Economic Survey of Australia 2006

Development Centre of OECD

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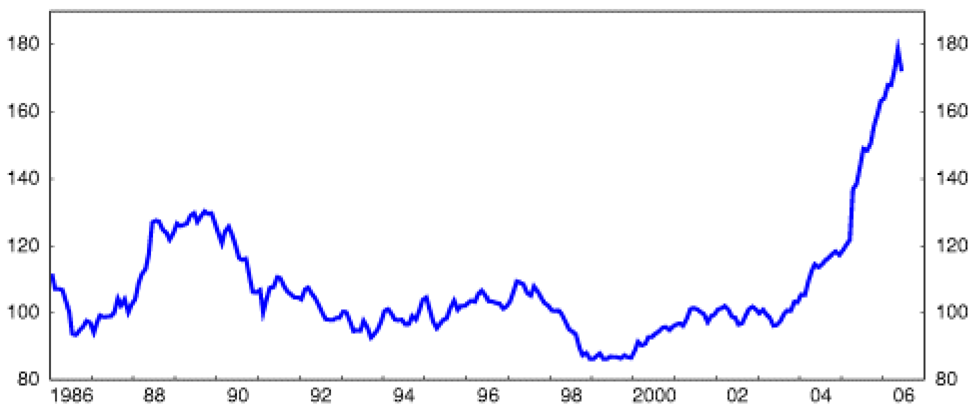
Chapter 1. The short-term challenge: riding the commodities rollercoaster

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. CPI 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 5¾ 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.

Australian commodity prices are booming

Index (SDR) for all items, 2001/02 = 100



Source: Reserve Bank of Australia.

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.

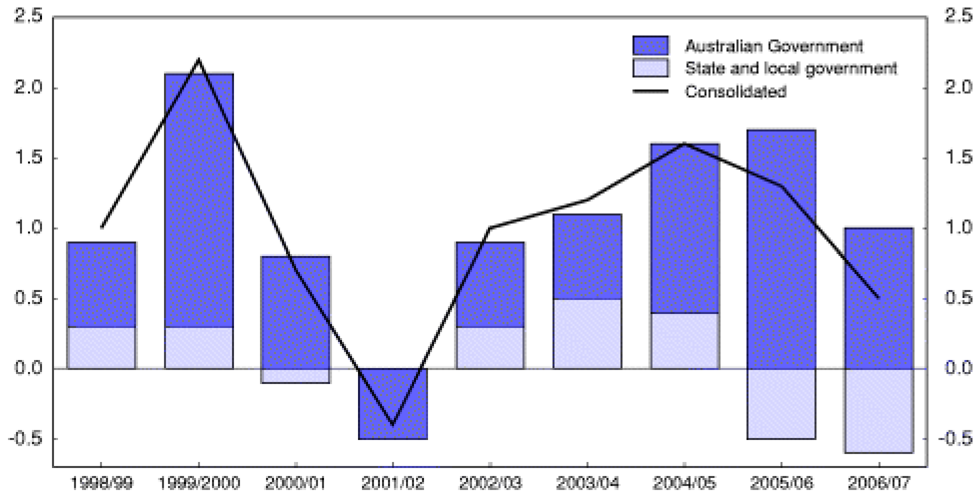
How should fiscal policy respond to the substantial terms of trade gains?

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 1¾ per cent of GDP. The assumption incorporated in recent budget projections of federal surpluses of about 1% of GDP over the next 4 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.

The general government fiscal balance

In per cent of GDP



Source: Australian Government (2006), Budget Strategy and Outlook 2006-07, Budget Paper No. 1, CanPrint Communications Pty Limited, Canberra.

What are the priorities for future tax cuts?

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.

Chapter 2. Long-term structural challenges

How strong has recent performance been and what challenges remain?

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.

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.

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.

[Chapter 3. Fiscal relations across levels of government]

Co-operative fiscal federalism works overall well

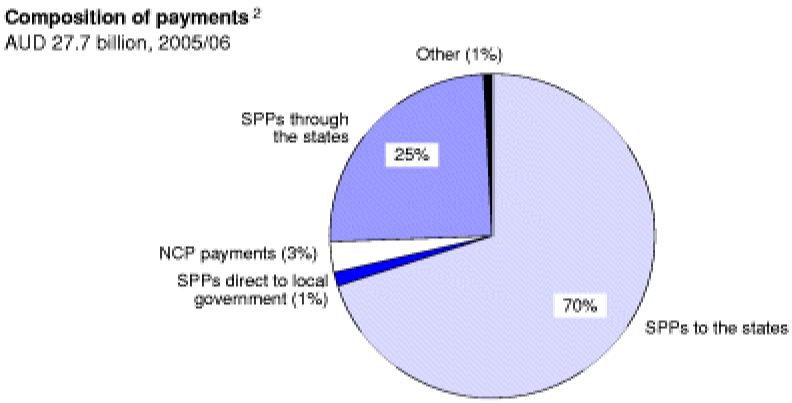
The special chapter in this Survey considers fiscal federalism, which is inevitably a difficult and controversial issue, but one which permeates many areas which are key to determining long-run economic performance. As in other countries where such systems operate there is an inevitable tension between 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.

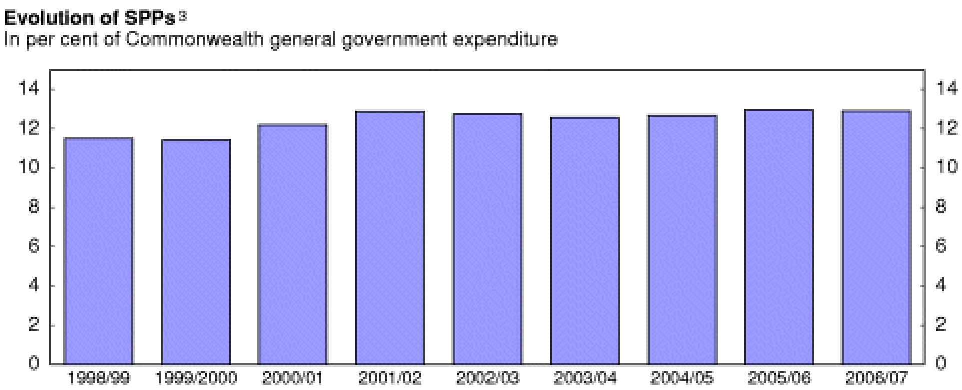
Spending assignments between the central government and the states should be clarified

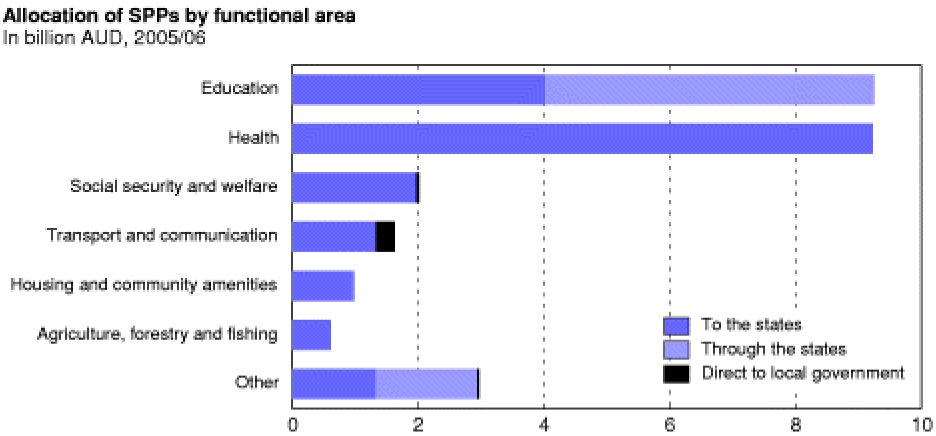
Key areas of public service provision are subject to complex joint government involvement, sometimes leading to inefficiencies. Fragmented decision making and funding arrangements are particularly notable in hospital services and old-age care, creating incentives for cost and blame-shifting between government 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.

Australian Government payments to sub-national governments(1)







1. Data from 2005/06 onwards are estimates.

2. NCP: National competition policy.

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

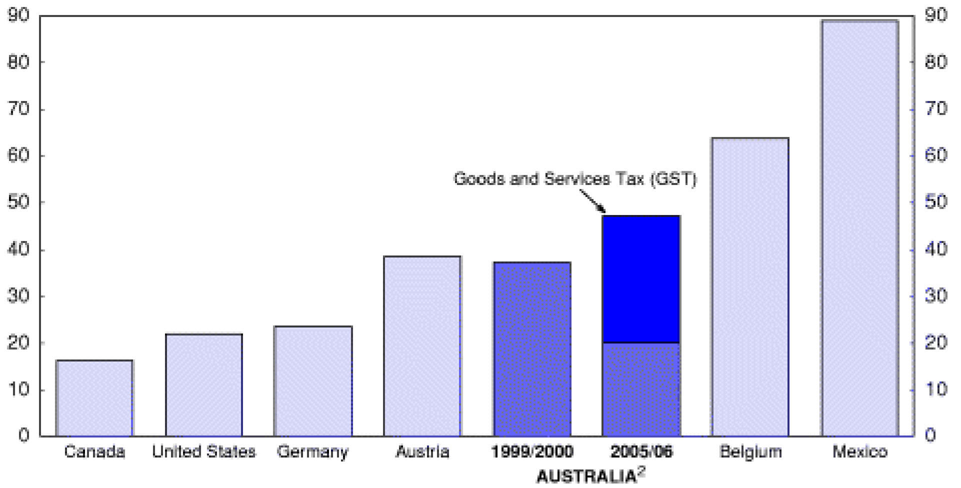
Source: Australian Government (2006), Budget Paper No. 3: Federal Financial Relations 2006-07 and Final Budget Outcome papers for earlier years, Australian Government, Canberra.

The vertical fiscal gap raises design issues for inter-governmental transfers, while inefficient 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.

The vertical fiscal imbalance: a comparison with other federations

In per cent of total sub-national revenue, 2003(1)



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.

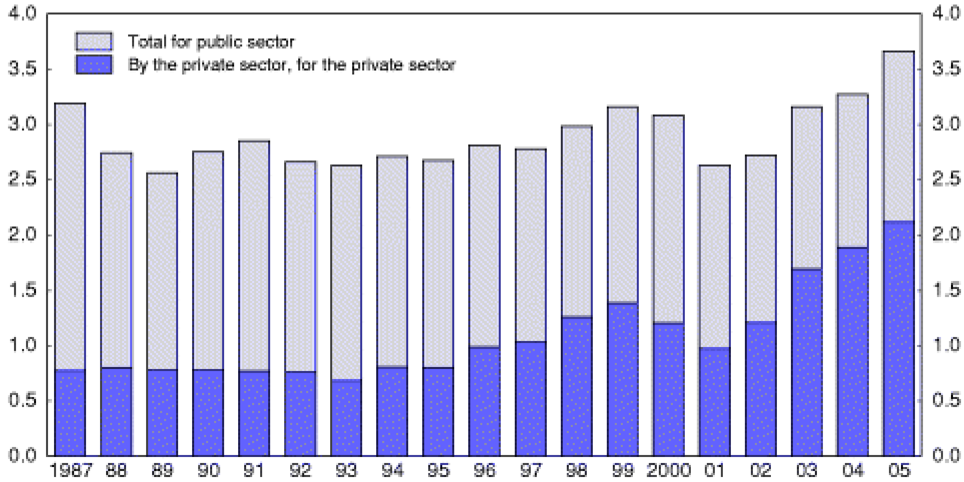
Chapter 4. The need for further reforms to infrastructure services

How could infrastructure service provision be improved?

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.

Trends in infrastructure investment

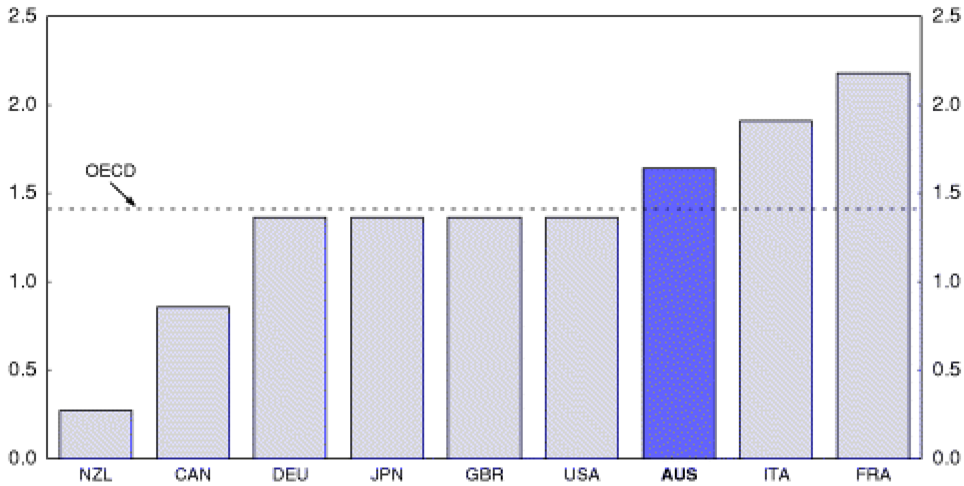
Engineering construction activities, current prices, in per cent of GDP



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

Legal barriers to entry in infrastructure servicesare relatively high(1)

2003

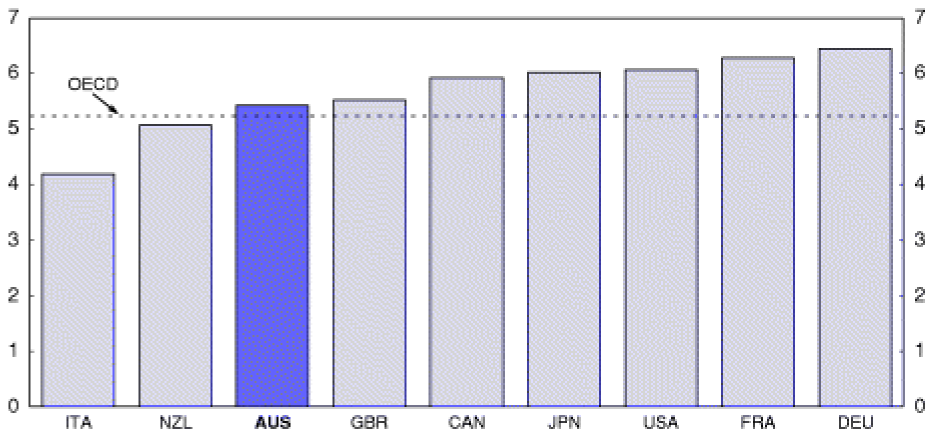


1. Indicator, higher values denote greater legal barriers to entry.

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.

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.

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.

Chapter 5. Reforming industrial relations

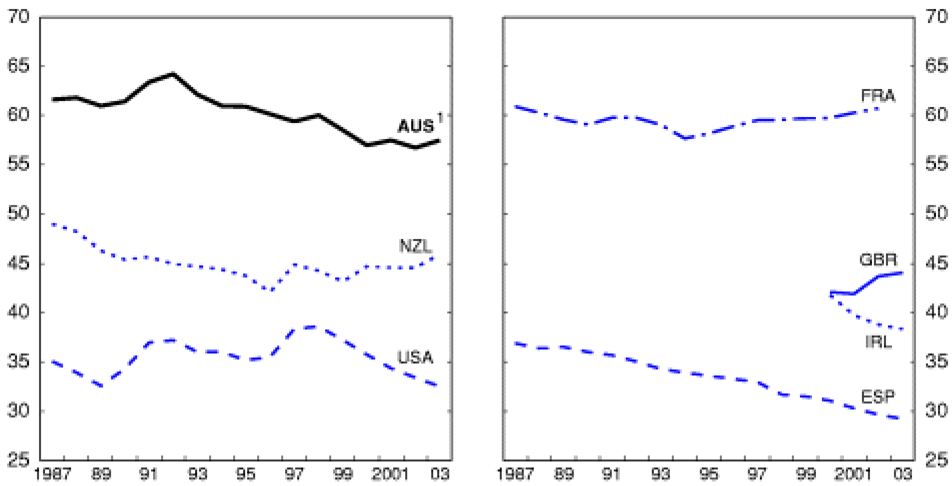
What will be the effect of the recent reform to industrial relations?

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.

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.

The federal minimum wage is high in international comparison

Minimum wage as a percentage of median wage



1. Basic metal industry classification C14.

Source: OECD database on minimum wages, May 2006.

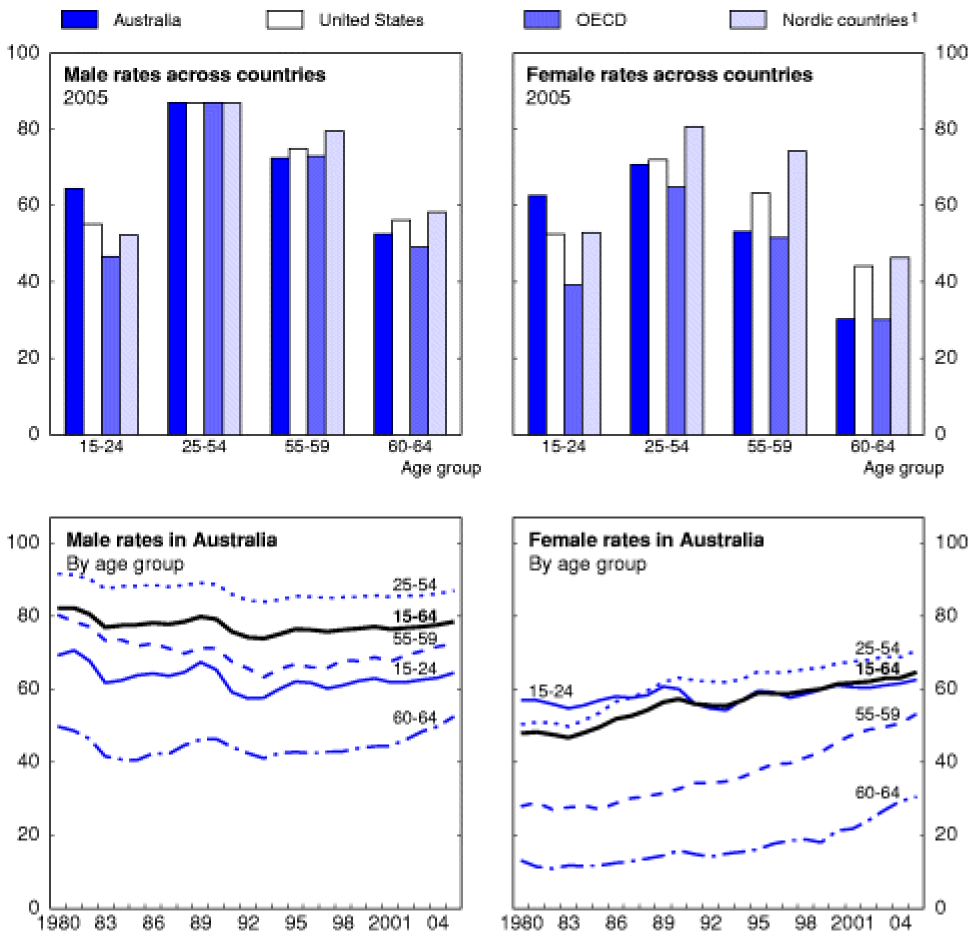
[Chapter 6. Improving incentives to work](#)

How can labour force participation be further increased?

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.

Employment rates

Employment as a percentage of population in the same age group

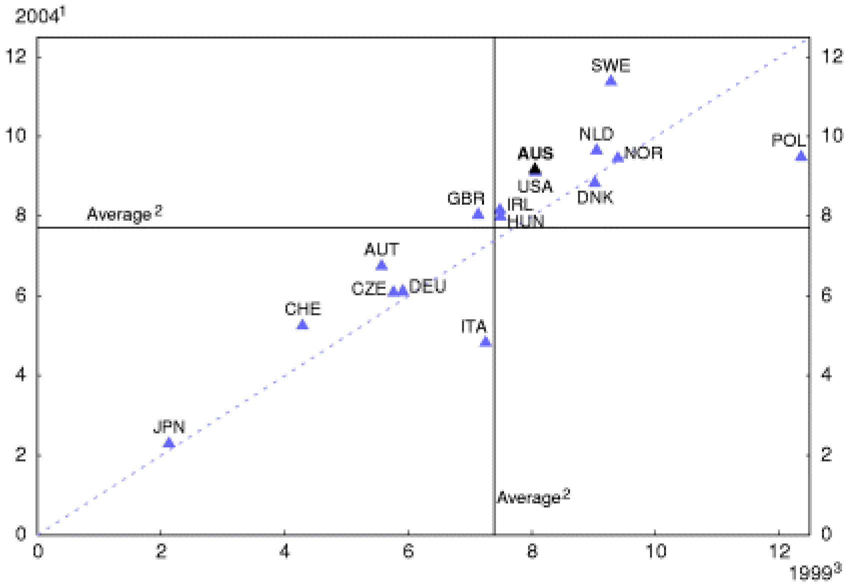


1. Denmark, Finland, Iceland, Norway and Sweden.
2. 2004 for the Nordic and OECD averages.
Source: OECD, Labour Force Statistics database, May 2006.

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.

Disability rates are high and have worsened

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



Source: OECD calculations based on data from Labour ministries.

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.