination of death duties is often cited as an example. In particular, its abolition, by Queensland, in 1976, induced the migration of more affluent elderly people to the state, forcing the other states to do the same. As a result, all states lost this revenue source. In the Productivity Commission’s view, however, it is debatable whether this was destructive or constructive competition, with the answer depending on whether death duties should be included or not in an efficient mix of tax bases (Productivity Commission, 2005a).
 25. The Peloquin and Chong sample includes Canada, Germany, Switzerland and the United States as well as Australia. On the basis of the findings, Germany is the next most egalitarian federation after Australia.
 26. In November 2001, New South Wales, Victoria and Western Australia – who argue that the HFE methodology disadvantages them – commissioned a Review of Commonwealth-State Funding to examine the methods used to distribute federal grants among the states including the application of HFE (Webb, 2002a). For the final report of this review, see Garnaut and FitzGerald (2002a).
 27. A similar conclusion about the size of the impact of the principle of fiscal equalisation on the efficient allocation was derived by the CGC in its 1988 report on General Grant Relativities, which assessed the effects as not being serious enough to justify a change in equalisation procedures. Looking at the issue of whether or not to include location-specific costs, the CGC concluded that there was no evidence that fiscal equalisation influenced location decisions (Williams, 2005b).

28. Currently, six of the eight jurisdictions base their primary budget Statements on Government Finance Statistics (GFS), and two base their budgets on Generally Accepted Accounting Principles (GAAP), while the Australian Government provides its budget Statements according to both GAAP and GFS.
29. The Financial Reporting Council set the Australian Accounting Standards Board the task of harmonising the GFS and GAAP frameworks in order to enable the development of an Australian Accounting Standard which makes it possible to prepare a single set of government reports which are auditable, comparable between jurisdictions and in which the outcome Statements are directly comparable with the relevant budget Statements. Revisions to the uniform presentation framework of financial data were agreed by the Australian Loan Council in March 2002 and March 2003.
30. For example, an examination of the Report on Government Services – which applies a common overarching reporting framework to 14 areas of government service provision (such as education health management, aged care) – indicated that this report could be improved as a benchmarking exercise. In particular, the Steering Committee concluded that there are a number of areas where indicators have yet to be developed, for which data have not been collected, or where incomplete or non-comparable data are used.

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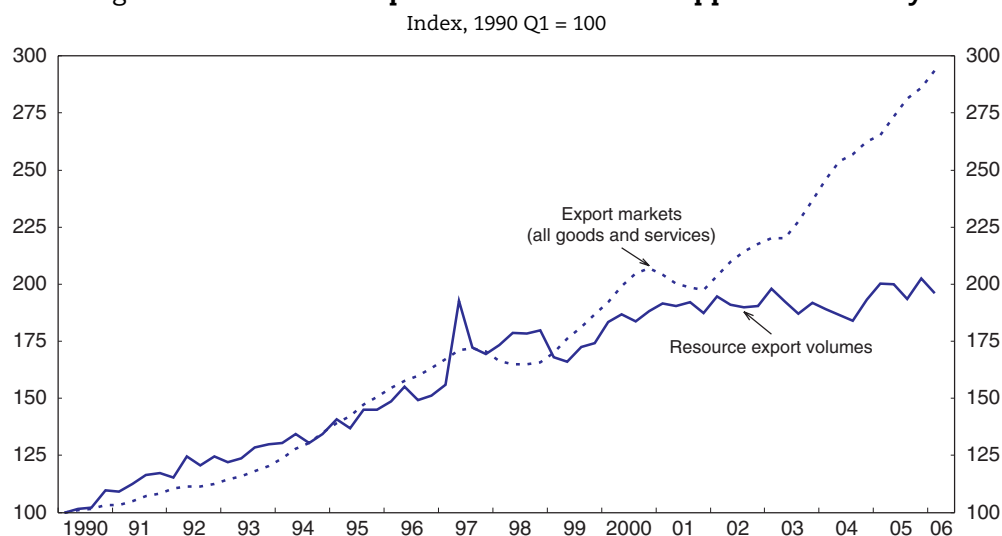
Chapter 4

The need for further reforms to infrastructure services

Australia's National Competition Policy (NCP) has set out competition principles which extended the reach of competition law to previously exempt activities and provided a coherent framework for reforms in essential infrastructure industries. Among the major achievements are the establishment of an overarching national access regime – together with sector-specific regimes – which introduced third-party access arrangements for infrastructure services such as gas pipelines and rail track networks. Independent authorities were established in all jurisdictions to monitor and set prices for monopoly services. However, there remains unfinished business and the NCP infrastructure reform agenda was not exhaustive, leaving room for additional measures to improve the efficiency in essential areas such as electricity, water, road and rail transport. Implementing them, including through the new National Reform Agenda, should raise multifactor productivity further and should help to narrow the gap between Australia's per capita income and that of the OECD's best performers.

The issue of inadequate infrastructure received headline attention recently when more than 50 ships were forced to queue, some for more than a month, at one of Australia's bulk commodity ports. This was seen as symptomatic of the disappointing growth in export volumes of resources despite rapidly growing demand (Figure 4.1), with the Reserve Bank (RBA, 2005) suggesting that infrastructure was a factor holding back exports. In response to these concerns the government commissioned an inquiry into whether bottlenecks of a physical or regulatory kind were acting as an impediment to exports. The government-appointed *Exports and Infrastructure Taskforce* (2005) confirmed the existence of localised infrastructure capacity constraints, partly explained by the unexpectedly strong upturn in global demand for mineral and metal commodities. It also concluded that there was no general infrastructure capital "crisis", nor was there any lack of funds holding back additional infrastructure investment. Instead, the main problems lay in the regulatory and governance framework and the involvement of multiple stakeholders with different objectives that discourage investment. It characterised the current structure and administration of infrastructure regulation as "adversarial, cumbersome, complicated, time consuming, inefficient and subject to gaming by participants".¹ The Taskforce warned that without action to remove impediments to efficient investment in infrastructure, particularly to simplify and streamline regulatory processes, Australia's export potential risked being compromised over the medium term.

Figure 4.1. **Resource export volumes have disappointed recently**



Source: ABS (2006), *Balance of Payments and International Investment Position, Australia* (cat. No. 5302.0) and OECD Economic Outlook 79 database.

In June 2005, the Council of Australian Governments (COAG) considered the findings of the Taskforce and agreed, in principle, to a simpler and consistent national system of regulating ports and export related infrastructure, to be considered in the context of

COAG's 2005 review of existing national competition policy arrangements. At its meeting in February 2006, COAG announced a new *National Reform Agenda*, which includes infrastructure regulation and planning, together with reforms of health services, skills recognition, and a lessened regulatory burden on business. It was also agreed to establish a Reform Council to report to COAG annually on progress in implementing the National Reform Agenda. The Council will be an independent body that will replace the National Competition Council which has played a pivotal role in the achievement of the NCP reforms since 1996.² COAG further signed a *Competition and Infrastructure Reform Agreement* to provide for a simpler and consistent national system of economic regulation for nationally-significant infrastructure, including for ports, railways and other export-related infrastructure. It was separately agreed that each jurisdiction will provide five-yearly reports to COAG on infrastructure for which they are responsible. The reports will provide a strategic overview of existing infrastructure, an outlook for infrastructure demand, and a forward-looking strategic assessment of future needs. The first set of reports will be provided to COAG by 31 January 2007.

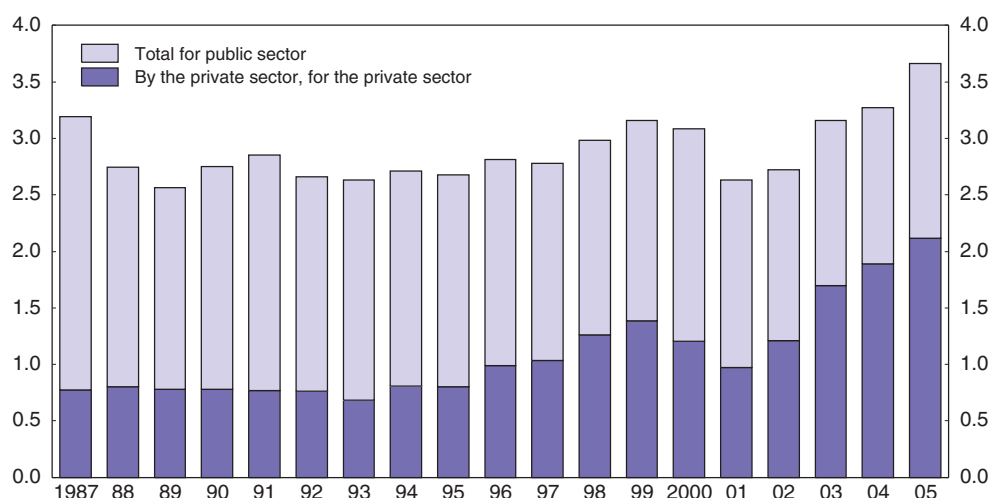
The remainder of this chapter begins by examining data on aggregate infrastructure investment before reviewing existing opportunities to enhance the efficiency of essential economic infrastructure through competition-related reforms. The following sections then focus on the provision of port, road and rail freight transport, electricity and water as these are the areas where gains from reform are likely to be most significant. Hence, sectors such as passenger transport, communications, postal services and aviation services, which were discussed in the previous *Survey* are not taken up again, although they also offer scope for gains from further reforms.

Insufficient infrastructure capital is not a general problem

Engineering construction as a share of GDP remained fairly stable over the 1990s, generally fluctuating between 2½ and 3% of GDP (Figure 4.2). At the turn of the current decade the share fell, partly due to a large fall in mining-related investment in response to a period of low mineral and metal prices. The sharp upturn in the commodity price cycle explains much of the subsequent pick-up with engineering construction accounting for 3¾ per cent of GDP in 2004/05. But the most striking feature of recent trends is the growing role of the private sector in infrastructure investment, largely reflecting the outsourcing of government services and the privatisation of state-owned enterprises.

The growing involvement of the private sector has been associated with increased productivity of the existing infrastructure stock – for the most part the result of NCP reforms – which led to decreasing absolute and relative prices of infrastructure services. While there is a shortage of infrastructure in some areas, the level of government and private sector expenditure on infrastructure has recently increased substantially, partly in response to the commodities boom. Indeed, it is important that this expenditure is not pushed to a level beyond the infrastructure supply capacity of the economy as this will add to cost pressures. Furthermore, in the Australian context, the major challenge is to improve pricing and regulatory arrangements, rather than increasing the total volume of infrastructure. This requires pushing ahead with reforms to further raise the productivity of the existing infrastructure and provide as competitive an environment as possible, overseen where necessary by judicious regulation, to ensure that prices provide clear signals of any emerging bottlenecks. Although overall product market regulation is among the most favourable in the OECD, there is scope to further raise competition in the

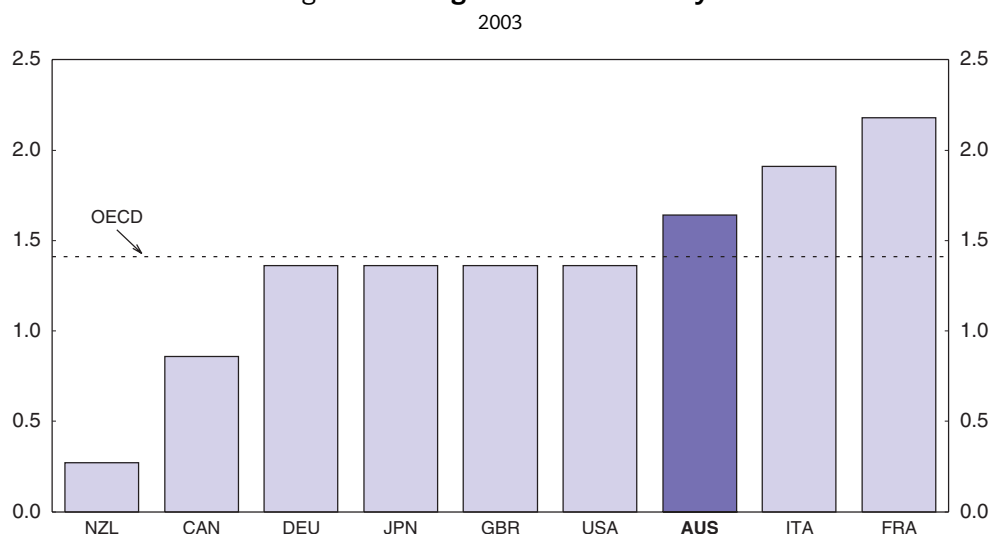
Figure 4.2. **Trends in infrastructure investment**
Engineering construction activities, current prices, in per cent of GDP



Source: The Treasury, Australian Government; ABS (2006); Australian National Accounts: National Income, Expenditure and Product (cat. No. 5206.0) and Engineering Construction Activity, Australia (cat. No. 8762.0).

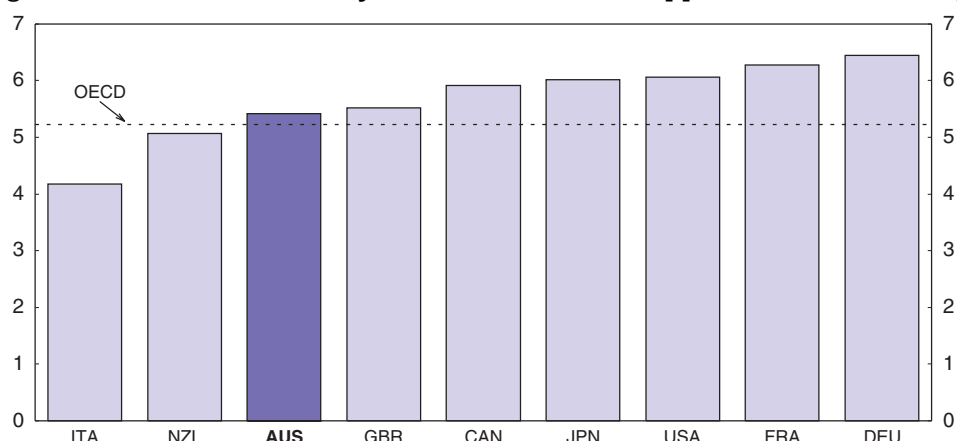
provision of water, transport, electricity and telecommunications, particularly through ensuring greater regulatory consistency and competition across states. Indeed, national or state laws restricting the number of competitors allowed to operate a business in these sectors result in one of the OECD sub-indicators of product market regulation measuring legal barriers to entry scoring above the OECD average (Figure 4.3). Finally, while international comparisons of infrastructure investment are problematic, a survey-based index of the ability of basic infrastructure to support economic activity clearly suggests scope for improvement, with Australia ranked below all but one G7 country (Figure 4.4).

Figure 4.3. **Legal barriers to entry**¹



1. Indicator, higher values denote greater legal barriers to entry.

Source: Conway, P., V. Janod and G. Nicoletti (2005), "Product Market Regulation in OECD Countries: 1998 to 2003", Economics Department Working Papers, No. 419, OECD, Paris.

Figure 4.4. **Index of the ability of infrastructure to support economic activity**¹

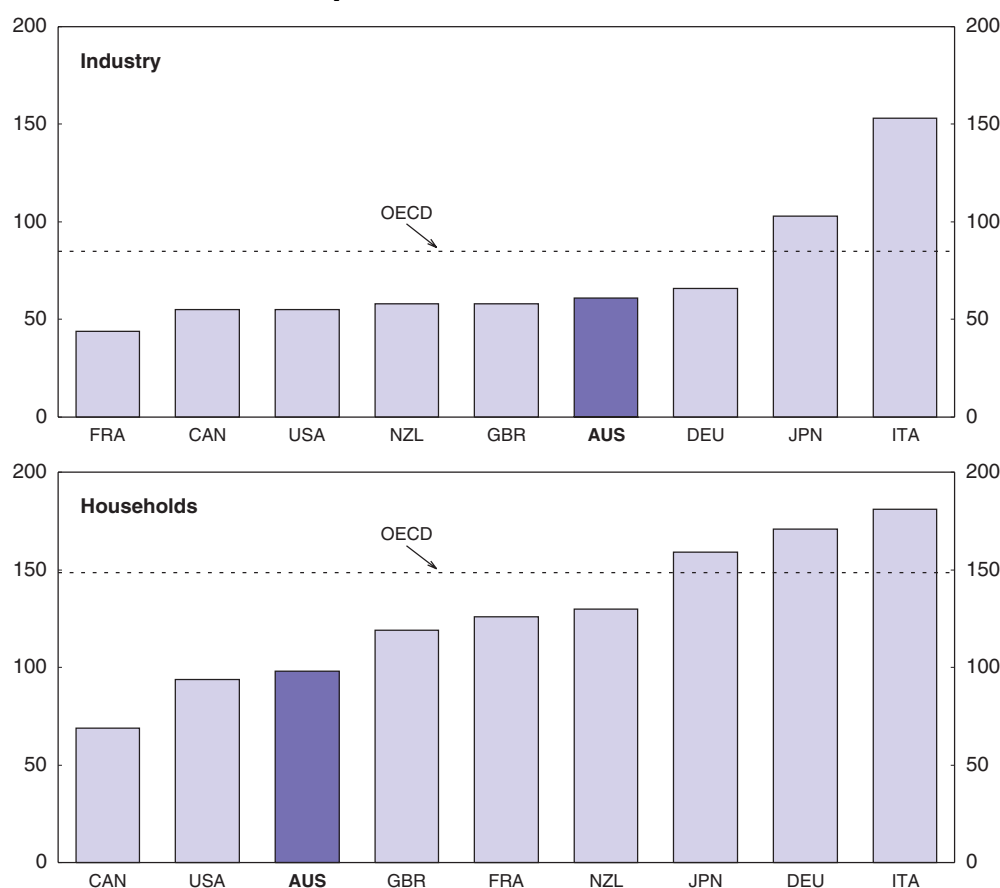
1. Global competitiveness index where the scale varies from 1: infrastructure is poorly developed, to 7: infrastructure is among the best in the world. The index combines publicly available data and the results of country surveys of business executives. The OECD aggregate is an unweighted average.

Source: World Economic Forum (2005), *The Global Competitiveness Report 2005-2006*, Palgrave Macmillan.

The infrastructure service reforms were largely a success

A main objective of the NCP was the establishment of competition in infrastructure services markets. The emphasis was based on the recognition that the provision of infrastructure services, which had been dominated by government enterprises, had entailed serious inefficiencies and often resulted in low-quality services. Specific NCP infrastructure reforms focussed on the markets for electricity, gas, road transport and water supply, while related reforms also dealt with rail transport, telecommunications and television broadcasting. Altogether, these sectors account for more than 10% of GDP. However, their significance for economic performance goes beyond their weight in total value-added, in part because infrastructure services are also key to the quality of life. They are also crucial inputs for many businesses so that their efficient provision and reliable access have a major influence on international competitiveness and growth.

In most infrastructure industries the NCP reforms are now in place or are in the course of implementation, with water provision being the main area of unfinished business (Productivity Commission, 2005). As a result of the reforms, the efficiency of infrastructure service provision has improved. For example, average real electricity prices have fallen by 19% since the early 1990s,³ which has helped to keep Australian electricity prices low in international comparison (Figure 4.5). Latest estimates of the Productivity Commission of the payoff in productivity and income growth from NCP and other microeconomic reforms in the 1990s suggest that they have raised the level of real GDP by 2.5%. However, the gain falls noticeably short of the Industry Commission's (1995) estimate of a 4.5% higher real GDP level once all of the proposed reforms had fully worked their way through the economy. Part of the discrepancy owes to the fact that the Productivity Commission's latest modelling work is based on the productivity and price changes already observed in the 1990s, hence it neither covers the effects of NCP reforms undertaken since 2000 nor the likely dynamic efficiency gains from earlier reform. The estimates also only take a subset of key infrastructure sectors into account (electricity, gas, urban water, telecommunications, urban transport, ports and rail freight). Finally, it should not be

Figure 4.5. **Electricity prices in industry and households**In USD per thousand kilowatt hours, 2004 or 2005¹

1. Data for the latest year available, 2003 for Canada. Price excluding tax for Australian industry and for the United States. National currency data converted to USD using current purchasing power parities. The OECD aggregate is an unweighted average of the latest year of data available.

Source: IEA (International Energy Agency) (2006), *Energy Prices and Taxes*, No. 1, OECD/IEA.

overlooked that the NCP reform package also had benefits which are harder to quantify such as greater reliability of infrastructure services and enhanced system security.

Ensuring competitive neutrality in the freight transport market

Given Australia's vast land area, sparse population, long distances between major cities and to global markets, efficient freight transport infrastructure is a key factor for the country's productivity and international competitiveness. And as the economy grows and becomes more globally integrated, the demand for efficient and cost-effective freight transport will continue to increase. Indeed, recent forecasts suggest that Australia's freight volume will almost double over the next 20 years (Productivity Commission, 2005).

Shipping goods faster through the ports

There is a strong national interest in the efficient performance of major sea ports given their central role in export performance; more than 99% of Australia's exports by weight, and four-fifths by value, leave Australia by sea. Australian sea ports are operated by a combination of state and territory-owned corporations and private sector stevedores,

with the role of the private sector having increased substantially since the 1980s. The *Exports and Infrastructure Taskforce* found capacity constraints at many of Australia's bulk ports for coal and iron ore, mainly arising from the perhaps inevitable unforeseen scale of the increase in the global demand for these commodities. Container ports were not found to suffer from a lack of capacity.

The *Taskforce* also highlighted a need for a greater government involvement in coordinating the transport chain to ensure adequate land transport links to the ports as well as terminal and storage space for the efficient and safe movement of freight. Exports make extensive use of the transport infrastructure: bulk mineral exports reach their departure seaport almost exclusively by rail; grain exports have traditionally been freighted using regional rail lines to ports, although road transport is increasing; whereas most manufactured exports are produced in or near metropolitan areas and reach ports by road. The *Taskforce* recommended that ports and associated shipping channels be included in the *AusLink* planning regime (discussed below) – which sets out an approach to planning, funding and developing national land transport infrastructure within a coordinated framework – in order to facilitate and speed-up joint planning processes, especially with respect to the port/rail/road interface. In response to this proposal, COAG agreed to extend *AusLink*'s corridor strategies to include relevant capital city and associated regional ports on the *AusLink* National Network. Moreover, in February 2006, as part of its new National Reform Agenda, COAG signed the *Competition and Infrastructure Reform Agreement*, which contains measures for achieving a simpler and consistent national approach to the economic regulation of significant infrastructure. It includes the commitment that each jurisdiction will review the regulation of its ports and port authority, handling and storage facility operations to ensure that where economic regulation is warranted it conforms with agreed access, planning and competition principles.

Competitive neutrality in transport modes

Because of the likely further expansion of road transport and its important implications for road congestion, greenhouse gas emissions, and noise and air pollution, the NCP programme had put road transport on its reform agenda. With the objective of transforming the road transport sector into a truly national industry with minimal impediments to interstate operations, the NCP road transport programme focussed on effective and nationally consistent regulation. It covered a large number of initiatives in the areas of registration charges for heavy vehicles, transport of dangerous goods, driver licensing, and compliance and enforcement. The aim of these initiatives was to harmonise safety and operation rules to avoid differences between them entailing distortions of competition. By 2004, the Australian government and the states had completed practically all of their NCP road transport reform obligations (NCC, 2004).

But unlike the situation in energy and water industries, the NCP did not provide a comprehensive and integrated national reform plan for the entire freight transport industry. Instead, reforms have been developed and implemented in a piecemeal approach across transport modes and jurisdictions, addressing each transport mode on its own. Not surprisingly, there is a widespread view among transport economists that there is much more scope for reform in the freight transport sector than envisaged by the NCP transport programme, especially in the areas of service pricing, infrastructure access and the regulatory framework, with the objective of an efficient mix of transport modes and a smooth movement of freight along the entire logistics chain. This would require converting

the traditional modal freight operators into providers of a range of integrated services across the entire logistics chain. It should eliminate distortions created by modal biases in the movement of freight which resulted from the earlier traditional approach to decision making. Some studies suggest that such a bias shows, for example, in excessive investment in road transport infrastructure and the heavy use of roads at the expense of rail transport. The development of such an integrated national network should lead to improved productivity, for example through the elimination of bottlenecks.

To arrive at a modally-neutral freight transport system it will be important to introduce price-setting arrangements for transport services which make sure that freight tasks are assigned to the transport mode which will deliver the services at the lowest cost to the economy in the long run. This should take account of externalities ensuing from the provision and use of freight transport services, although full externality pricing may be an elusive goal.⁴ Currently, the road pricing regime only relies on an annual registration fee and a road user fuel charge collected via the excise system, which are only loosely related to the marginal costs of road use. Hence, the former more compartmentalised transport policy approach was abandoned. In 2004, the government established a better integrated multi-modal transport policy, *AusLink*, a long-term, strategic approach to the planning of Australia's national roads and railways (*AusLink*, 2004). Under this plan, including measures announced in the 2006/07 Budget, the Australian government will spend AUD 15 billion on land transport infrastructure between 2004/05 and 2008/09 (equivalent to about 0.3% of GDP per annum on average over five years).

However, a number of obstacles are in the way of achieving an efficient, integrated and sustainable national freight transport system. According to submissions from the transport industry to the Productivity Commission's 2005 Inquiry (Productivity Commission, 2005) these include:

- An insufficient degree of competitive neutrality across transport modes.
- Continuing inefficiencies within individual transport modes.
- Inadequate quality and capacity of inter-modal connections.
- Institutional arrangements which are inconsistent with the multi-modal approach of *AusLink*.

Competitive neutrality across transport modes requires investment planning and evaluation which ensures an optimal allocation of scarce resources on the basis of rigorous cost-benefit analyses, a requirement which hitherto has not been met by any of the transport investment projects. Finally, regulatory standards to achieve broader social, economic and environmental objectives should be made consistent across transport modes. In view of these problems, at its February 2006 meeting, COAG asked the Productivity Commission to develop proposals for efficient pricing of road and rail freight infrastructure, and has committed to harmonise rail and road regulation, strengthen and better coordinate transport planning and project appraisal, reduce urban transport congestion, and general productivity-enhancing reforms.

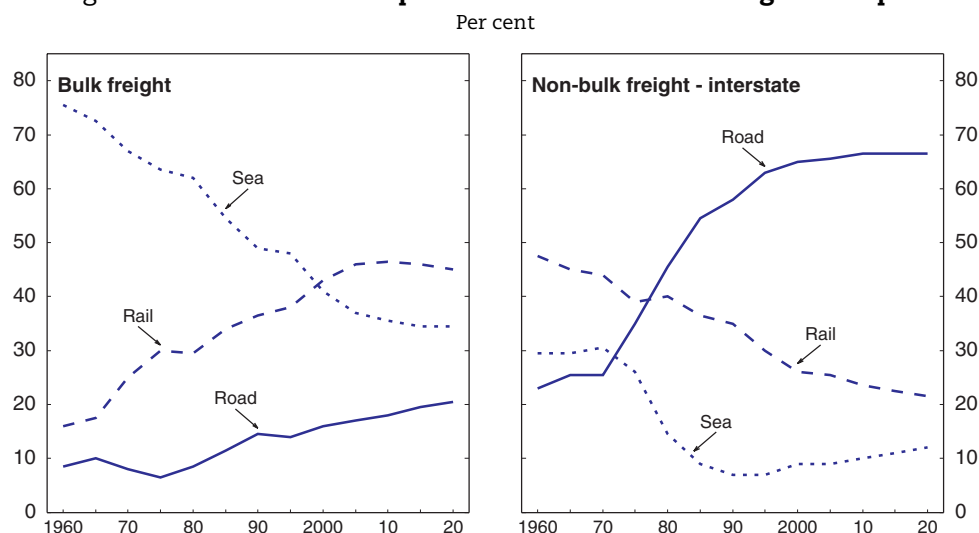
More attention should be given to rail transport reform

Prior to the early 1990s, each state (except South Australia and Tasmania) had its own rail freight company which owned both trains and tracks. These state-based rail freight entities served the intra and interstate markets and were all loss making. And because moving freight between states required the co-operation of various state-based entities,

accountability for freight delivery was often unclear. Despite this unsatisfactory situation, there were no specific rail reforms in the NCP agreements. But because rail services are subject to the general provisions of the NCP's 1994 Competition Principles Agreement there were nevertheless significant structural reforms. In general, these reforms have included structural separation, the introduction of commercial disciplines (incorporation and privatisation) and arrangements for third party access to a large proportion of interstate track infrastructure through the 1997 establishment of the Australian Rail Track Corporation. They resulted in improvements in the productivity of government-owned railways over the 1990s, leading to a decline of about 30% in real freight rates. But there is still considerable scope for further improvements, as productivity remains significantly below that of the best performing countries (OECD, 2004).

The continuing involvement of the states and the lack of nationally uniform operating requirements on the interstate rail network still undermine the viability of the rail transport sector. Currently, railway operators have to cope with a variety of accreditation and rail safety requirements which should be harmonised. Moreover, the multiplicity of state access regimes, pricing and overlapping regulatory agencies act as powerful barriers to entry and should thus be made nationally consistent. To avoid the risk of under-investment both in the track network and the above-rail operations, rail regulators should establish an access pricing system which gives investors a higher degree of certainty, thus facilitating investment planning over a longer time horizon. As discussed above, there is also an insufficient degree of competitive neutrality between different transport modes and there is evidence to suggest this is to the disadvantage of rail transport. Noting COAG's recent National Reform Agenda commitments regarding road and rail infrastructure pricing and rail access regulation, if not addressed, these deficiencies are likely to perpetuate the ongoing loss of market share of rail services to road and sea transport (Figure 4.6). As a first step to further rail reform, a comprehensive national rail agenda should be developed.

Figure 4.6. **Shares of transport modes in domestic freight transport**



Source: Sims, R. (2005), "Furthering Significant Freight Transport Reform in a Federal System", paper presented at a Productivity Commission Roundtable on Productive Reform in a Federal System, 27-28 October, Canberra.

Energy markets are still not fully competitive

A competitive and efficient electricity industry was a key objective of the NCP, featuring a national wholesale electricity market and an interconnected national electricity grid. To this end, Australian governments embarked on a range of reforms since the mid-1990s aimed at a fully competitive National Electricity Market in the eastern and southern states. This was to be achieved primarily through breaking down barriers to interstate and intrastate competition, including dismantling state-owned monopolies and implementing a third party access regime for electricity transmission and distribution, which are services with natural monopoly characteristics. Today, most states and the Australian Capital Territory are part of an interconnected national electricity market. Western Australia and the Northern Territory are exceptions because of the long distances between their load centres and the interconnected electricity network in eastern and southern Australia. However, Western Australia plans to disentangle its electricity monopoly into generation, transmission and distribution networks and retail entities, and to undertake other restructuring measures to provide for more competition.

The NCP programme comprised a similar reform of the gas market with the main elements being structural separation of transmission, distribution, production and retail sectors; the introduction by all governments of third party access regulation for natural gas pipelines; and the provision for all gas consumers to choose their supplier (i.e. full retail contestability). These reforms of the gas market are largely complete, although there is a need to consider the regulatory framework underlying the natural gas industry, which has been addressed through the establishment of a new energy regulator (see below).

In the electricity industry, structural separation of previously vertically integrated electricity providers has progressed, with most jurisdictions opting to maintain government ownership of the separated entities under a corporatised governance model. Competition has been introduced into the generation and retail sectors through allowing eligible users to negotiate directly with suppliers of their choice. All large customers (consuming more than 100 megawatt hours per year) are now able to choose their provider, while retail contestability for smaller customers, including domestic ones, is in place in all jurisdictions except Queensland, where retail contestability is to be introduced from 1 July 2007.

Although the majority of jurisdictions have fulfilled their key obligations under the NCP electricity agreements, the original objective of a fully competitive national electricity market is yet to be realised, even across the contiguous eastern states. A number of reviews (COAG, 2002; NCC, 2003; Productivity Commission, 2005) have identified significant deficiencies of the current national electricity market which still exist and can be summarised as:

- Insufficient competition in generation.
- Lack of grid interconnection (arising from poor incentives for transmission investment and inappropriate pricing structures).
- Perceived conflict of interest where governments are asset owners.
- Inadequate price signals for residential customers.

As a result, the Australian electricity market still consists of a set of regional markets with limited interconnection rather than the integrated national electricity market the NCP had aimed at, which holds back parts of the efficiency gains expected from an integrated national market. Recognising these deficiencies, COAG recently established as part of its

new National Reform Agenda a taskforce, the *Energy Reform Implementation Group*, to report by the end of 2006 on proposals for: achieving a fully national electricity transmission grid; measures that may be necessary to address structural issues affecting the ongoing efficiency and competitiveness of the electricity sector; and any measures needed to ensure transparent and effective financial markets to support energy markets. COAG also requested the Ministerial Council on Energy to oversee the roll out of electricity “smart meters” from 2007, which should improve price signals for residential customers, and to implement a work program for establishing effective demand-side response mechanisms in the electricity market.

Moreover, the electricity generating industry has an important role to play in greenhouse gas abatement. All Australian governments have already implemented a broad range of measures which aim at reducing all types of greenhouse gas emissions. However, these measures are widely judged as poorly targeted and uncoordinated (COAG, 2002). The regulatory fragmentation across jurisdictions imposes a substantial compliance burden on energy producers, especially on those operating in more than one jurisdiction. It also causes considerable uncertainty for potential investors which complicates decision-making and may deter investment.

Earlier energy market reviews (COAG, 2002 and NCC, 2003) also criticised the regulatory inconsistencies arising from the co-existence of state and national regulators in both the electricity and gas sectors. Accordingly, COAG decided to establish a single national regulator – the Australian Energy Regulator (AER) – and an agency to manage the national market – the Australian Energy Market Commission (AEMC), both of which began operations in July 2005. The AER is a new independent national body responsible for the economic regulation and compliance with the electricity and gas rules at a national level. It brings under one umbrella the regulatory functions formerly conducted by the Australian Competition and Consumer Commission (ACCC) and the National Electricity Code Administrator and will cover some functions undertaken by state regulators. Bringing regulation under one body should reduce the complexity and compliance costs for business. Its initial functions include regulating the natural monopoly transmission sector of the national electricity market, monitoring the wholesale electricity market and enforcing electricity market rules. The AER will also regulate gas transmission pipelines in all states and territories (except Western Australia) and transmission and distribution pipelines in the Northern Territory.

The functions of the AEMC include rule-making (a more structured and transparent rule-change process) and market development functions aimed at improving planning and cooperation at the national level. The AEMC is a statutory commission and replaces the three bodies previously performing these functions. The AER and AEMC are scheduled to receive functions in relation to gas transmission and gas and electricity distribution networks by 1 January 2007, and retail functions by 1 January 2008. Although the two new national regulatory bodies should help to reduce duplication, to clarify regulatory roles and lower the cost and complexity of regulation facing investors, clear government policy direction will be needed to develop a consistent regulatory framework.

Another weakness of the current energy market regime is the possibility of electricity generators in some jurisdictions (e.g. New South Wales and Western Australia) to exert market power at the wholesale level. This risks favouring “gaming activity” which may add to electricity price volatility, distort investment signals and cause the national electricity

market to work less smoothly than initially envisaged (Productivity Commission, 2005). Recent measures which facilitate the inter-regional trade in electricity through transmission development appear to have been insufficient to strengthen competition among generators. Accordingly, it seems advisable to further disaggregate government-owned generation businesses as a cost-effective way of promoting competition in electricity generation.

While noting jurisdictions recent commitments to phase out retail price regulation where markets are competitive, all such regulation should be abolished, as it prevents prices from reflecting changes in market conditions. For example, artificially low prices of peak-time electricity have encouraged the growth of demand. Retail price regulation also exposes retailers to substantial price risks in the face of unregulated wholesale prices. Social policy measures other than price controls should be employed to ensure that low-income users have affordable access to energy.

Much remains to be done to make water supply sustainable

Water is scarcer in Australia than in any other continent, except Antarctica. Australia also has the highest year-to-year rainfall variability, many of its rivers have highly variable flows,⁵ and droughts are common. And because Australia is a large country, there is an enormous spatial and seasonal variation in rainfall. Against this background it may seem surprising that Australia has the fourth highest rate of water abstraction per capita in the OECD (OECD, 2006).

A fundamental reform of water policies was a key element of the NCP because the heavily subsidised water supply encouraged an excessive use and inefficient allocation of water. The heavy use of water has entailed extensive damage to river systems and groundwater resources. Around three-quarters of the water is used for irrigation in agriculture, of which two-thirds goes to relatively low-value activities such as rice, cotton and dairy. And a sizeable share of irrigation water – between 20 and 40% – is lost due to leakage and evaporation from open channels. This alone suggests that the potential gains from better water management are considerable. However, rising water consumption is also a result of the rapid growth of population and activity in urban areas.

A major objective of the 1994 NCP water reforms was to establish a market-based system by 2005. This was to be achieved by prices which reflect the full cost of resources, the removal of cross-subsidies and by making other subsidies transparent. Regulatory functions were required to be separated from water provision, while trading in water entitlements should improve allocative efficiency. At the same time, the NCP reforms sought to strike a better balance between consumption and environmental needs in stressed rivers. The development of water management arrangements, which allocate water among extractive uses and to the environment, is progressing, with priority given to stressed and over-allocated systems where governments are reducing the water available for extraction, or establishing arrangements which allow the possibility of future reductions. Australian governments have allocated funds for the compensation of farmers who see their extraction rights reduced.

So far, progress in implementing water reform has been uneven across water-use categories and between states. Pricing reform in urban areas is generally well-advanced as most urban authorities have introduced consumption-based pricing to discourage wasteful use. Moreover, full cost recovery by water service providers is largely achieved which helps

to ensure appropriate investment in infrastructure. Institutional changes have been implemented to encourage efficiency in water provision and to make providers accountable for the quality and cost of water and sewerage services.

Although considerable progress has been made in establishing water rights, reform has proceeded much more slowly in rural areas. Full cost recovery has been interpreted to exclude the costs of existing infrastructure and current delivery charges paid by irrigators and urban areas do not reflect the scarcity value of water. Some scarcity value is reflected in the market price that irrigators pay for their water in the market but where trade is not permitted between rural and urban areas it can result in the price of water supplied to agriculture remaining below that of households. Although water trading is already opening up opportunities for some cities to buy water from irrigators to ease the pressure on urban water supplies, it is still in its early stages. In most states, trading mainly involves temporary transfers while irrigation districts limit the amount of water that can be permanently traded. Moreover, in most states standardised water contracts are not yet available. All these features constitute important barriers to effective trading and to moving water to its most productive use, which is regrettable as they prevent the realisation of substantial potential welfare gains from water trade.

The NCP water reform agenda was enhanced by the National Water Initiative (NWI) Agreement in June 2004. The NWI aims to improve the security of water access entitlements, ensure ecosystems' health and encourage the expansion of water markets and trading (Box 4.1). It focuses on areas in which greater cross-jurisdictional compatibility in the approaches adopted would improve outcomes. Given that water is a state property in Australia, it includes a commitment by jurisdictions to complete the return of all currently over-allocated and over-used river and groundwater systems to environmentally-sustainable levels of extraction. The NWI commits all states to the continued

Box 4.1. The National Water Initiative

In June 2004, COAG agreed to a new water reform programme to be implemented over the next ten years – the National Water Initiative (NWI). The key elements of the NWI include:

- States and territories prepare water plans, which include environmental and other public benefit outcomes.
- Existing arrangements to deal with over-allocated or stressed water systems will be enhanced.
- Tradeable water entitlements as perpetual or open ended rights in accordance with water plans will be established.
- A formula for sharing the costs of reductions in water access entitlements between users and governments will be set.
- Measures to deal with interception of water flows that reduce entitlements will be taken.
- Public registers of water entitlements and trades and the development of standards for water resource accounting will be introduced.
- Barriers to interstate trade in water will be further reduced.
- More detailed pricing principles for water storage and delivery will be established.
- Actions to improve demand management of water use in urban areas will be taken.

implementation of full-cost recovery pricing for water in both urban and rural areas. Full implementation of the NWI would result in a nationwide, market, planning and regulatory based system of managing water resources. The NWI also created the *National Water Commission* as an independent body reporting to the Australian government (and the Council of Australian Governments) on progress in implementing the NWI.

With evidence that parts of Australia's water infrastructure requires increased investment,⁶ the government decided in 2005 to establish the Australian Government Water Fund, which disposes of AUD 2 billion over five years, intended to finance investment supporting *inter alia* initiatives under the NWI. The main objectives of the Fund are to accelerate the dissemination and adoption of the latest water use technologies and practices, to ensure that Australia has the best available science and data necessary to manage water resources, and to reward a culture of "wise water use".

Given that the (rather ambitious) objective of completing the rural water reform by 2005 has not been attained as planned, substantial additional efforts are required to accomplish the NCP water reform programme. Among the major unfinished tasks is the necessity to specify water rights properly, to make them enforceable and fully tradeable. Clear specification of water rights would be better served with the introduction of accounting system standards under the NWI and better information on the volume and accessibility of water and the implementation of water management plans. Such water plans establish water allocation policies for a particular river system or groundwater basin, taking account of environmental, social and economic aspects. In addition, for the enforceability of ownership rights an effective registry system is needed, while transferability of ownership rights requires water trading systems to operate efficiently. It is also important that the setting of environmental minimum flows in rivers where there has been over-allocation of water in the past does not jeopardise the successful introduction of trading. To reap the full benefits from a better allocation of water, barriers to trading between irrigation districts and states also need to be dismantled. Cross-subsidisation of water usage as between urban and rural users, and also between different types of agricultural users, should be phased out over time. Altogether, it will be important to ensure that the scarcity of water is reflected either in the initial price of water, through water trading arrangements that reveal the opportunity cost of using water in different ways, or in the shadow price of water implicit in regulatory controls on the pattern of water use.

Box 4.2. Recommendations regarding essential infrastructure reforms

General

Avoid reform timetables from slipping in the context of the National Competition Policy (NCP) framework.

The government should explore ways of ensuring cost-effective and timely investment decisions in regulated network sectors that operate across several jurisdictions. Infrastructure investment projects should be evaluated on the basis of rigorous cost-benefit analyses.

Box 4.2. Recommendations regarding essential infrastructure reforms (cont.)

In the light of regulatory delays relating to infrastructure development, which have recently been a factor in holding back exports, the time taken for regulatory decisions should be closely monitored, especially where it is likely to impinge on export performance. The recent Exports and Infrastructure Taskforce suggested that an appropriate time for such decisions should be at most six months, rather than as in some recent cases a number of years. Where delays continue to be excessive then further intervention by the Commonwealth would be appropriate.

Freight transport

The current road pricing methodology should be refined to reduce any undercharging of heavy vehicles. A mass-distance road pricing regime should be introduced.

Competitive neutrality of the freight transport industry should be improved to ensure an optimal allocation of freight transport tasks to the most cost effective transport mode.

National land transport reforms planned under the AusLink framework need to be effectively implemented, to ensure efficient long-term investment and better integration of the network.

Electricity and gas

Stronger efforts should be devoted to the implementation of a fully competitive national electricity market, including full retail contestability. In particular:

- The existing retail price regulation should be abolished so that prices reflect market conditions.
- Grid interconnection should be improved and competition in electricity generation intensified by setting better incentives for investment in transmission and generation.
- Outstanding issues concerning the operation and governance of the Australian Energy Regulator and the Australian Energy Market Commission should be resolved to end regulatory inconsistencies, arising from the earlier co-existence of state and national regulators in both the electricity and gas sector.
- Once efficient market structures have been established, governments which currently own generation businesses should consider divesting them.
- The framework governing greenhouse gas abatement should be improved.

Water provision

All governments should complete their obligations from the NCP water reform programme, which should be encouraged by appropriately designed monitoring arrangements.

Price setting should aim at reflecting the scarcity of water and the environmental externalities.

Rural water reform needs to be accelerated through better specification, enforcement and trading of water property rights as well as the determination and pricing of appropriate environmental allocations.

Rural and urban water reform should be better integrated and provisions be developed to encourage water trading between rural and urban areas.

Cross-subsidisation of water usage as between urban and rural users, and also between different types of agricultural users, should be phased out.

Notes

1. For example, investment in both the New South Wales and Queensland coal industries has been hindered by the fragmented ownership of the supply-chain assets; a large number of mines share mostly state-government-owned rail and port infrastructure. Transport infrastructure is generally operated not by the coal mining companies, but by public or privately owned third parties who are responsible for new investment, some of which are subject to regulatory control owing to the monopolistic nature of the assets. In the case of a port at Dalrymple Bay in Queensland, a major expansion of capacity was uncertain because investment in new capacity was contingent on an increase in the allowable user charge, whereas the Queensland Competition Authority had proposed that user charges be lowered.
2. More details of the National Reform Agenda and the Reform Council can be found in the COAG communiqué and related documents of 10 February 2006, available from www.coag.gov.au/meetings/100206/index.htm.
3. For more examples of declining real prices of infrastructure services, and improvements in service quality and better user choice see Productivity Commission (2005).
4. The Treasurer announced on 23 February 2006 that the Productivity Commission will undertake a public inquiry to review economic costs of freight infrastructure and efficient approaches to transport pricing.
5. For example, the ratio between the maximum and minimum annual flows of the Rhine and the Yangtze is 2.0. That same ratio, a measure of variability, for the Murray River is 15.5 and for the Darling it is 4 700 (Turnbull, 2006).
6. For example, the Pratt Water Report (2004) found that much of Australia's irrigation infrastructure requires upgrading and recommended a nationwide refurbishment of irrigation channels.

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Chapter 5

Reforming industrial relations

The industrial relations system has evolved gradually from a very prescriptive set of rules set by judicial bodies to a much more flexible system, with many enterprise and individual agreements. However, the judicial rulings have remained important in setting a floor on what can be agreed upon. Many attempts have been made in recent years to instil greater flexibility, while maintaining a social safety net. The latest is the WorkChoices legislation, which took effect in March 2006. This chapter reviews WorkChoices and assesses the room and options for further reforms.

The industrial relations arrangements have evolved gradually

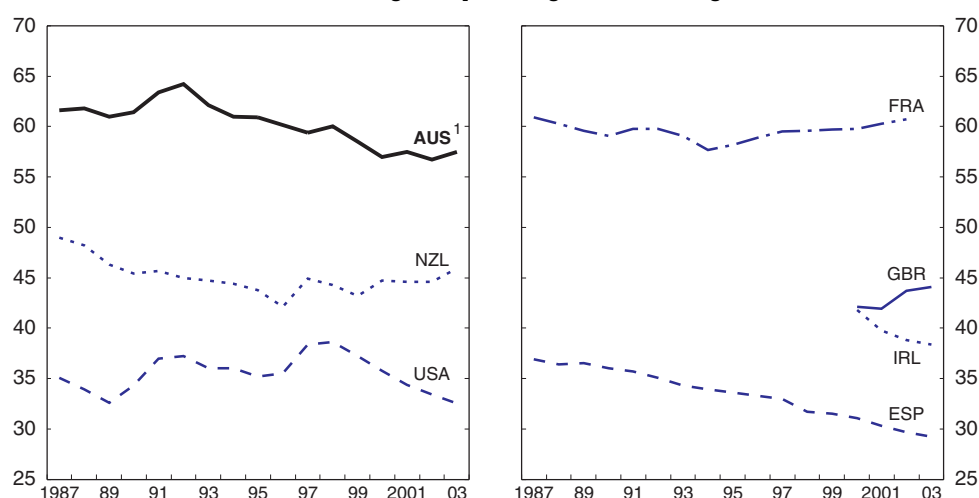
The Australian industrial relations arrangements are unusual, if not unique in the OECD (Harper, 2006). But they have evolved gradually, becoming thus more akin to arrangements in other countries. Industrial relation arrangements cover a whole host of regulations or contractual arrangements such as wages, holidays, redundancy pay, parental leave and many other things.

Until the late 1980s, these workplace rules were set by a judicial body, the Australian Industrial Relations Commission (AIRC) or by industrial tribunals at the state level. The remit of the AIRC, which still exists, was to set fair minimum wages and conditions of employment. Most working conditions are enshrined in awards, which became very prescriptive. The AIRC, for instance, did not only fix a single, nationwide minimum wage, but whole minimum wage grids for an industry or occupation. With unemployment rising sharply between the late 1980s and mid-1990s, several reforms instilled greater flexibility, particularly by providing greater room for bargaining over working conditions, including wages, at the enterprise and individual level. However, the rulings of the AIRC remained central as such enterprise agreements had to be vetted by the AIRC and pass a “global no-disadvantage” test, meaning that any agreement could not provide for less globally than the award for an industry or occupation, though some provisions could be less generous.

Greater use of bargaining over work conditions was facilitated by reducing the complexity of the awards and restricting the number of matters that could be contained in the awards. In 2005, there were still 20 so-called allowable matters, which are the issues to be awarded or negotiated.¹ Concerning wages, the scope for bargaining was also increased by the way pay increases were set. In 2005, for instance, award wages were raised by an absolute amount of AUD 17 across the whole wage grid for all award rates of pay. For metal workers, this means that the percentage increase was 3.6% for the lowest wage category but only 1.5% for a professional engineer. While wages have not always been set in this manner, real minimum wages have risen cumulatively by 11.9% between 1996 and 2005, while the real wage awarded to intermediate professions in the metal industry has risen by only 1.4%. This compares with an economy-wide increase in real average weekly ordinary time earnings of 20% over this period (AIRC, 2005). There are also separate lower wage rates for young people, which are graded by age between 16 and 20 years and for apprentices and trainees. The way of deciding wage awards has kept the minimum wage high. It has declined somewhat in relation to the median wage between the early and late 1990s, but was stable in the first half of the 2000s (Figure 5.1 and Box 5.1). Currently, 1½ per cent of all employees are paid at the minimum wage and about 20% are paid the award wage rate. Award wages have become less and less binding for workers higher up the wage hierarchy, thus widening the room for bargaining.

Concerning the other allowable matters, like holidays, which are set in awards and influence bargaining, they are often viewed as safety net provisions in Australia. But this is

Figure 5.1. **The federal minimum wage in international comparison**
Minimum wage as a percentage of median wage



1. Basic metal industry classification C14.

Source: OECD Minimum Wage database, May 2006.

a myth. Usually they are closer to European than US standards. Awards generally provide for four weeks of holidays, holidays are often even better paid than work via leave loadings and maximum ordinary hours worked are generally 38 hours. However, severance pay and dismissal rules are much more lenient than in most European countries, but somewhat stricter than in the other English-speaking countries.

The co-existence of state level and federal awards and agreements adds to the complexity of the industrial relations arrangements. It implies that many large, but also some smaller companies have some employees covered by the federal and by the relevant state system. It forces many employers to deal with two or more distinct systems and gives rise to time-consuming jurisdictional disputes. The multiple system generates confusion and transactions costs, though co-operation between the systems has increased. So far, only one state, Victoria, has agreed to harmonise work conditions with those at the federal level. The federal rules also apply in the Northern Territory and the Australian Capital Territory.

Collective and individual bargaining has been encouraged by the 1996 Workplace Relations Act. It provided for collective agreements that can be conducted with or without union involvement and for individual agreements (Australian Workplace Agreements or AWAs). Despite streamlining and simplification there were still over 4 000 federal and state awards in 2006, which set 40 000 weekly wage rates. Notwithstanding the large number of awards and award wage classifications, in practice the 14 wage classification levels of the Metal Industries Award have formed the basis of minimum wage adjustments under the AIRC's Safety Net wage reviews. In 2004, federal and state awards covered 21% of all employees, collective agreements covered 41% and individual agreements, including enterprise agreements 38%. On the other hand, the uptake of AWAs has been disappointing, as they still only cover 5% of all employees. However, the take-up has risen rapidly over the last year. Collective agreements are prevalent among bigger companies and individual agreements among smaller companies. In 1990, 67.6% of employees were paid at the award rate, while this has fallen to some 20%. Agreements tend to top up award pay rates, while the most common innovation in agreements concerns more flexible

Box 5.1. How high is the minimum wage in international comparison?

International comparisons of minimum labour costs are usually based on ratios that measure their value relative to some measure of average cost. The advantage of using ratios over level comparisons is that they take cross-country differences in productivity into account. Nevertheless, such ratios may vary substantially depending on both how the minimum labour cost and the average cost is measured. The measures here are based on wages paid to the worker and include employers' social security contributions and other pay-roll taxes.

The OECD has traditionally used a proxy of average earnings based on the earnings of a full-time employed manual production worker in manufacturing (APW, average production worker) for international comparisons. In the last decade the number of people employed as manual manufacturing workers has declined as a share of total employment in most OECD countries (OECD, 2004a). This proxy has thus become less representative as a measure of average earnings. The OECD will start to use a broader concept of average wages (AW) which covers both manual and non-manual workers in a wider set of industries including services, utilities and construction. Income distributions typically have a long tail to the right because there are a few persons earning a lot more than what most people earn (positive skewness). This dispersion in earnings differs across countries therefore influencing the measure of average earnings to differing degrees. The median earning measures the wage at the middle in an income distribution showing that half of the population earns more than the median and the other half less. In a positively skewed distribution the median is lower than the average wage. The median is less sensitive than the mean to outliers and is therefore the preferred average measure for skewed distributions such as the income distribution.*

The measure of average earnings matters for the ranking of countries. The ratio of the minimum labour cost to the cost of an APW is highest in France and lowest in Korea, Australia ranking 9th (Table 5.1). However, when the minimum labour cost is related to the broader concept of average earnings then Finland is followed by Australia, while France's ranking drops to the 7th position. The ranking based on median earnings ranks Australia at the top followed by Finland. The rank correlation between the ratios is fairly high at 0.61 and 0.83. Nonetheless, the ranking of some countries and the apparent relevance of the minimum wage is significantly affected by the choice of the measure of the average wage.

* In the case of Australia the pay-roll tax is included, based on the rate in New South Wales. On the other hand, the compulsory contribution to the Superannuation Guarantee system is not considered a tax as it is not an unrequited transfer to general government. As the contribution rate is flat, it would not affect the ratios if it were taken into account.

working time arrangements. The greater up-take of bargaining has gone hand in hand with a marked decrease in the number of labour disputes, which were among the highest in the OECD at the end of the 1980s.

Implementing WorkChoices

Reforming industrial relations is a heavily contested area. Since the 1996 Workplace Relations Act, 16 laws relating to industrial relations were passed, but 14 were blocked in the Senate. And the latest overhaul of industrial relations, the WorkChoices Act also aroused much passion. Proponents of the reform point to the complexity of the current system. Besides the award setting procedures, there are 130 pieces of state and federal legislation pertaining to industrial relations law. This generates heavy transactions and

Table 5.1. **Labour cost at the minimum wage level in international comparison**
2004

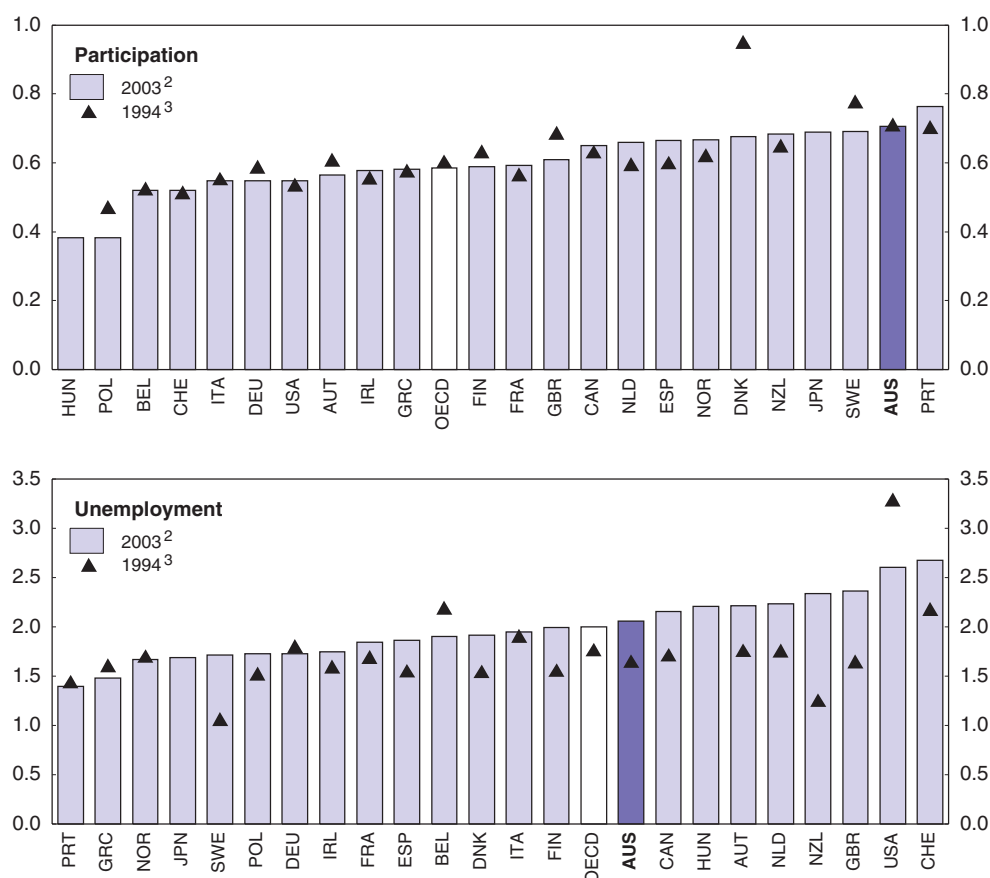
	Minimum labour cost as a ratio of the cost of the:					
	Average production worker		Average wage		Median worker	
	Ranking	% ratio	Ranking	% ratio	Ranking	% ratio
Australia	9	45.1	2	49.1	1	57.6
Finland	2	54.4	1	50.8	2	57.3
Luxembourg	3	52.0	6	43.1	3	54.5
France	1	55.2	7	42.4	4	53.3
Netherlands	8	46.7	5	43.2	5	50.4
Greece	5	50.8	12	36.7	6	49.2
Ireland	7	46.9	3	46.9	7	48.6
Belgium	15	36.2	8	40.8	8	46.8
New Zealand	10	44.0	4	46.6	9	46.6
United Kingdom	11	43.9	15	33.9	10	45.9
Hungary	4	51.6	11	37.5	11	44.2
Portugal	6	49.3	16	33.8	12	43.8
Canada	16	35.8	10	37.5	13	40.6
Poland	13	37.2	17	33.8	14	40.4
Slovak Republic	14	36.7	14	34.7	15	36.7
Czech Republic	12	37.6	9	38.4	16	36.6
United States	19	30.7	13	35.4	17	32.6
Japan	17	32.8	19	27.9	18	31.5
Spain	18	31.9	18	28.8	19	29.5
Korea	20	19.9	20	19.9	20	25.1

Source: Calculations based on OECD Taxing Wages models, May 2006.

compliance costs. And there is a concern that the minimum wage is too high for the low-skilled to obtain and remain in employment. Several studies have addressed this issue. They are summarised and discussed in AIRC (2005). They find an elasticity of employment with respect to a rise in real wages or the minimum wage of between -0.2 and -0.8 . Some of these studies are fairly old and most of them focus on the elasticity between aggregate real wages, rather than that of the minimum wage, on employment. But all show a negative sign, though the actual magnitude is clearly uncertain. While the participation rate of the low-skilled is relatively high, the number of the low-skilled being unemployed is more than twice that of prime-age males (Figure 5.2), 55% of the long-term unemployed have the lowest level of education and none of the studies takes into account the high number of inactive, especially disabled, people, 60% of whom have no post-school qualifications (McCallum, 2005). In a sample of OECD countries, Australia has the lowest proportion of disabled in employment (Figure 6.8 in Chapter 6). Moreover, the number of the disabled as a percentage of the working age population has drifted up and is now higher than that of the unemployed, though the trend increase in the number of the disabled has flattened in recent years.

The increasing scope for direct negotiations between employers and employees has probably also helped to raise productivity, as enterprise bargaining allows firms to adopt productivity enhancing practices and promotes a more co-operative work environment where performance and reward are more closely linked. Indeed, scatter plots by industry suggest that sectors with high productivity growth tend to be those with more decentralised bargaining (Access Economics, 2005 and the Australian government's submission to the AIRC's 2005 Safety Net Review). In an econometric analysis, Connolly

Figure 5.2. **Participation and unemployment of workers with low education**
Rates for workers with a low level of education relative to the rate for prime age men¹



1. Age 15-64 for workers with low education, age 25-54 for prime age men. Low education covers levels ISCED 0/1/2 (pre-primary to lower secondary education). The OECD total is an unweighted average.

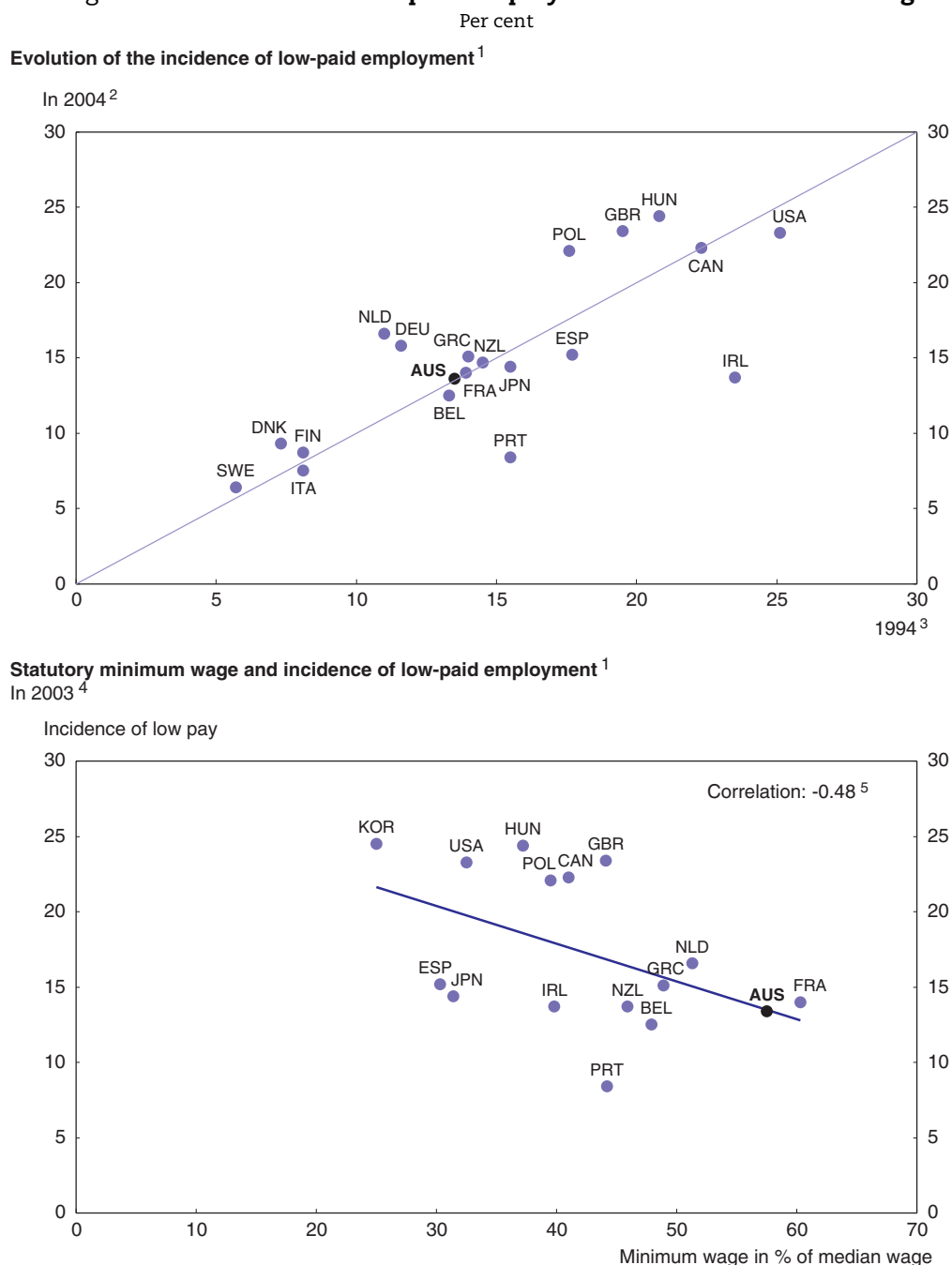
2. 2002 for Italy and Netherlands.

3. 1995 for Poland.

Source: OECD, Labour Force Statistics and Education databases, June 2006.

et al. (2004) estimated that an increase in the coverage of employees with more flexible workplace arrangements (federal enterprise bargains and Australian Workplace Agreements) was followed (with an average lag of two to three years) by an increase in labour productivity, after correcting for a wide range of other factors influencing labour productivity.

Opponents of the reform argue that further liberalisation would threaten the entire system of social protection, of which centralised wage setting is seen as a cornerstone. Reforms would increase job insecurity and lead to growing in-work poverty (for critical views of reform efforts, see for instance JAPE, 2005; CLRIQ, 2005; The Economic and Labour Relations Review, 2006). It is true that past reforms were accompanied by some widening in the wage earnings distribution (Saunders, 2005). But this is mainly because of faster growth in the real wage of the highest paid, while the ratio of average to lowest earnings has hardly changed. Moreover, the incidence of low pay is among the lowest in the OECD (Figure 5.3). It is considerably lower than in the United Kingdom and United States and only lower in the Nordic countries and Italy and Portugal. It is noteworthy that the minimum wage in New Zealand is considerably lower in relative terms than in Australia, but the incidence of

Figure 5.3. **Incidence of low-paid employment and the minimum wage**

1. Incidence of full-time wage-earners earning less than two-thirds of the median wage.
2. 2000 for Hungary; 2001 for Belgium, Finland, France, Greece, Italy, Portugal and Spain; 2002 for Germany and Poland; 2003 for Canada and Denmark.
3. 1996 for Denmark and Finland; 1997 for Canada and Sweden.
4. 2000 for Hungary; 2001 for Belgium, France, Greece, Ireland, Netherlands, Portugal and Spain; 2002 for Poland.
5. Statistically significant at the 10% level of confidence.

Source: OECD (2006), *OECD Employment Outlook* and Minimum Wage database.

low pay is nearly the same. Moreover, more than half of the low paid live in families with income above the median, which means that pushing up wages is a blunt tool to enhance fairness.

Against this background and the need to get the legislation through the Senate, the government opted for a reform that contains the following major elements (Australian Government, 2005).

The arrangements will move towards a simpler national system as the legislation covers up to 85% of all employees, as compared to about 50% before. Only a few employers, such as unincorporated businesses and some state government employees and a few items, such as health and safety regulations, will remain covered by state regulations. The move towards a national system has been brought about by the use of the Commonwealth's corporations power, whereas previously it had only relied on its power to settle industrial disputes crossing state boundaries. This gives the federal government, for the first time in Australia's history, the power to determine the framework for setting wages and working conditions for the majority of workers.

A new, independent body, the Australian Fair Pay Commission has been established. It is modelled on the UK Low Pay Commission. It will set and adjust a single minimum wage for adults, minimum wages for young workers, trainees and apprentices and award classification wages. Minimum and award classification wages will be protected at the level set by the 2005 Safety Net Review and will increase as decided by the Fair Pay Commission. The primary objectives of the Commission are to consider: i) the capacity for the unemployed to obtain and remain in employment; ii) employment and competitiveness across the economy; and iii) providing a safety net for the low paid and for young people and the disabled. The first decision on wages will be taken soon.

The government has set minimum conditions for annual leave (4 weeks), personal/carer's leave, including sick leave (10 days paid, 2 days unpaid carer's leave per occasion, 2 days paid compassionate leave per occasion), maximum ordinary hours of work (38 hours) and parental leave (52 weeks unpaid, including maternity, paternity and adoption leave). These minimum conditions together with the wages set by the Fair Pay Commission constitute the Australian Fair Pay and Conditions Standard. More generous provisions in awards will be preserved. Overtime pay will continue to be set in awards and agreements and awards may provide for less ordinary working hours, but not for more.

Agreement making will become simpler. All agreements have to be lodged with the Office of the Employment Advocate including an attestation that the agreement was negotiated in compliance with the Fair Pay and Conditions Standard. This will replace the former complex, time consuming and legalistic approval process (the "global no-disadvantage" test).

There will be six types of agreements: employee and union collective agreements, Australian Workplace Agreements, union and employer greenfield agreements (for newly established businesses) and multiple business agreements. All new agreements need to include terms and conditions, including wages that meet the Fair Pay and Conditions Standard. All workplace agreements will thus need to include wages that are no less than the relevant award classification wage as set by the Fair Pay Commission. Some content in agreements is prohibited, such as clauses prohibiting AWAs, restricting the use of independent contractors or allowing industrial action during the term of a contract. There is a hierarchy of agreements: Conditions negotiated in AWAs will overwrite conditions in both collective agreements and awards. Collective agreements will overwrite awards, but not AWAs and awards will overwrite neither AWAs nor collective agreements.

Concerning awards, the allowable matters that will be included in the future will be fewer as some are now provided for in the Fair Pay and Conditions Standard and others are included in specific legislation (long service leave, superannuation, jury service and notice of termination). Further, some matters, such as restrictions on training arrangements, are no longer allowable and have become unenforceable. In total, fourteen matters remain allowed in award setting, though with some modifications of the current rules.

An Award Review Task Force was set up to recommend an approach to the government on how to reduce the duplication and complexity of current federal awards. In the meantime, it has provided interim reports to the Minister of Employment and Workplace Relations on its proposed strategy for the rationalisation of federal awards and the rationalisation of wage and classification structures. The government will then decide on a strategy to rationalise awards which will be implemented by the AIRC. The AFPC must have regard to recommendations of the Award Review Taskforce in relation to the rationalisation of wage and classification structures.

The AIRC will be responsible for simplifying awards, regulating industrial action and registered institutions and play a role in relation to the termination of employment. While the government wants employers and employees to resolve disputes between themselves, they can decide to use the AIRC to help them resolve the dispute. The AIRC will also continue to regulate protected industrial action.

WorkChoices also clarifies the role of unions in agreement making, reiterates the freedom of association and restricts the right of unions of entry to workplaces to ensure that it is not abused.

Finally, businesses with up to and including 100 employees will be exempted from unfair dismissal laws. These businesses will still be covered by the rules concerning unlawful termination, which generally relate to discrimination (Box 5.2).

Assessing WorkChoices and options for further reform

The reform implies changes that will materialise gradually over time. Indeed a Citigroup survey found that only few businesses expect a significant immediate effect of the legislation on labour cost and productivity and that the impact would only be felt in three to five years.² This is not surprising, as the wage minima set in awards have become less and less binding, while there is already quite some flexibility in setting other work conditions. Moreover, when it comes to wage minima, future developments will depend on the decisions of the Fair Pay Commission: its remit has now a stronger emphasis on employment of the low paid. The system has moved towards a simpler, national system, leaves more room for bargaining and has streamlined the workplace agreement making process. At the same time it will keep fairly generous working conditions in terms of ordinary hours worked or holiday entitlements. But the system is still not simple: the legislation runs to nearly 700 pages, distinct federal and state systems remain, and businesses have complained about compliance costs. And wage minima are now set by a Commission, rather than a court, including, as before, award wages above the federal minimum wage. A unique feature of the Commission is that it sets the rates, rather than, as for example in the United Kingdom, proposing an increase to the relevant Minister who decides on the increase.

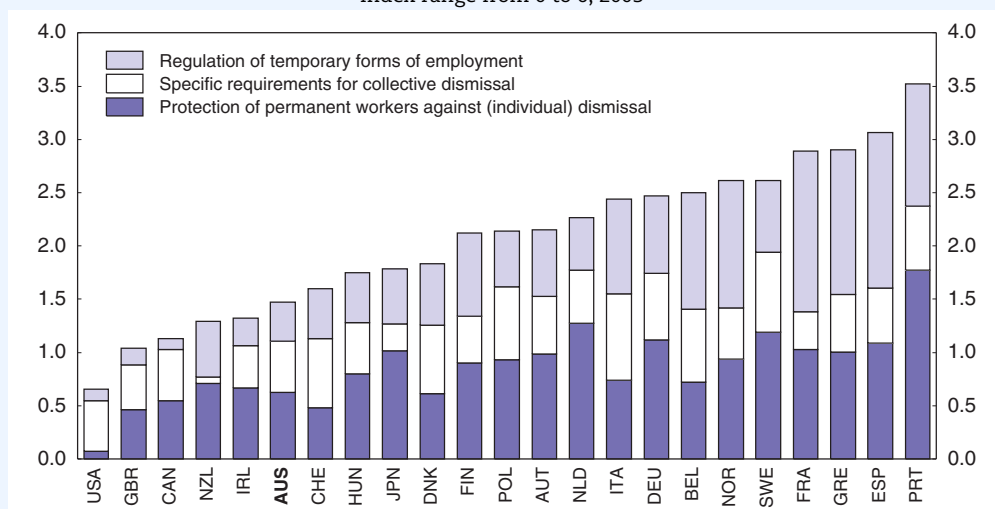
In English-speaking countries, bargaining over work conditions usually takes place at the enterprise level, while the government sets a minimum wage, with little of the other

Box 5.2. Employment protection legislation is eased for smaller enterprises

In international comparison employment protection legislation is already fairly lenient (Figure 5.4). However, there are concerns that it is still onerous for small and medium-sized enterprises, leading to reticence to hire. Business surveys (Sensis, 2005 and MYOB, 2005), for instance, indicate that about a third of small businesses may consider not hiring due to the unfair dismissal laws, while academic research found either some impact or only little effect. Harding (2005) estimates that the unfair dismissal laws reduce employment by 46 000 jobs, while Freyens and Oslington (2006) arrive at only 6 000 jobs.

Figure 5.4. **Summary index of employment protection legislation strictness**

Index range from 0 to 6, 2003¹



1. A higher index represents stricter regulation.

Source: OECD (2004), OECD Employment Outlook, www.oecd.org/els/employmentoutlook.

Against this background, the WorkChoices legislation has exempted small and medium-sized businesses from unfair dismissal laws if they have up to and including 100 employees. For businesses with more than 100 employees, employees must have been employed for six months before they can pursue an unfair dismissal remedy. This is a three months extension from the earlier rules. The law contains a provision preventing companies from restructuring to avoid the 100 employee threshold. As for the other WorkChoices legislation, only businesses that are constitutional corporations are covered by the new unfair dismissal laws. All employees will continue to be protected against the unlawful termination of employment.

working conditions being set by law. In continental European countries, collective bargaining at the sectoral level is prevalent, with agreements often extended to all workplaces. But, remarkably, even in Europe things are moving. In Denmark, sectoral agreements are nowadays framework agreements, while most working conditions are agreed at the enterprise level. In Germany and some other countries, opening or opt-out clauses, which allow firms to negotiate under certain circumstances with their workforce a payment level underneath the wage floor set at the branch level, have become more prominent (OECD, 2004b). There is clearly room in Australia to provide still more flexibility, for instance by only

setting a federal minimum wage rather than a whole award wage grid, by supporting opt-outs from sectoral awards, or by further reducing the number of allowable matters.

More ambitious reforms are hampered by wide-spread concerns that they would lead to widening income inequality and poverty. Yet, international experience suggests that a good labour market performance is in general associated with a lower incidence of poverty, a lower risk of entry into poverty and a higher probability of exit (OECD, 2006). The presence of a second worker in the family, even working part-time, considerably reduces the risk of poverty. Moreover, while income inequality has risen somewhat over the last decade in the OECD on average, the small rise has not prevented a rise in the real incomes of the bottom deciles, an experience Australia has shared. Finally, reductions of unemployment have been associated with rising wage dispersion for workers, but with declining gross earnings inequality for the whole population (including people out of work), especially at bottom deciles. This suggests that gains from higher employment have offset the impact of rising wage dispersion. Moreover, the Household, Income and Labour Dynamics in Australia (HILDA) Survey, which only exists since 2000/01 and measures all income and tax/benefit payments, suggests that poverty rates have declined between 2000/01 and 2002/03 and that poverty persistence is low, which is in line with the finding of considerable income mobility (Headey and Wooden, 2005).

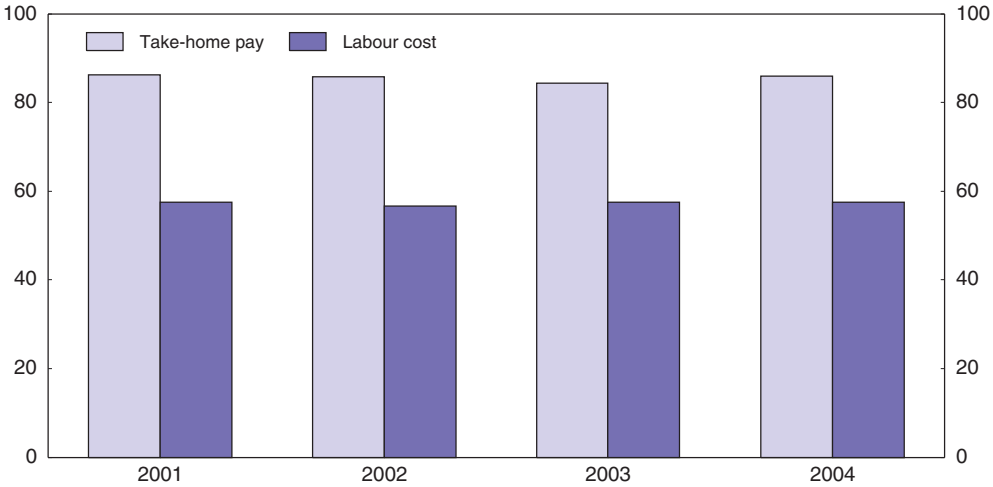
If the Fair Pay Commission were to decide that the current wage minima hamper employment and that they should increase only slowly,³ fears of a widening earnings distribution or in the event a significant widening should occur, could be addressed by making the current tax/benefit system more generous. And current arrangements are already fairly generous as the take-home pay of a worker at the minimum wage is considerably higher than the minimum wage. Figure 5.5 shows that both the ratio of the minimum to the median wage and the ratio of the take-home pay at the minimum wage level to the take-home pay of the median wage earner have been stable since 2001, with the latter ratio close to 85%, reflecting mainly low direct taxation and high family benefit payments. The ratio has probably increased since 2004, given the raising of tax brackets and considerable increases in family benefits. Given the fairly high minimum wage, the additional support received from the tax/benefit system and relatively low price level, the take-home pay of a minimum wage earner was the second-highest on a purchasing power parity basis in 2004 among the OECD countries for which data are available (Figure 5.6).⁴ Yet, the family situation does matter. The case shown in Figure 5.5 is for a worker earning the minimum wage with two children, where the spouse has no income. In the case of singles or families without children, take-home pay is considerably lower as they do not benefit from family benefit payments.

Moreover, in-work benefits (such as the US Earned Income Tax Credit) could complement the current tax/benefit system. There was a considerable discussion about in-work benefits in the late 1990s. A manifesto signed by five prominent economists, for instance, suggested freezing the minimum wage for several years, while raising the income of the low paid by an employment-conditional tax credit. This suggestion was again taken up by Access Economics (2005), which provided an assessment of workplace relations policy for the Business Council of Australia.

The objectives of employment-conditional tax credits or benefits are to increase both employment and the incomes of disadvantaged groups. The attraction is that such policies aim to achieve both employment and distributional objectives. They exist in Canada, New

Figure 5.5. **Take-home pay and labour cost at the minimum wage level**

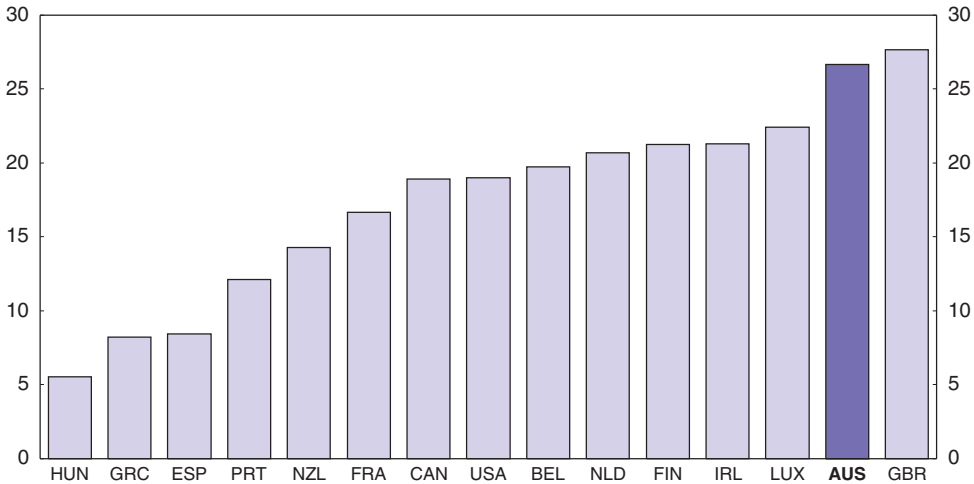
For a married couple with two children where the principal earner earns the minimum wage and the spouse does not work, as a per cent of the median values



Source: OECD Tax-Benefit models, May 2006.

Figure 5.6. **Take-home pay at the minimum wage level in international comparison**

For a married couple with two children where the principal earner earns the minimum wage and the spouse does not work, in thousand US dollars and purchasing power parities, 2004



Source: OECD Tax-Benefit models, May 2006.

Zealand, United Kingdom and United States, where the earning distribution is much wider than in Australia and in five European countries, where distributional issues are prominent. In general, these systems do not guarantee a minimum standard of living. Rather, being in employment is required to claim the tax credit. Only low-wage earners qualify and eligibility is often limited to families with children. The limitation to low-wage earners means that from a particular level of income, net transfers diminish and ultimately vanish. All these countries have a minimum wage or wage floors set by collective agreements so that the income supplements clearly benefit low income households. For the United States and the United Kingdom, which have the longest experience with such systems, these tax credits are also generally found to promote employment overall, thus reducing unemployment traps,

even though labour supply of secondary earners may be adversely affected. Moreover, higher marginal tax rates in the abatement range imply that incentives for additional work effort are reduced, exacerbating poverty traps. And the financing of these programmes from general tax revenues may have adverse effects on employment or savings, which would also need to be taken into account (Ochel, 2000 and Duncan *et al.*, 2003). Designing a tax credit that raises labour utilisation, redistributes income and comes at a moderate fiscal cost would be challenging in the Australian context as a well-developed welfare system already exists. In the case tax credits were to be introduced, separate taxation of each spouse should be maintained and they would likely be a supplement, rather than an alternative to the existing support for low-income families.

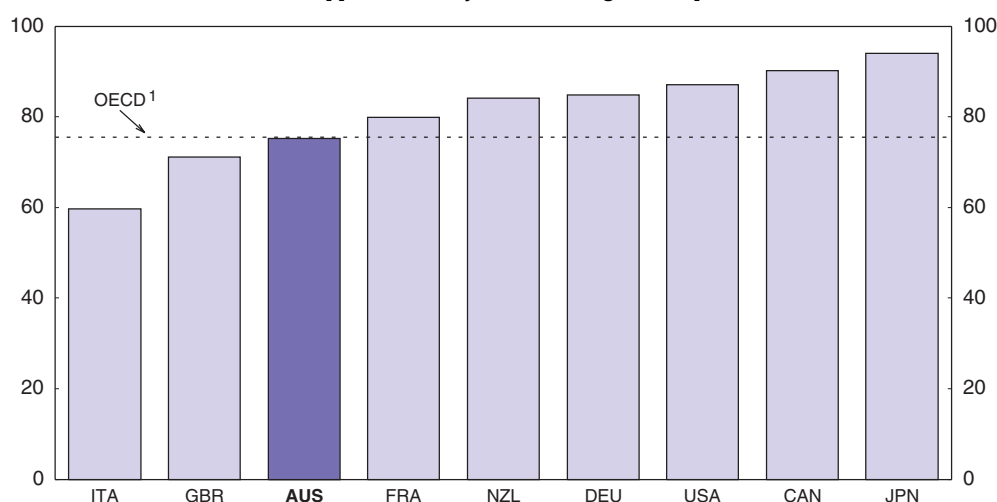
Another option to price low-skilled workers into jobs is to reduce payroll taxes as they cannot be shifted onto labour in the presence of wage minima. This has been pursued fairly aggressively in a number of European countries (Belgium, France and Netherlands), where lowering the minimum wage also encounters strong political resistance. Most evaluations report significant positive impacts on employment (OECD, 2006). In the case of Australia, the major payroll tax is a state tax and varies across the states, sectors and by company size. As argued in Chapter 3, the way they are currently set is not efficient. In addition, superannuation is funded by a 9% employer contribution and this could also be lowered for the low skilled. However, a broad move to reduce them would become a major funding issue and deadweight effects are likely to be substantial if a broad group of workers is covered.

Finally, education and training could help in aligning pay and productivity levels and in reducing the current skill shortages. In this respect, much progress has been made, as shown by the substantial difference in the educational attainment of the young and older generations. Moreover, the OECD Programme for International Student Assessment (PISA) shows that 15 year-old students in Australia perform considerably better than the OECD average in terms of reading, scientific and mathematic literacy. They are also very good in problem solving (OECD, 2005). However, although Australians have higher than OECD-average tertiary attainment across all age groups, the population that has attained at least upper secondary education among the young is still lower than in many other OECD countries and the gap for older workers is very wide in international comparison (Figure 5.7).

Since the mid-1990s, the vocational education and training (VET) system, which is a competence of the states, has expanded rapidly, notably since the introduction of the New Apprenticeship Scheme in 1998. The system does not focus only on the young as more than 50% of VET clients are aged 25 to 64, though participation drops off sharply after age 45. The number of people in training has reached a plateau since early 2003 and the number of completions of courses or of schooling is only half of commencements, with completions rising only little between 2000 and 2005 (NCVER, 2006). Completions are much lower for the young than older people being trained. Non-completers of VET courses are more likely to be unemployed and to have only 10 years or less of previous education. Vocational education and training institutions need to offer greater support to these students. Moreover, some specific sub-groups of young people tend to miss out on VET. These include people with disabilities, those from single-parent families and those from families with a history of parental unemployment. To raise the number of people in such programmes, improve the quality of programmes and tackle increasing skills shortages, the government launched the National Skills Shortages Strategy in 2004 and a 2005-08 Commonwealth-State Agreement for Skilling Australia's Workforce was reached in mid-2005. It provides for more central government funding for training and national goals and

Figure 5.7. Educational attainment of younger cohorts

At least upper secondary education, age 25-34, per cent



1. Unweighted average.

Source: OECD (2005), *Education at a Glance*, www.oecd.org/edu/eag2005.**Box 5.3. Improving financial incentives to acquire skills**

The United Kingdom has introduced an Education Maintenance Allowance (EMA), which paid £30 in 2005 to students continuing in full-time education if household income is below £19 630 and lower rates for household income up to £30 000 a year. Also a bonus is paid in January and July and in September/October for those who return to learning after the school holidays. The scheme was first implemented in pilot areas and rolled out nationally in September 2004. An evaluation of the allowance suggests that participation in full-time education increased by nearly 6 percentage points, of which 2½ percentage points would otherwise have gone into the group of those not in education, employment or training (DfES, 2005). Interestingly, the evaluation found that paying a higher amount did not have a large effect, indicating that the symbolic value of being paid something matters more than the actual amount paid. It was also found that the allowance raises participation in education twice as much when paid directly to the student than when paid to parents. In Australia, the Youth Allowance is available for young people between 16 and 25 years, if studying full-time and up to 21 years for others, if they are studying full-time, looking for work or doing a combination of activities. Youth allowance is also paid to full-time New Apprentices who have an approved apprenticeship contract with their employer. The allowance is means and asset tested. In contrast to EMA, Youth Allowance does not provide extra support to people who study, compared to those who look for work.

objectives when set, covering quality, more training places and funding. In this context, national consistency in providing training is also an important focus. Moreover, 24 technical colleges are being built to further strengthen the vocational education and training system. Incentive issues also arise. VET students cannot defer payment of tuition fees, while undergraduate students can, which may distort student choices. Greater financial incentives to students to continue post-compulsory education may also help to raise educational attainment (Box 5.3).

Box 5.4. Recommendations concerning industrial relations reform

While the industrial relations reform is very recent its effects should be assessed carefully and options for further reforms explored. These include:

- The system should be further simplified. For instance, more states could refer their industrial relations powers to the government.
- Opt-outs from awards and collective agreements should be supported, if the employees and employer agree.
- The rationale for maintaining the award system should be questioned as the WorkChoices Act provides for the setting of national minimum standards in terms of wages and working conditions. Therefore, these awards should be either phased out or substantially rationalised further in terms of their number and content.
- The fairly high labour cost at the minimum wage level may constrain the employment prospects for the low-skilled. This will be assessed by the Fair Pay Commission. If wage increases of the low-skilled should not keep pace with average wages in the future, distributional concerns should be addressed by social policy instruments as well as by strengthening vocational education and training to raise the skill levels of the low paid.

Summing up

The industrial relations reforms are a step in the right direction, with benefits likely to surface gradually over the coming years. And some time is clearly needed to assess the reform's impact. Yet, even after the reform the industrial relations system remains highly prescriptive and there is still considerable room for further simplification that would leave more room for bargaining over workplace conditions. Distributional concerns should not be addressed by centralised wage setting, but by social policy instruments as is already happening to quite some extent. Moreover, education and training could help in aligning pay and productivity levels.

Notes

1. These are: classification of employees and skill-based career path; ordinary work hours, rest breaks, notice periods and variations to working hours; rates of pay, rates of pay for juniors, trainees and apprentices, and rates of pay for employees under the supported wage system; incentive-based payments, piece rates, and bonuses; annual leave and leave loadings; long service leave; personal/carer's leave, including sick leave, family leave; many other forms of leave; public holidays; allowances; loadings for working overtime or for casual or shift work; penalty rates; redundancy pay and notice of termination; stand-down provisions; dispute settling procedures; jury service; type of employment, such as full-time employment, casual employment, regular part-time employment and shift work; superannuation; and pay and conditions for outworkers.
2. Eight per cent of businesses thought that there would be a significant impact on labour cost and 16% on productivity (*Financial Review*, 12 April 2006, p. 12). The major benefits were thought to come from less prescriptive agreements, the single jurisdiction and more freedom in hiring and firing.
3. While a wider income distribution would favour labour demand, it would also increase the number of individuals choosing to be on welfare, which underlines the importance of raising the work requirements of those on welfare (Frijters and Gregory, 2006 and Chapter 6).
4. Not surprisingly, the poverty rate for working-age households with one or two members in employment was among the lowest in the OECD at the end of the 1990s (Förster and Mira d'Ercole, 2005).

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Chapter 6

Improving incentives to work

Raising labour force participation is of major importance for sustaining vigorous growth, especially in the face of population ageing. The major challenge is to increase participation among women with families and lone parents, disability benefit recipients and older workers over 55. While participation decisions reflect personal choices, these are influenced by policy settings. Despite improvements in “inactivity traps”, Australia ranks high internationally in terms of “low wage traps” for lone parents and one earner households. Tackling such “low wage traps” either by addressing allowance and parenting payment income tests or by reducing the lowest income tax rate or raising the threshold at which income tax is first paid, should be a priority. Access to affordable child care also plays an important role in facilitating female participation, and efforts towards this end need to continue. Encouraging older people to stay in work longer requires removing incentives for early retirement. Imposing the recently announced tighter eligibility and participation requirements for disability pensioners uniformly across all recipients would also be beneficial.

Australia's overall labour force participation rate is above the OECD average. However, it lags behind the leading countries, indicating scope for doing even better. The remainder of this chapter focuses on those groups where there is greatest scope to raise participation, namely: women with families and lone parents; disability benefit recipients; and older workers over 55. In each case recent reforms are examined and the case for further policy change considered.

Raising labour supply of women with families and lone parents

The female participation rate has risen by 14 percentage points between 1985 and 2005, but international benchmarking suggests that there is scope for further improvement. Even though above the OECD average, the employment rate of women lags behind the leading countries, particularly for women with children aged under 6 (Figure 6.1, upper panel). Effective labour supply is even lower than these figures suggest since part-time work accounts for over 40% of total female employment, which is one of the highest in the OECD (Figure 6.1, lower panel). There is nothing wrong with this situation if it reflects free choices made by individual families. However, according to Russo and Hedley (2004), part-time work may be seen as a potential source of additional labour supply with around a quarter of part-timers wanting to work extra hours.

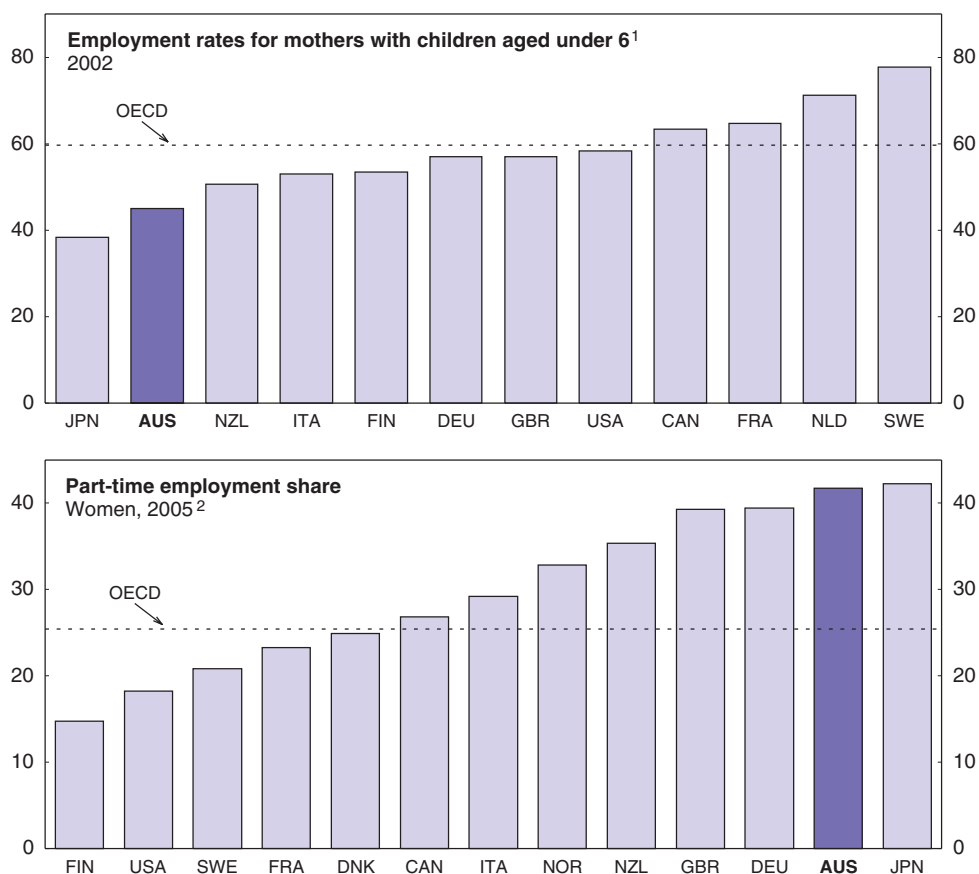
Of particular concern is the high proportion of people living in jobless families, which is well above the OECD average (Figure 6.2). Around 70% of jobless families with children aged under 15 are headed by lone parents, raising concerns about the welfare of such children. Joblessness is a major contributor to financial hardship in Australia – more than 60% of poor children in Australia live in households where no adults are in paid employment, a share nearly twice the OECD average (Whiteford and Adema, 2006). “Activating” lone parents and other parents in families with children receiving income support is therefore of major importance, as recognised in the government’s welfare reform agenda.

Current welfare support for families

The flat rate and highly means-tested nature of benefits in Australia have resulted in a social security system that costs less and is more re-distributive than in most other OECD countries. Even though gross spending on social welfare lies below the OECD average, the spending on family benefits is more than 1½ times the OECD average, partly because assistance that used to be provided through the tax system before 1975, is now provided mainly through cash benefits (Whiteford, 2006). Lone parents and unemployed parents receive the seventh highest benefits in the OECD (adjusted by purchasing power parities). Family benefits appear generous compared to other OECD countries in relation to the maximum level of benefits available (OECD, 2004), although these are withdrawn as income rises (Table 6.1). On the other hand, benefit withdrawal rates are well below the 100% rate that is typical in social assistance schemes operating in many OECD countries. The “generosity” of the system for low income families is enhanced by the relative ease of

Figure 6.1. **Characteristics of female employment**

Per cent



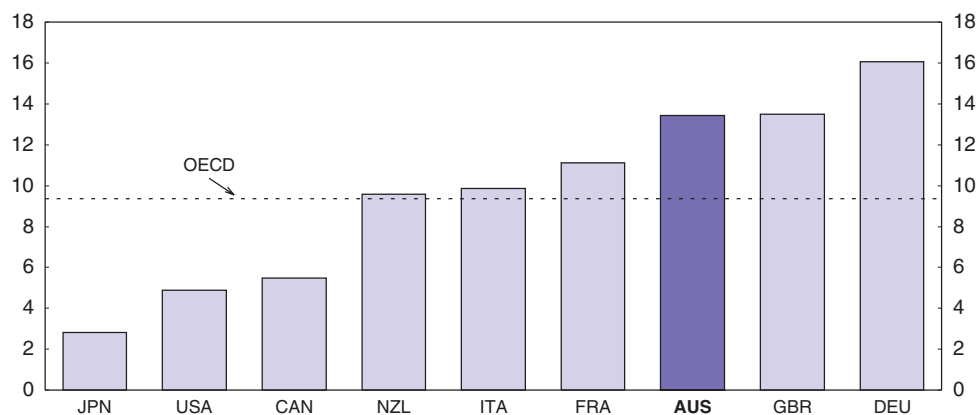
1. Average of the rates for mothers whose youngest child is in the age group under 3 with those aged 3 to 5.

2. 2004 for Sweden and the OECD average.

Source: OECD, Directorate for Employment, Labour and Social Affairs; OECD, Labour Force Statistics database, May 2006.

Figure 6.2. **Jobless families: an international comparison**

Individuals living in households with a working-age head where no one works, in per cent of the total population, 2000¹



1. 1999 for Australia, 2001 for Germany and New Zealand.

Source: OECD (2005), *Society at a Glance*.

Table 6.1. **The structure of main income support benefits received by families**
June 2006

Type of benefit	Eligibility conditions	Maximum benefit rate ¹	Income tests
Family Tax Benefit Part A	Dependent child under 21 or qualifying dependent full-time student aged 21-24.	Varies with the age of the children. For a child aged under 13 is 8.2% of AW.	Subject to a family income test (save few exceptions). Withdrawal rate 20-30%.
Family Tax Benefit Part B	Extra assistance to families with one main income, including sole parents. Dependent child under 21 or qualifying dependent full time student up to 18.	If youngest child is under 5 is 6.6% of AW. If youngest child is 5-15 (or 16-18, if a full-time student) is 4.8% of AW.	No income test for sole parents. For two parent families, only income of the lower earner is not taken into account. Withdrawal rate 20%.
Parenting Payment	Support for principal carer of child under 16 for those on low income. Subject to participation requirements. ²	Sole parents up to 25.4% of AW. For a parent who is part of a couple up to 18.8% of AW.	Subject to income and asset tests. Withdrawal rate 50-70% for partnered parents and 40% for lone parents. ³

1. Rates applicable between 20 March and 30 June 2006, expressed as a percentage of the average wage (AW) equal to AUD 51 169 in 2005/06.

2. From 1 July 2006, support for principal carer of a child under 6 (partnered parents) and 8 (sole parents) for those on low income. Participation requirements apply when the youngest child turns 6.

3. From 1 July 2006, withdrawal rates for partnered parents were reduced to 50-60%.

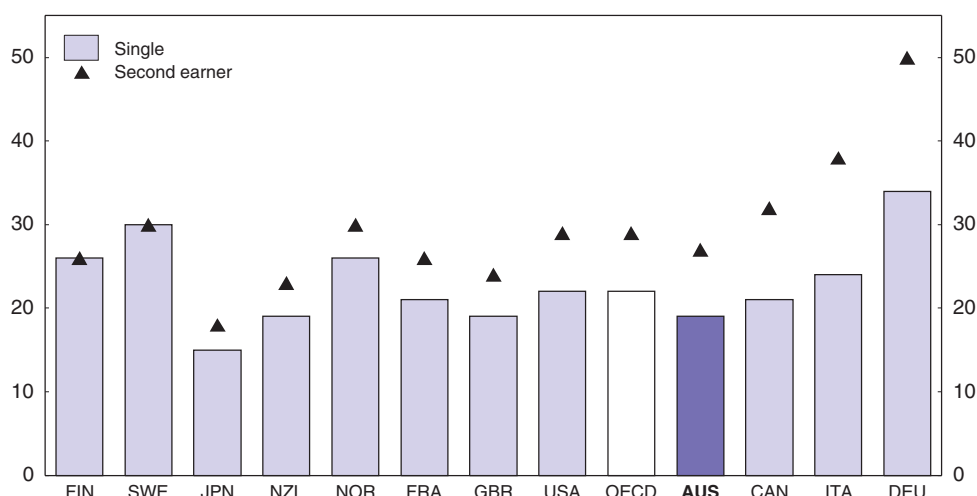
Source: Australian Government (2006), "A Guide to Australian Government Payments", Family Assistance Office; OECD (2004), *Benefits and Wages*.

access to benefits, with the result that rates of receipt of income support benefits by lone parents are amongst the highest in the OECD and employment rates amongst the lowest.

Effective marginal tax rates (EMTRs) provide a way of assessing the balance between the comprehensive targeting of the income support system and work incentives. High EMTRs can occur, particularly, in cases of income tests with high withdrawal (taper) rates (even if there is no interaction with the income tax system), when different social security payments overlap, implying that individuals or families may face two or more tapers on different income support payments at any one time (Table 6.1) (Dawkins, 2001 and Beer, 2003). The EMTR profiles for secondary earners are higher than for single individuals (Figure 6.3). The heavier tax burden, despite a system of separate personal taxation, is mainly due to the withdrawal of benefits based on family and second-earner income. This is particularly the case for second earners in low wage families, as these families are still eligible for various benefits even if the head has a full-time job. About one-fifth and one-quarter of households in the lowest and second lowest income deciles, respectively, are estimated to face EMTRs of over 70% which is a much higher proportion than in any other income decile (Buddelmeyer et al., 2004; CEDA, 2006). This is consistent with the findings by Beer (2003), who suggests that high EMTRs mainly hit families with children – with a quarter of sole parents and 15% of individuals in couples with children facing EMTRs in excess of 60%, largely due to the impact of the withdrawal of family assistance.

EMTRs have declined in recent years largely as a result of reduced income tax and family assistance withdrawal rates. However, while measures introduced, at least until the beginning of the decade, have reduced the "inactivity trap", they appear to have increased the marginal effective tax rates from moving up the wage distribution exacerbating a "low wage trap" (Figure 6.4). The OECD tax-benefit models suggest that Australia has among the highest EMTRs in the OECD for single parents and one-earner couples with children for the transition from part to full-time work. On the other hand, Australia is significantly below

Figure 6.3. **Tax rates of single persons and second earners**¹
 Women earning two-thirds of the average production worker wage, per cent



1. The relevant effective tax rate for a married woman's decision to participate is the average tax rate on the second earner's earnings. The husband earns 100% of Average Production Worker earnings (APW), and the couple has two children. This tax rate is compared to the average tax rate for a single individual without children and a two-child, one-income family, both earning the APW. The tax rates are net of universal cash benefits, but do not include means-tested benefits (except child benefits that vary with income). The reference year is 2004 for the effective tax rate on one-income couples and 2003 for second earners and singles. The OECD aggregate is an unweighted average.

Source: OECD (2005), *Going for Growth*, Economic Policy Reforms; OECD (2004), *Taxing Wages* and OECD calculations.

the OECD average in international comparisons with regards to the EMTRs faced by these groups when they move from inactivity to part-time work.

Recent reforms to tighten eligibility and participation requirements

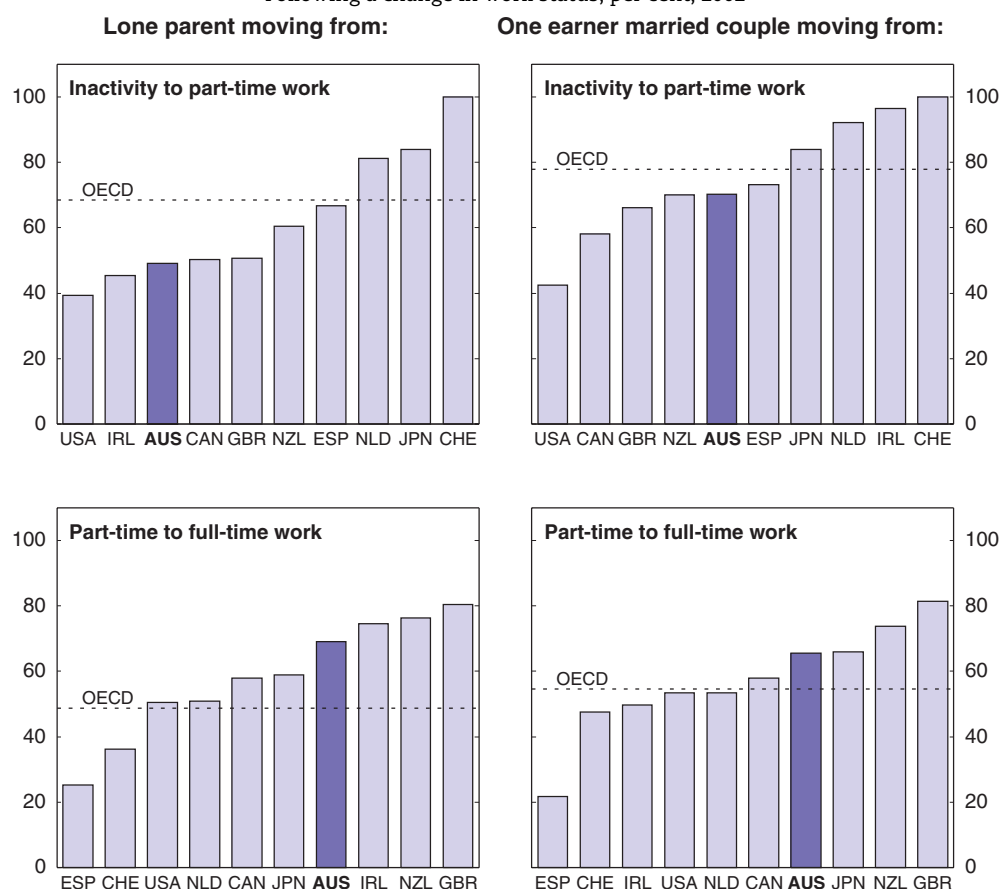
The 2005/06 Budget increases work obligations for principal carer parent recipients with school age children who will now be obliged to seek part-time work.¹ Eligibility criteria have also been tightened for new Parenting Payment claimants; new applicants will move to the unemployment benefit when the last child turns 8 in the case of lone parents or 6 in the case of partnered parents. New parenting payment claimants will be subject to participation requirements when their youngest child turns 6. Existing recipients whose youngest child is under 16 years old will continue to receive the Parenting Payment, but will be subject to participation requirements from 1 July 2007 or when their youngest child turns 7 (whichever is the later). At the same time, the income test for the Newstart and Youth Allowance and for Parenting Payment (Partnered) has been changed to encourage a return to part-time work, by allowing people to keep more welfare payments as their income from work increases.² Compliance with the conditions attached to welfare benefits is expected to be encouraged by the move towards a suspension-based approach for most people who fail to comply with participation requirements. The new arrangements include the retention of a non-payment period of 8 weeks for serious or repeated participation failures, although financial case management will seek to avoid unreasonable hardship on eligible recipients (Australian Government, 2005a).

Recent reforms to facilitate access to affordable child care facilities

Alongside financial incentives to work and tighter criteria for the entitlement of welfare benefits, access to affordable quality child care is an important determinant of the

Figure 6.4. **Marginal effective tax rates for low-income families¹**

Following a change in work status, per cent, 2002

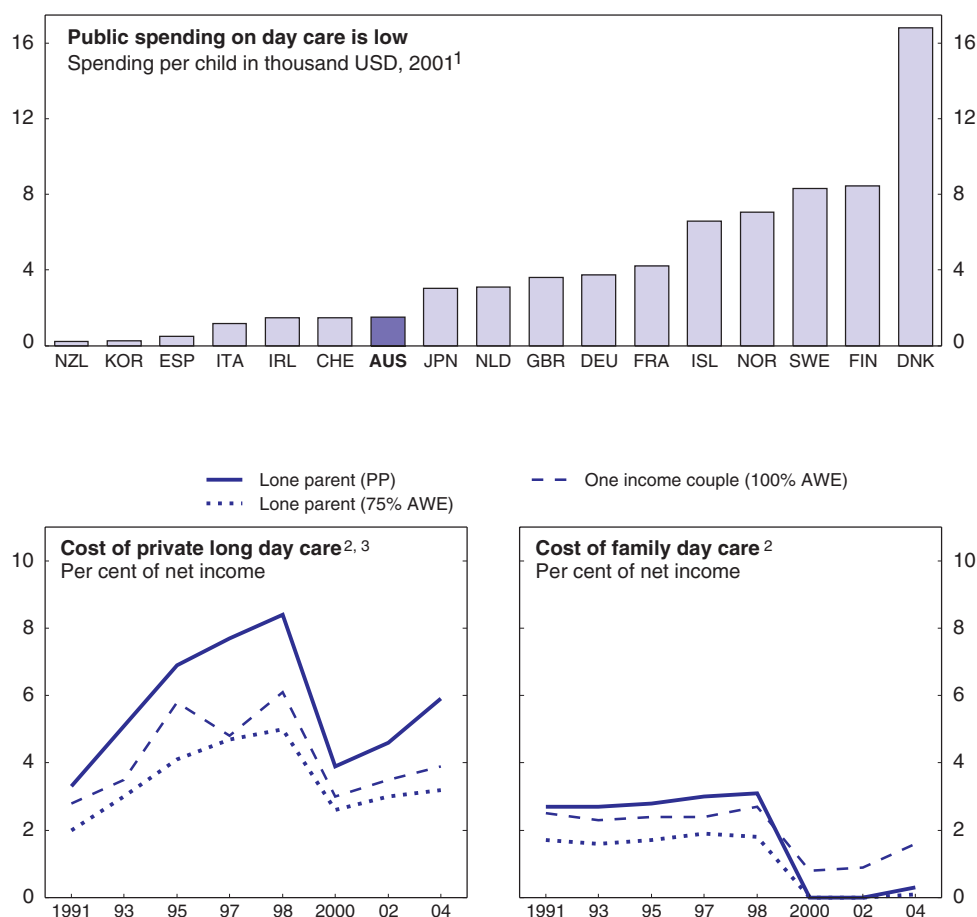


1. Families with two children. Part-time work is defined as 20 hours a week at a wage level equal to 50% of the earnings of an average production worker (APW), full-time as 40 hours a week at a wage level equal to 100% of the earnings of an APW. This figure shows how much of the wage earned (or wage rise) following a change in work status is taken away in the form of higher taxes and lower welfare benefits. The OECD aggregate is an unweighted average.

Source: OECD (2005), OECD Employment Outlook and OECD Tax-Benefit models.

participation decision of second earners (OECD, 2005a; Jaumotte, 2003). Recent empirical findings for Australia suggest that a 10% rise in the price of child care results in a decline in the participation rate of lone parents and married women by 0.5% and 0.2%, respectively (Doiron and Kalb, 2005). Up until the beginning of the decade, public spending on child care was low in international comparison (Figure 6.5), although recent reforms have led to significant increases in the subsidisation of child care services (Box 6.1).

Though on an upward trend since the mid-1980s, the use of formal child care is still limited: about 75% of children do not attend CCB-approved care, with their child care needs being met through informal care arrangements (in which the Australian government is not involved) (OECD, 2004). Analysis based on the HILDA (Household Income and Labour Dynamics in Australia) Survey also highlights ongoing concerns about the cost of child care as a barrier for some families to access such facilities, especially in the case of households with under-school age children (NATSEM, 2005). Affordability of child care – proxied by child care costs (fees charged less government assistance) as a percentage of net family income – improved for many family types with the introduction of the Child Care Benefit in 2000, with the groups least affected being those on higher income (Figure 6.5). However,

Figure 6.5. **Child care spending and affordability**

1. Public spending on non-parental day care for children aged under 3 years old. At current prices and purchasing power parities.
2. Cost for 20 hours of care for families earning different levels of average weekly earnings (AWE) or the parenting payment (PP) for lone parents that are studying.
3. The cost of community-based long day care follows a broadly similar profile.

Source: OECD (2005), Social Expenditure database; OECD (2005), *Education at a Glance*; AIHW (2006), "Trends in the Affordability of Child Care Services 1991-2004", Bulletin, No. 35, Australian Institute of Health and Welfare, April.

the effect was short lived, with some of the gains being eroded by 2004, as a result of increases in child care fees that outpaced increases in average weekly earnings and government assistance to families (AIHW, 2006).

The cost of child care is an important determinant of the quality of the chosen services, and more importantly, the decision between using formal child care arrangements or looking after a child at home by withdrawing from the labour market (OECD, 2002). The introduction of the 30% Child Care Tax Rebate will further reduce child care costs paid by parents. Nevertheless, the affordability of child care services is not influenced solely by changes in government funding and family assistance. Supply constraints may also play a role. Though "unmet demand" for formal child care has declined significantly over the 1990s, the 2002 ABS Child Care Survey data indicate that there is additional demand for formal child care (around 6%), mainly in the areas of before and after school care (27% of demand), long day care (27%) and occasional care (22%) (ABS, 2003). Under-supply is a particular concern in rural and remote areas. The fees for facilities

Box 6.1. Measures to improve access to child care

Important steps towards helping parents meeting the cost of formal child care include: i) the expansion of assistance through the introduction, in July 2000, of Child Care Benefit (CCB) providing fee relief to parents (both working and non working) who have their children in approved or registered child care; and ii) a 30% Child Care Tax Rebate (CCTR), in effect since July 2004, on out-of-pocket child care expenses for approved care, complementing CCB.

CCB is an income-means tested benefit whereby eligible families can claim up to 50 hours of CCB per week, per child. Families where both parents (or a single parent) are not working, studying, training or looking for work are eligible for up to 20 hours of CCB for approved care. Through the CCTR scheme eligible families are able to claim 30% of the costs in excess of CCB payments received (out-of-pocket costs) for approved child care up to a maximum of AUD 4 000 per child per year. The CCTR is a non-refundable, transferable (so that any excess may be transferred to the taxpayer's spouse) tax offset that can only reduce a person's tax liability to zero. Additional funding was introduced in the May 2005 Budget through the "jobs, education and child-care" programme, which pays gap fees for care to low-income families while the parent is undertaking training or searching for work, topped up by extra funding (AUD 877 million over the period 2005/06 to 2009/10) in the latest budget earmarked for a programme to assist parents with child care fees.

Recent policy reforms increased significantly the number of funded child care places. They are expected to reach more than 700 000 by 2009 compared with only 307 000 in 1996. The 2006/07 Budget abolished the cap on the number of funded places in outside school hours care and family day care places, thus removing one of the complexities in the child care industry. This initiative is expected to result in an additional 25 000 child care places (at a cost of AUD 60 million over 4 years) (Australian Government, 2006).

in these areas are higher, reflecting the additional financial incentives needed to attract and retain staff and/or a lack of competition (AIHW, 2006). Planning controls applying to family day care and outside school-hours care could influence supply decisions as well as the structure of the Child Care Benefit. In particular funding does not take into account the fact that child care services are more expensive for younger children.

Recommendations for further action

Dealing with the problem of high EMTRs is tricky, because there are difficult trade-offs which have to be faced (OECD, 2005b). For example, financial incentives to work could be improved by lowering welfare benefits, but doing so raises equity concerns. Alternatively, lowering benefit withdrawal rates at the low end, but extending the income range over which they apply exposes more people to high EMTRs higher up in the income range, which poses the risk of undermining work incentives there (Warren, 2004). Given these trade-offs it is important to be clear exactly which disincentive problems are the priority to tackle. While "inactivity traps" remain a concern, especially in the light of the high prevalence of jobless households with children, it appears that in international comparisons this is not necessarily a consequence of high EMTRs, as previously discussed. Recent measures toward tightening the eligibility criteria for Parenting Payments should raise the activity rates of lone parents and low-income partnered mothers. Moreover, the extension of work obligations for benefit receipt to sole parents is in line with reforms in many other OECD countries, a number of which apply even stricter requirements.³ On the

other hand, where Australia stands out with regard to EMTRs is in the transition from part-time to full-time work, suggesting that the future policy priority could be to reduce “low wage traps”. That said, there are economic and social benefits from moving from joblessness to part-time work; and the Australian evidence indicates that part-time work is a stepping stone to full-time work. Furthermore, three quarters of Australians in part-time work are satisfied with their number of hours worked, although this may be influenced by current policy settings. This highlights that there are a number of competing considerations which the government’s policy changes to the tax, family benefit and income support systems attempt to address.

In this context, recent simulations using the Melbourne Institute Tax and Transfer Simulator (MITTS) – a micro-simulation model with detailed information about the tax and transfer system and on household characteristics – are illuminating in highlighting the various trade-offs from tax and benefit reforms designed to reduce EMTRs (Buddelmeyer *et al.*, 2004; CEDA, 2006). A range of policy options, each involving a similar cost in revenue foregone, were considered and their main effects can be summarised as follows:

- Reducing the lowest tax rate or lifting the tax free threshold provides the largest aggregate labour supply response in terms of additional hours worked. While such policies induce less new participation than some other policy options, particularly Earned Income Tax Credits, they do not increase anybody’s EMTR (as many of the other policy options considered do) and the additional work effort they induce from those already in work more than compensates to produce the highest aggregate labour supply response.
- Employment Income Tax Credits are more effective at inducing labour supply from currently jobless households, but reduce labour supply where they increase EMTRs for middle and higher income families.
- Reducing the taper rate at which benefits are withdrawn would reduce the number of jobless households. However, the net effects of higher labour supply in lower income households and lower labour supply in high income households reduces both total participation and total hours worked.

Overall, if the future policy priority is to reduce low wage traps, which are high in international comparison, reducing the lower rates of income tax and raising the tax free threshold is likely to have the largest effect on aggregate labour supply. On the other hand, reforms involving a reduction in taper rates at which benefits are withdrawn are likely to be more successful in reducing the number of jobless households. The relative attractiveness of such policies will also depend on the success of recent reforms designed to increase the participation requirements of those receiving parenting payments (as well as increases in child care provision).

Further efforts should also be made towards reducing the cost and increasing the availability of child care places. Recent OECD cross-country empirical work suggests that the scope for raising female participation from increased child care support is greater than in most other OECD countries; full-time participation for women aged 25-54 years is predicted to rise by 3 percentage points if public child care spending were raised to the average OECD level (Burniaux *et al.*, 2003). However, the design of subsidies is crucial in achieving such outcomes. Making CCB more conditional on employment – in contrast to the present situation where it is still available for up to 20 hours to families where no family member works – would provide incentives for mothers to participate in the labour market, while reducing fiscal costs (OECD, 2006). Moreover, further bringing the structure

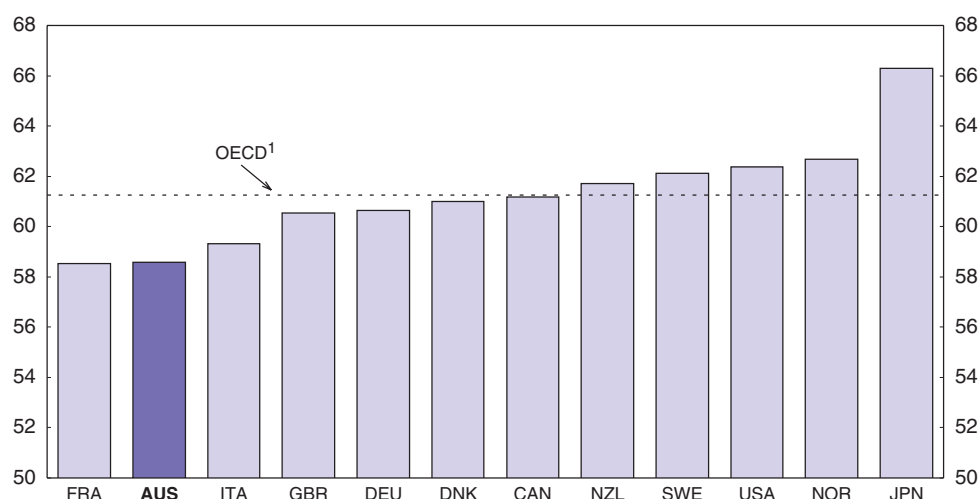
of CCB in line with the age-related cost profile of child care provision would help to boost the use of formal care facilities, with beneficial effects on female participation, given the close correlation between labour market activity and the presence of dependent children (OECD, 2002). The introduction of tighter eligibility criteria for the existing recipients of parenting payments, in line with those applicable to new claimants, is also advisable.

Raising the labour force attachment of older workers

Recent developments in the participation rate of older workers are encouraging, with the rise in the participation rate among the 55-64 age group from 2000 to 2005 of over 7 percentage points, substantially exceeding the rise in the OECD average. In addition to sustained strong economic growth and a tight labour market, changing employer attitudes towards older workers and policy measures to improve the participation of older workers have contributed to the change. Nevertheless, there is still a marked decline in participation from age 55, well before the age pension eligibility of 65 years (for men) and 63 for women (Figure 6.6). Australia therefore remains below the OECD's leading countries in terms of participation for those aged over 55. Early retirement decisions are also affected by a range of welfare benefits, especially the Disability Support Pension, as well as the eligibility requirements for old-age pensions and superannuation benefits.

Figure 6.6. **Effective retirement age of older male workers**

Estimates for 2000



1. Unweighted average.

Source: OECD (2005), *Going for Growth*, Economic Policy Reforms.

Helping the disabled to find work

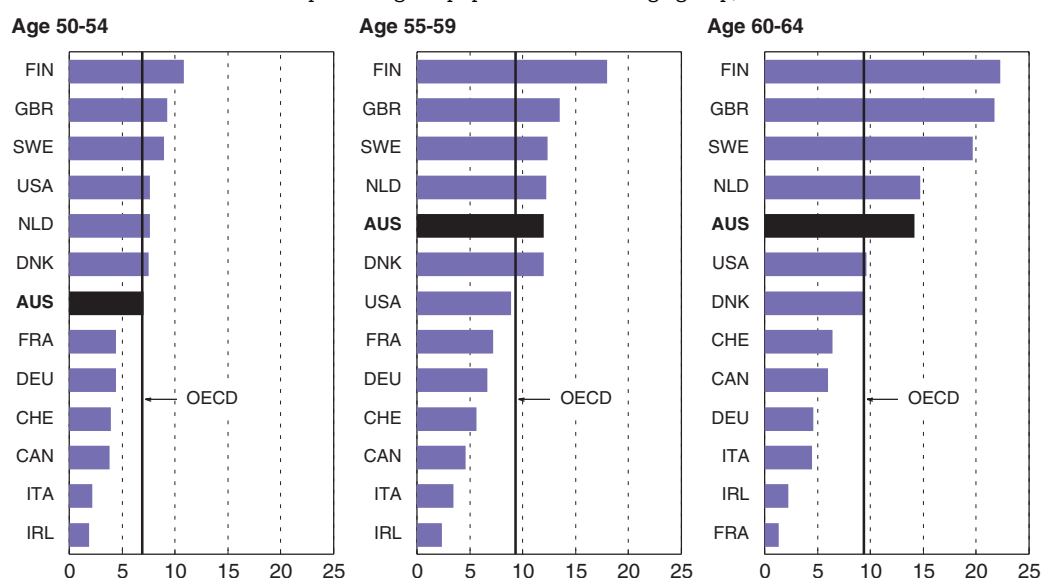
Eligibility for a Disability Support Pension (DSP) is based on age, residency, assessed medical impairment and work capacity. Applicants must be aged between 16 and Age-Pension age, have a medical impairment that attracts at least 20 points under the *Welfare to Work* reform DSP impairment tables and a continuing inability to work (30 hours or more per week in the case of existing recipients or 15 hours for new claimants). DSP recipients are not subject to any job search, rehabilitation, re-training or other participation requirements, although employment assistance is available. The benefit is generally not subject to income tax and replacement rates are similar to those for an Age Pension, but

significantly higher than for unemployment benefit.⁴ In addition, the income and asset tests for disability benefit recipients are less strict than for the unemployed.

A relatively high share of men in the older age groups is inactive because of illness or disability compared with many OECD countries (Figure 6.7). In contrast, the share of older women is below the OECD average. Although the number of Disability Support Pension beneficiaries has begun to level out,⁵ its steep increase in recent years is of particular concern; in the mid-1990s the number of DSP beneficiaries was 60% of those receiving unemployment benefit, but this ratio has risen to 130% in 2005, with DSP beneficiaries currently accounting for around 6% per cent of the workforce. The adverse effect on labour supply is aggravated because participation rates for persons with disabilities are the lowest in OECD, a situation partly explained by the minimal obligations placed on beneficiaries (Figure 6.8). Outflows from the disability scheme are approximately 85% the rate of the inflow, but close to three quarters of those leaving DSP either because they died or took up the Age Pension.

Figure 6.7. **Male inactivity because of illness or disability in selected OECD countries**

As a percentage of population in each age group, 2003¹



1. The OECD average is an unweighted average of available data for 25 countries.

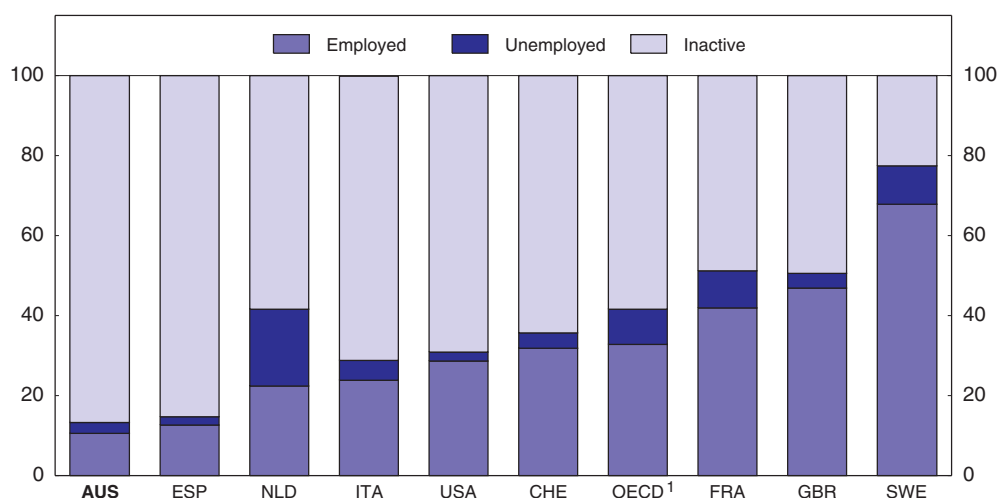
Source: OECD estimates using European Labour Force Survey data for European countries and ILO data for non-European countries, Ageing and Employment Policies Thematic Review.

Past reforms,⁶ demographic changes (including population ageing) and structural adjustment, which resulted in the displacement of workers, especially of older males, have all influenced developments in the number of DSP beneficiaries. There is evidence to suggest that the DSP programme may be increasingly used in preference to unemployment, given the greater generosity of the benefit and the absence of requirements for job search or participation in rehabilitation or re-training programmes, and also as a pathway to early retirement:

- Around 35% of new disability pension beneficiaries in 2003 were previously on unemployment benefit and deteriorating labour market conditions tend to increase

Figure 6.8. **Participation rates of disability benefit recipients**

Per cent, late 1990s



1. Average of 14 OECD countries.

Source: OECD (2003), *Transforming Disability into Ability*.

disability pension take-up rates. Argyrous and Neale (2003) found a positive relationship between the availability of work and the DSP rates of various age groups. Cai and Gregory (2003) also conclude that the deterioration of labour market conditions has been the most important factor for DSP changes over the period 1971-99, while the impact of population ageing was negligible. Furthermore, the probability of moving from unemployment to DSP increases with the duration of unemployment benefit receipt (Cai and Gregory, 2005).

- While as might be expected the incidence of sickness and disability increases with age the increase is particularly pronounced above the age of 55, at which point the medical assessment for DSP has in the past been less stringent with greater weight put on the potential employability. Thus, while inactivity for males in the age group 50-54 is close to the OECD average for older age groups it is well above it (Figure 6.7).

Recent reforms to the disability support pension

The *Welfare to Work* reform announced in the 2005/06 Budget included a tightening of eligibility criteria for new applicants for DSP, which will result in more income support recipients with disability facing work requirements. In particular, new applicants for DSP who are assessed as being capable of working 15 hours or more per week at, or above, the relevant minimum award wage are no longer eligible for the DSP after 1 July 2006, but will receive the Newstart Allowance instead, and have job search requirements which match their assessed work capacity. This represents a reduction by one-half in the capacity to work requirement of 30 hours per week, which will continue to apply to existing DSP recipients.

The reform package also provided for additional 20 900 places in the disability employment network and 36 600 places in vocational rehabilitation services for job seekers with a disability who have partial capacity to work and participation requirements. It also entailed funding for 12 300 extra vocational and training places.

Recommendations for further action: disability

Recent initiatives go in the right direction. However, further gains could be achieved if the stricter eligibility and participation requirements entailed in the *Welfare-to-Work* package did not focus solely on new entrants (which annually are typically around 10% of the existing stock), but also applied to the stock of the 700 000 existing disability pensioners who have no part-time work requirements. In particular further progress could be made by extending the new eligibility and obligation conditions to those existing beneficiaries who have the least severe medical conditions.

The provision of more vocational rehabilitation places, which are essentially demand-driven, is also encouraging, although the number of places remains small in relation to the overall stock of disability beneficiaries. As demonstrated by the success of the *Pathways to Work* scheme in the United Kingdom (OECD, 2005c), where claimants are required to attend work focused interviews with ready access to specialist employment advice, timely rehabilitation can help beneficiaries return to work.

Current retirement income arrangements

Australia has a three-pillar pension system. The tax-funded public pension (Age Pension) is the first pillar and is means tested. The pension is payable at age 65 for men and 63 for women, gradually increasing to 65 by 2014. The Age Pension is flat rate, means-tested, with a comparatively low replacement rate, aiming essentially to prevent poverty. The second pillar involves the Superannuation Guarantee, introduced in 1992, which, with few exceptions requires employers to provide a minimum level of pension contributions, currently set at 9%, for all employees earning above a (low) threshold level of wages. The earliest age for access to superannuation benefits is 55 years. A phased increase in the preservation age (i.e. the age until which the benefits must be preserved in a superannuation fund) to 60 will be implemented between 2015 and 2025. The third pillar mainly comprises private savings, mainly voluntary superannuation contributions, encouraged by tax concessions including incentives such as the ability of the self employed to claim a tax deduction and government co-contributions for low to middle income earners (OECD, 2005d and the previous Survey).

Recent reforms

There have been numerous reforms to pension arrangements aimed at extending the retirement age, including a combination of: more flexible superannuation access arrangements and measures to improve financial incentives to continue working; increases in eligibility ages for access to some components of retirement income; increased job search obligations for the older unemployed; and enhanced services to assist them to find a job.

Recent measures to improve financial incentives to retire later are commendable (Box 6.2). In particular, the removal, from 1 July 2005, of the restriction to receive superannuation by those still in employment, enables older workers – in case they choose to work on a part-time basis – to move gradually into retirement, by supplementing their lower income from employment with superannuation payments. The latest 2006/07 Budget proposes simplifying and streamlining superannuation, including a reduction in the pension asset test withdrawal rate (Chapter 2) and the abolition of the taxation of superannuation benefit for those over 60 who have already paid tax on their superannuation contributions

Box 6.2. Initiatives to improve financial incentives to retire later

The main measures to encourage older workers to retire later are as follows:

- *The Mature Age Worker Tax Offset*: It is available to those aged 55 and above who earn income from working. From 2005/06 it provides a maximum annual tax rebate of AUD 500, and phases out once net income from working reaches AUD 53 000, with no offset available when net income from working exceeds AUD 63 000.
- *The Pension Bonus Scheme and other changes to the Age Pension*: The Pension Bonus Scheme, introduced in 1998, provides a tax-free lump sum to people who defer claiming the Age Pension and instead continue to work longer. The maximum period over which a bonus can be received is five years. Moreover, the Age-Pension income-test withdrawal rate was eased from 50 to 40%, increasing the amount of pension benefit that can be received while working.
- *Changes to the superannuation scheme*: In recent years, the government has introduced a number of changes to superannuation arrangements. These include:
 - ❖ The age of accessing superannuation – currently at 55 – will gradually increase to 60 between 2015 and 2025.
 - ❖ Removal of the restrictive rule, from July 2005, requiring a person under age 65 who has reached their preservation age of 55 to retire or leave employment before they can access their superannuation benefits (as a lump sum or an income stream).
 - ❖ As from 1 July 2004 the work-test for superannuation contributions has been removed for anyone under age 65, implying that non-working people can make additional contributions to their superannuation and claim a tax deduction.
 - ❖ In the May 2004 Budget, the government increased significantly the co-contribution matching rate (first introduced in 2003) and raised the qualifying income threshold, to increase eligibility and encourage additional voluntary superannuation contributions. Moreover, as part of the budget the superannuation surcharge was abolished for contributions made from 1 July 2005.
 - ❖ The 2006/07 Budget proposed measures to simplify and streamline superannuation which will boost incentives for those over 55 (see Chapter 2).

Source: OECD (2005d); Australian Government (2005a; 2005b).

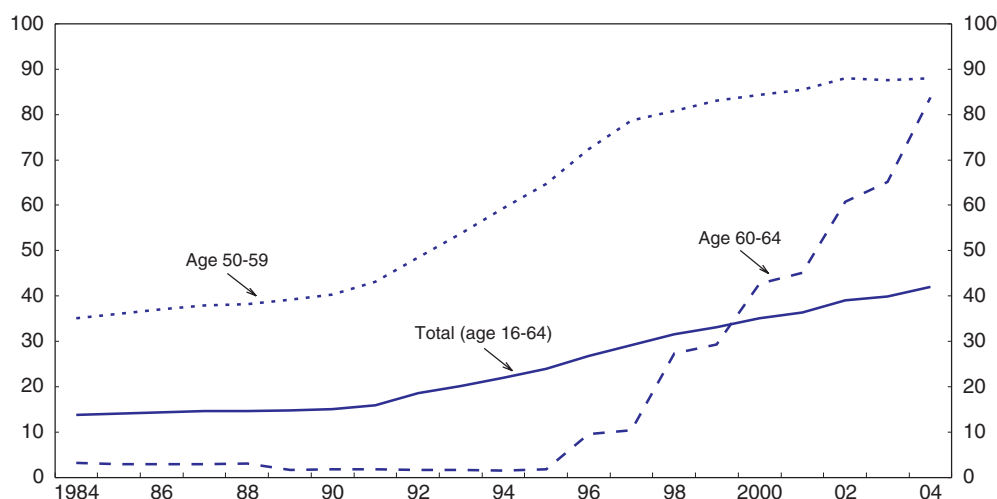
and earnings. These proposals would boost incentives to work and save in a number of ways. In particular, they would encourage individuals to work till 60 when superannuation will become tax free for most people, and as superannuation from age 60 would not be included in a person's assessable income this may also reduce the tax payable on other work income providing further incentives to work.

The phased increase in the superannuation preservation age, from 55 in 2015 to 60 by 2025, should also reduce incentives to retire early. In addition, it reduces the scope for “double dipping”, a practice whereby individuals may spend their superannuation benefits paid out as a lump sum before they are 65, relying later on the Age Pension, without being penalised for the superannuation benefits through the asset or income test, although there is little evidence that double dipping is a practical problem. In addition, earlier access to the Age Pension for females is being gradually removed; women's eligibility age has started to rise progressively since July 1995 and will reach 65 in 2014. This measure should boost participation of older women, although its impact

will be partly offset by an increasing use of the DSP programme. This view is supported by the fact that the DSP rate for women in the 60-64 age group has increased markedly since 1996 in a “two-yearly step pattern” – corresponding to the years that the changes to the eligibility age of the Age Pension were implemented (Parliament of Australia, 2005) (Figure 6.9).

Figure 6.9. **Disability support rate for women**

Number in each age group per 1 000 population¹



1. Data for June of each year. For the period 1984-88, the age group 60-64 includes women aged 65 and over.

Source: Parliament of Australia (2005), “Disability Support Pensioners, 1984-2004”, Research Note, No. 2 2005-06, Department of Parliamentary Services, Canberra, July.

The *Welfare to Work* reform announced in the 2005/06 Budget included an increase in the obligations for the older unemployed through a closer alignment of participation requirements for older people on unemployment benefit to those for younger recipients. In particular, it abolished reduced job search requirements for Newstart Allowance recipients aged 50 to 64, obliging them to look for the same number of jobs per fortnight as other jobseekers.

Recommendations for further action: Retirement incomes

Efforts towards encouraging people still in the labour force to delay retirement should continue. Potential reform initiatives include:

- Changes to the Age Pension to improve the incentives to remain in work after Age Pension age, through a reduction in penalties for combining a pension with income. In particular, removing earned income from the Age Pension income test (or further reducing the income-test taper) would be an important step to increase incentives to work at older age, with higher participation rates offsetting, at least partly, the fiscal cost (OECD, 2005d).
- Reducing incentives to retire early under the Superannuation Guarantee scheme by aligning the eligibility age of superannuation (currently 55, but to be increased to 60 by 2025) with that of the Age Pension (age 65) over time. If evidence of significant “double dipping” emerges, the generous tax-treatment of superannuation if drawn as a lump-sum after the age of 60 should be withdrawn and limits placed on the exemption of

Box 6.3. Recommendations to raise labour force participation**Raising female participation**

- Introduce tighter eligibility criteria for existing recipients of parenting pensions, in line with those applicable to new claimants. Although existing recipients will have the same job-search obligations as new claimants from 1 July 2007 or when their youngest child turns 7 (whichever is the later), new claimants could be on a different benefit (Newstart Allowance), with different levels of generosity and income tests, compared to existing claimants with the same circumstances. The enforcement of the eligibility and participation requirements should be closely monitored.
- Maintain efforts towards providing employment services to people on welfare benefits with participation requirements to help them find a job.
- Reduce low wage traps, which are high in international comparison, either by addressing allowance and parenting payment income tests or by reducing the lowest income tax rate or raising the threshold at which income tax is first paid. Relevant considerations for evaluating these options are the fiscal cost and the labour supply response.
- Efforts to facilitate access to affordable child care should continue. The structure of the CCB could be changed to reflect the age-related cost profile of child care provision. Consider making CCB more conditional on employment, in contrast to the present situation where it is still available for up to 20 hours to families where no family member works.

Reducing reliance on disability pension

- Extend the tighter eligibility requirements applicable to new entrants of the DSP programme to all recipients, monitoring closely the enforcement of eligibility and participation.
- Steps towards expanding employment, rehabilitation and education and training services to help people with disabilities find a job, and retain it, should be continued.

Improving the labour force attachment of older workers

- Encourage older workers to continue working after they become eligible for an Age Pension by excluding earned income from the Age-Pension income test or, alternatively, by continuing to ease further the income-test taper (but with adjustments to reduce the favourable income-tax treatment of pensioners).
- Reduce incentives to retire early under the Superannuation Guarantee scheme by aligning the eligibility age of superannuation with that of the Age Pension over time. If evidence of significant “double dipping” emerges, the generous tax treatment of superannuation if drawn as a lump-sum after the age of 60 should be withdrawn and limits placed on the exemption of owner-occupied housing in the means test for the Age Pension. Implementation of the proposals to simplify superannuation announced in the 2006/07 Budget would further encourage workforce participation by older workers.

owner-occupied housing in the means test for the Age Pension. Implementation of the proposals to simplify superannuation announced in the 2006/07 Budget would further encourage workforce participation by older workers.

Notes

1. Under the previous arrangements, Parenting Payment recipients with a youngest child between 6 and 12 years were only required to attend an annual interview with a personal advisor. Recipients with a youngest child aged between 13 and 15, were obliged to undertake 150 hours of approved activities in each 26-week period.
2. The maximum withdrawal rate for the Newstart Allowance was reduced from 70 to 60 cents in the dollar and the income at which this rate commences increased to AUD 250 per fortnight, from AUD 142.
3. In the United States the age of a child at which lone parents are excluded from work requirements was reduced in 1988 from 6 to 3 years, and since 1996 this has been left to individual states to determine. In Nordic countries, sole parents are expected to actively search for a job once a child reaches three years of age, while in Germany and the Netherlands labour force participation requirements for lone parents have been extended to those with primary school age children. In France, participation is required when the youngest child reaches three years of age (Saunders, 2003).
4. For example, from March 2006, the maximum single rate of DSP is AUD 499.70 per fortnight (plus a pension supplement of AUD 17.80 per fortnight), compared with AUD 410.60 in the case of the Newstart Allowance (Cai and Gregory, 2005).
5. The growth of DSP recipients stood at 0.9% between March 2005 and March 2006, the lowest in 20 years.
6. The 1991 Disability Reform Package replaced the invalid pension and the sheltered employment allowance by the DSP, with the corresponding restructuring adding 10 100 new claimants. The new scheme also broadened the eligibility criteria, permitting part-time workers to claim the pension while working up to 30 hours per week, as well enabling greater access to the DSP for people with psychiatric and drug and alcohol conditions. The increase in the late 1990s in the female retirement age from 60 to 62 also influenced the number of DSP recipients (Saunders, 2004).

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Glossary

ABS	Australian Bureau of Statistics
AEMC	Australian Energy Market Commission
AER	Australian energy regulator
AIRC	Australian Industrial Relations Commission
APW	Average production worker
AUD	Australian dollar
AW	Average wage
AWA	Australian workplace agreement
CCB	Child care benefit
CCTR	Child care tax rebate
CGC	Commonwealth Grants Commission
COAG	Council of Australian Governments
CPI	Consumer price index
DSP	Disability support pension
EMTR	Effective marginal tax rate
G7	Group of 7 countries (Canada, France, Germany, Italy, Japan, United Kingdom and United States)
GAAP	Generally accepted accounting principles
GDI	Gross domestic income
GDP	Gross domestic product
GFS	Government finance statistics
GSP	Gross state product
GST	Goods and services tax
HFE	Horizontal fiscal equalisation
ICT	Information and communication technology
IGA	Intergovernmental agreement
IGR	Intergenerational Report
LITO	Low income tax offset
MFP	Multi-factor productivity
NCC	National Competition Council
NCP	National competition policy
NCPP	National competition policy payments
NRA	National Reform Agenda
NWI	National water initiative
OECD-10	Group of countries used to compare tax systems (Australia, Canada, Ireland, Japan, Netherlands, New Zealand, Spain, Switzerland, United Kingdom, United States)
PBS	Pharmaceutical benefit scheme

R&D	Research and development
RBA	Reserve Bank of Australia
SPP	Specific purpose payments
US	United States
USD	United States dollar
VFI	Vertical fiscal imbalance
VET	Vocational education and training

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