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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

– to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
– to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and
– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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Publié également en français.

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BASIC STATISTICS OF AUSTRALIA

THE LAND

Area (thousand sq. km.)	7 682
Agricultural area , 1986-87, per cent of total	61
Urban population, 1991, per cent of total	85

Population of major cities, 30 June 2001 (1000) :	
Sydney	4 155
Melbourne	3 484
Brisbane	1 653
Perth	1 397
Adelaide	1 111

THE PEOPLE

Population, 31 December 2001 (millions)	19 603
Number of inhabitants per sq. km, 2001	2.5
Natural increase, 2001 (1000)	117
Net migration, 2001 (1000)	110

Civilian employment, 2002 (1000) :	9 311
of which :	
Agriculture	405
Industry *	1 981
Other activities	6 926

PARLIAMENT AND GOVERNMENT

Composition of Parliament :

Party	Senate	House of Representatives
Australian democrats	7	. .
Australian Labor Party	28	64
Independent	3	3
Greens	2	1
Liberal Party of Australia	31	67
National Party of Australia	3	13
Country Liberal Party	1	1
Pauline Hanson's One Nation	1	. .
Total	76	149

Present governement: Liberal/National Party coalition

Next general elections for House of Representatives is expected by the end of 2004

THE PRODUCTION

Gross domestic product, 2001 (A$ million)	691 033
Gross fixed capital formation, 2001 percentage of GDP	21.6

GENERAL GOVERNMENT SECTOR, PER CENT OF GDP, 2001

Current disbursements	35.4
Current transfers	14.1
Current revenue	36.2
of which: Direct taxes	16.5

THE FOREIGN TRADE

Main exports, 2002, per cent of total exports :	
Food, beverages and tobacco	19.5
Raw materials	18.7
Fuels	20.6
Machinery and transport equipment	11.9
Other manufactured products	29.2

Main imports, 2002, per cent of total imports:	
Food, beverages and tobacco	4.5
Raw materials	1.7
Fuels	7.3
Machinery and transport equipment	45.9
Other manufactured products	40.6

THE CURRENCY

Monetary unit: Australian dollar

Currency units per US$, average of daily figures:	
2002	1.841
January 2003	1.717

* Including mining, electricty, gas and water, and construction.

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 economic situation and policies of Australia *were reviewed by the* Committee *on* 5 *February* 2003. *The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole* Committee *on* 25 *February* 2003.

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The Secretariat's draft report was prepared for the Committee by Helmut Ziegelschmidt, Vassiliki Koutsogeorgopoulou, Richard Herd *and* Paul O'Brien *under the supervision of* Nicholas Vanston.

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The previous Survey *of* Australia *was issued in* August 2001.

Assessment and recommendations

A judicious mix of macroeconomic and structural policies…

Dogged pursuit of structural reforms across a very broad front, and prudent macroeconomic policies firmly set in a medium-term framework, have combined to make the Australian economy one of the best performers in the OECD, and also one notably resilient to shocks, both internal and external. Incomes growth has remained brisk, employment is expanding, inflation is under control, and public finances are healthy. All the indications are that the continuing effects of previous reforms will continue to help the economy to combat shocks in the immediate future. In order to meet the longer-term objective of raising living standards towards the highest in the OECD, further reforms to labour, product and financial markets and to social policies will be needed, that will encourage more people to join the labour force, remain in it, and steadily raise their productivity.

… has resulted in exceptional economic performance which is expected to continue

Underpinned by historically low interest rates, rising terms of trade, strong productivity growth, a generous subsidy to first-time home buyers and high levels of business and consumer confidence, domestic demand growth has barely been affected by the recent cyclical downturn in most other OECD countries. Notwithstanding robust growth and a depreciating exchange rate, consumer price inflation has been kept in line with the Reserve Bank's 2 to 3 per cent inflation target over the cycle. Employment recovered in 2002, and unemployment has continued to fall to just over 6 per cent. Though the severe drought will impact on growth in 2002 and 2003, the expected improvement in the global environment should help the economy to expand at a robust 3¾ per cent rate in 2004, despite a likely downturn in the residential property sector. The demand for labour should continue to rise, but strong productivity gains are expected to help to keep labour costs and inflation under control. Rising incomes and real-estate wealth, and comparatively low debt-servicing costs for households should support consumer confidence and private consumption. The residential construction boom could be nearing its end, but surveys suggest that business investment will pick up further, underpinned by low financing costs, healthy company profitability and low corporate debt. Exports are expected to recover in line with overseas markets. Together with further terms-of-trade gains reflecting falling manufactured goods prices, this should bring the current external deficit back below 4 per cent of GDP in 2003-04.

The risks to the outlook are mostly on the downside

Risks to the short-term outlook are not symmetrical. A delayed recovery in the global economy would weaken the projected pick up in Australian exports. Moreover, the generally depressed and uncertain business outlook in most other countries could eventually sap business confidence in Australia. A large increase in investment underpins Australia's short-term growth outlook and, in the past, this component of demand has been particularly sensitive to global economic conditions and the level of uncertainty surrounding the outlook. It is not yet clear if the house price boom is a bubble that will burst, with negative impact on household financial positions and spending, or an adaptation to an era of strong real income growth and low interest rates. The longer it continues, the greater the likelihood that some of the run-up in prices will eventually be reversed. The other major domestic uncertainty is the length and severity of the drought. While the effects of the adverse seasonal conditions on activity in 2002-03 are becoming clearer, the outlook for economic activity in 2003-04 is underpinned by the assumed breaking of the drought. Consequently, should unusually dry conditions persist into 2003-04, the risks to the outlook for farm production and activity more generally are significant. On the upside, a faster than expected recovery in major trading partners could generate stronger demand for Australian exports, while the domestic economy could display more momentum than anticipated.

Monetary policy has become less expansionary…

When domestic and foreign demand slowed in early 2001, macroeconomic policies responded appropriately, given the benign inflation outlook. The Reserve Bank cut the cash rate six times during 2001, and monetary conditions were further eased by the depreciating Australian dollar. With the improvement in the international outlook in the first half of 2002, and with consumer price inflation staying just at the upper end of the Reserve Bank's target range, the Bank raised the cash rate in May and June 2002 by altogether 50 basis points to 4.75 per cent, still low by historical standards. The Bank indicated its intention to move policy back to a more neutral setting over time, but has appropriately desisted from further tightening so far, in view of the loss of momentum in the global economy and the severe drought.

… while fiscal policy is firming

Part of the buoyancy of domestic demand since mid-2001 owes to the loosening of fiscal policy at a time when growth had slackened, and was not expected to recover quickly. Easing for the most part took the form of higher subsidies to first-time home-owners and unanticipated increased expenditure for defence, domestic security and border protection. It resulted in a swing in the Commonwealth's underlying cash balance from a moderate surplus in fiscal year (FY) 2000-01 to a marginal deficit in FY 2001-02. Reflecting the gathering strength of the economy, the Commonwealth Budget for 2002-03 appropriately projects a return of the underlying cash balance to small surplus, and larger budget surpluses are projected over the medium-term.

Public sector net debt is low and falling, and could disappear altogether

In practice, actual budget outturns over the cycle have on average resulted in surpluses. Together with asset sales in earlier years, and some still to come, the result has been that Commonwealth net debt has fallen to low levels and would disappear altogether in the medium term on current policies. States' net debt is also low and falling. Paying down debt is arguably a desirable way of reducing the fiscal burden on future generations, particularly if capital markets can function efficiently on the basis of private financial assets. However, very low levels of government bonds may hinder the efficient operation of the Australian capital market, and complicate the implementation of monetary policies. It is not obvious, though, that possible capital market problems should be "solved" by public borrowing to purchase private-sector real assets. If capital markets do require risk-free public paper to function efficiently, then an alternative approach would be to fund the unfunded liabilities of the public servants pension scheme.

Pension policies are fiscally sustainable…

The Government's *Intergenerational Report* of May 2002 indicates that, under unchanged policies, public spending could rise by as much as 5 per cent of GDP more than tax revenues over the next four decades, primarily reflecting higher health related expenditures rather than purely age-related spending. Compared with most OECD countries, Australia is well-placed as regards the burden of public pensions which is low relative to GDP and not expected to rise appreciably in the future. The Age Pension is flat-rate, income and asset tested and modest relative to average wages, and is financed out of general taxation. The compulsory funded superannuation scheme that started in 1992 is slowly maturing, thereby reducing entitlements to the Age Pension in the long run. Both the mandatory defined contribution system and voluntary retirement saving plans are effectively taxed on the same basis as owner-occupied housing for equity reasons. However, the superannuation tax system is unduly complicated, with a lump sum having up to seven alternatives to the standard flat rate income tax normally paid on the withdrawal of superannuation benefits. A simplification of the tax rules is needed with an anchoring to income tax rates. Though currently aligned, the rates of tax on retirement saving are set independently of income tax rates – opening the possibility that the neutrality of the tax treatment on saving through pensions and housing may break down in future. Finally, the means testing of the basic pension may encourage people to retire from the labour force and dispose of assets before the age of eligibility for the state pension, thus lowering incentives to work. This "double-dipping" needs to be discouraged, for example by aligning the preservation age for superannuation benefits with that required for access to the Age Pension (*i.e.* 65 years). More fundamentally, the assets test needs to be reviewed. A further reduction of the taper rate should be considered as marginal effective tax rates for the elderly can be nearly 70 per cent over a wide range of income. Such changes should be given priority over any changes in the taxation of pensions.

… but much higher health spending is expected

Although spending on public pensions seems fiscally sustainable, the Government's *Intergenerational Report* nevertheless estimates that on unchanged policies and likely developments in productivity and participation rates, total Commonwealth spending will exceed revenue in about 15 years. This mainly reflects the long-standing trend rise in health costs, especially pharmaceuticals, associated with technological advances and other autonomous forces, and the more intensive use of medical services by the elderly. The potential budgetary costs of health care for the aged will also need to be considered. Following the decision to encourage participation in private health insurance schemes, the growth in the use of public hospitals has slowed. Containing the growth of public spending on the Pharmaceutical Benefits Scheme – the fastest growing component of the health care spending – and developing a more affordable and better targeted aged care system, are essential for containing spending pressures and maintaining the sustainability of the health care system in the longer run.

Rising living standards will require higher participation and productivity growth

The government recognises that rising trends in public calls on economic resources in the future will be more easily accommodated if total output rises more rapidly, *via* increases in the size of the labour force, and its productivity, and can be further boosted by encouraging more people of working age to remain in, or join, the workforce. Their productivity would be enhanced by policies that increase human capital and the efficiency with which it can be used.

Incentives to participate in the labour market have improved, but high marginal effective tax rates remain

To encourage higher employment and higher participation, the government introduced in the 2001-02 Budget a comprehensive welfare reform package, *Australians Working Together*. It extends the mutual obligation requirements (broadly defined community service and active labour market policies) to 35-49 years olds and provides for a phased introduction of participation requirements to qualify for Parenting Payments. The reform also introduced a "Working Credit", that allows welfare recipients to keep more of their income support payments when they take up work. However, the Working Credit lowers the high marginal effective tax rates only transitorily, as the financial benefit depends on the amount of working credits accrued by the person. Hence, further reforms should aim at reducing the high effective marginal tax rates faced by welfare beneficiaries (and others) if and when they take up longer term employment. In the interest of raising participation rates, the Government has also undertaken initiatives to improve the work capacity of people with disability and to tighten the eligibility requirements for Disability Support Pension, to slow the large flow of people into this programme; a revised Disability Reform Bill, addressing this last issue, was unfortunately recently rejected by the Senate.

A competitive market for employment placement has probably raised efficiency more than employment

Labour market efficiency has also been enhanced by the introduction of a contestable employment placement market – the *Job Network* – as from May 1998. To ensure that disadvantaged job-seekers benefit from the new arrangements, a differential fee structure applies, with the government paying the highest fees for those who are most at risk and hardest to place in a job, and full payment to the agency is made only after a job-seeker has been off allowances for longer than six months. The new system has achieved a substantial reduction in the unit costs of employment assistance for unemployed job seekers and it also seems to have led to a higher level of satisfaction of job seekers and employers. The government's *Active Participation Model* will improve the linkages between the *Job Network* and other welfare arrangements as from 1st July 2003. However, the *Job Network* has had only modest positive effects so far on the job seekers' chances of gaining employment although there is probably a positive impact on productivity because of a better matching of people and jobs. Outcomes may improve over time as service providers learn what works best, and poor service providers lose their contracts.

A decentralised industrial relations system has improved the economy's resilience to external shocks…

The resilience of the economy to shocks has been improved by reforms which have made the labour market more adaptable to rapid changes in the economic environment and has permitted the economy to work closer to potential over time as a result. The ongoing reforms of the industrial relations system since the mid-1980s stand out in this respect as they have introduced a large measure of regulatory flexibility, especially by facilitating and encouraging the setting of wages and employment conditions at the enterprise level. The move to decentralised bargaining was underpinned by fundamental changes to the former exceptionally rigid and legalistic award system. These aimed at restricting its role to a safety net of *minimum* wages and other core conditions of employment, rather than, as previously, detailed prescriptions of *actual* wages and conditions. Among the many provisions designed to support decentralised bargaining were increased protection for freedom of association, a ban on union preference clauses in agreements and awards, and a strengthening of the Australian Industrial Relations Commission's powers to give directions to stop or prevent unprotected industrial action. The new system also enables employers to trade off wage increases for changes in work practices. Less adversarial labour relations and greater labour flexibility are likely to have encouraged innovation, and to have facilitated greater acceptance of new work practices, organisational procedures and modern technologies, and thus contributed to the observed acceleration in productivity in Australia over the past ten years or so.

… but further improvements, especially at the federal-state interface, are desirable

Despite this long programme of reform, a number of problems remain. So far, the number of formal individual workplace agreements remains quite low, probably reflecting their high initial transactions cost. And effective decentralisation may be inhibited by the growing practice of "pattern bargaining", namely concerted negotiations by the same trade union in a number of different enterprises. It will be important to assess the effectiveness of the proposed simplified procedures for making individual and collective agreements which are currently before Parliament. Moreover, the award system still plays an important role in setting minimum wages, which – at around half of average weekly earnings – are relatively higher than in most other OECD countries and may therefore constrain employment prospects for the low-skilled. And even though simplified awards impose far fewer constraints on the operation of enterprises than before, the rather extensive coverage of the twenty so-called "allowable matters" still implies a substantial degree of complexity compared with other countries. Hence, the number of employment conditions determined by awards should be reduced further and their specifications tightened to a less comprehensive set of core employment conditions. This would reduce the role of awards as benchmark against which the "no-disadvantage test" of enterprise agreements is conducted, allowing the individual situation of enterprises to be better taken into account when negotiating agreements. The overall reach of industrial relations reform would be extended by the harmonisation of federal and State legislation and practice, not only to reduce regulatory costs for businesses and governments, but also to avoid reforms of the federal system being rolled back at the state level.

There is scope for improving the transition of young people from school to work

Cross-country analysis indicates that human capital, as proxied by years of education and training, plays a very important role in raising labour productivity. While the level of educational attainment in Australia has improved considerably over the past twenty-five years, concern remains regarding the relatively high teenage unemployment and early school leaving rates in Australia, both exceeding the OECD average. Recent reform efforts focus on the better integration of vocational education and training (VET) with the broad education sectors, and the introduction of a National Transition system. In this context, particular attention should be paid to measures raising the incentives to remain in education beyond the compulsory age, including a broadening of the secondary school curriculum and the provision of better advice and guidance in schools. A strengthening of the links between VET and higher education is also desirable both in terms of enhancing the educational pathways and for improving efficiency in the allocation of resources in the two sectors. To improve standards, more flexible and better targeted arrangements for the funding of higher education provision should be considered, along with access on an equitable basis.

Product market competition has been greatly strengthened

The implementation of Australia's ambitious and comprehensive National Competition Policy over the past seven years has undoubtedly made a substantial contribution to the recent improvement in labour and multifactor productivity and economic growth. The Productivity Commission estimates that Australia's GDP is now about 2½ per cent higher than it would otherwise have been, and Australian households' annual incomes are on average around A$ 7 000 higher as a result of competition policy. Unfinished business encompasses the completion of the legislative review and the subsequent removal of restrictions which have been shown not to be in the general public interest; the introduction of a contestable national electricity market at the household level; the acceleration of the slow pace of the reform of rural water supply; enhancing competition in fixed-line telecommunications; and opening the postal services market to competition. Some of these reforms are advancing slowly because of resistance from groups that benefit from protection. This calls for continuing strong efforts of the government to convince opposing parties of the overall beneficial effects of enhanced product market competition, possibly accompanied by financial assistance to support the transition to new, more efficient arrangements.

Recent reforms have strengthened the efficiency of the financial system although weaknesses remain

Reforms to labour and product markets have been complemented since the mid-1990s by an extensive examination of regulations applying to the financial services industry. The comprehensive "Wallis reforms" in the late 1990s, which focused on prudential supervision, depositor protection and the promotion of competition among financial service providers, have been largely implemented. The *Financial Services Reform Act* 2001 of March 2002, provides for a single, harmonised licensing regime for financial service providers and product issuers, as well as a consistent and comparable financial product disclosure regime, and uniform arrangements for the regulation of financial markets. In addition, the reform seeks to cut compliance costs for financial service providers and to remove regulatory barriers to the introduction of technological innovations. A key element of the *General Insurance Reform Act* 2001, which came into effect in July 2002, is a substantial increase in the level of regulatory capital that must be held by insurers, to be phased in by 1 July 2004. Insurers will be required to hold capital commensurate with the risk profile of the insurance business being underwritten. However, the collapse of a major insurance company in early 2001 also gave rise to the question of the then adequacy of the investigative powers of the prudential regulator APRA. This issue is currently being examined in the context of the investigation by a Royal Commission into the causes of the insurer's failure, while APRA itself now takes a considerably more proactive stance in its surveillance role.

Tax reform has made significant headway, but there is unfinished business

Efficiency gains could also be achieved from the recent reforms to the tax system, notably the July 2000 introduction of the broad-based 10 per cent Goods and Services Tax (GST), and the July 2001 introduction of a simplified tax system for small firms and a unified capital allowances system. This is intended to reduce the compliance burden for most businesses and improve the efficiency of investment in Australia. Reforms in international taxation arrangements are also currently under review. However, some important policy issues remain to be addressed, among them the large gap between the top personal marginal income tax rate and the company tax rate, which acts as an incentive for a redefinition of personal income as company income. In addition, the top marginal income tax rate comes into effect at a relatively low income level, raising concerns about work and savings incentives, with potential adverse effects on output growth. And although the issue was addressed in the July 2000 reform package, marginal effective tax rates remain high for many low-income earners, which tends to create poverty traps. Additional benefits would also accrue from a faster-than-envisaged abolition of some harmful State indirect taxes, especially the tax on bank account debits. Another subject of reform should be the narrowly-based payroll tax, which is also under the jurisdiction of the States.

Bilateral trade agreements should be accompanied by further reductions in remaining high tariff areas

The Australian market has become progressively more open over the past decade under the influence of both unilateral and multilateral cuts in tariffs and abolition of quotas. A high proportion of imports from developing countries enters the country without paying tariffs. In agriculture only the dairy industry is now supported. Moreover, all remaining barriers against 48 Least Developed Countries and East Timor have now been abolished with immediate effect. However, high effective tariff barriers still affect other developing country exports of textiles, clothing and footwear. Lowering these beyond the cuts planned in 2005 will be particularly important in order to meet the government's pledge to APEC to introduce completely free trade by 2010. They will also be a welcome complement to the possible free trade agreement with the United States to lessen any potential trade diversion. In any case, this agreement should form a base for continued progress in multilateral trade liberalisation.

Immigrants are likely to have brought economic benefits…

Australia is an "immigration country" *par excellence*, and it is an assumption of policy that significant net immigration will continue for the foreseeable future. Immigration is accepted as contributing to a higher quality of life through expanding the labour force, output and markets. Current immigration policy has been successful in improving the economic return from immigration. It can be inferred from the high average level of education of immigrants, their relative youth, high participation and declining unemployment rates, that average incomes of successive immigrant intakes have been rising relative to those of the existing population. It is therefore likely that spin-offs for the existing population have also been increasing. However, it is difficult to quantify these gains for the existing population; the government is sponsoring studies in an attempt to better estimate these benefits. Studies also show that most immigrants create net fiscal benefits, especially those who enter through the points-based and business skills routes.

… based on their successful integration…

Benefits associated with the development of "multicultural Australia" depend on successful economic and social integration. Australia is successful in integrating immigrants on most economic measures, in part reflecting a focus on skills. Although immigrants on average have higher unemployment rates than Australian-born, the gap fell substantially during the 1990s and the difference between the likelihood of unemployment for an Australian-born person and an immigrant diminishes as length of residence increases. The position is relatively less favourable for the unskilled (mainly Humanitarian, and to a lesser extent, family migrants), particularly those with poor English language skills. Unemployment remains a problem for these categories of immigrants, and the consequences of this feed directly into their relatively unfavourable fiscal contribution.

The current policy of a lower level of entitlement to social security benefits for non-humanitarian immigrants in the first two years reduces the fiscal costs and increases the incentive to work, which underpins the high participation rates of most migrant groups. (Humanitarian immigrants, once accepted, are immediately entitled to the same benefits as existing permanent residents.) The two year waiting period may discourage some forms of immigration, though it is unlikely that the availability of welfare benefits is an important factor in the migration decision for many people, especially given the limitations on overall numbers.

... and supported by free language tuition for immigrants with poor English

Considerable efforts are made to improve the integration prospects for adult immigrants coming to Australia under the Family Stream and the Humanitarian Program and for adult dependants of Skill Stream migrants, notably through the provision of free or, in some cases, subsidised language tuition where less than functional English is held. In addition, the Government provides funds for English as a second language tuition to school-age children requiring such assistance. Studies repeatedly show that knowledge of English is the single most important factor in successful integration, both economic and social. There are some indications that this policy works, notably the results of the PISA study on education attainment. These showed relatively high levels of achievement for both Australian-born and immigrant children, including those with non-English speaking home environments, with a smaller gap between the groups than in almost all other OECD countries. Successful overall, these integration efforts should continue to be sensitive to the needs of particular groups, notably to ensure that the local ethnic concentrations that are inevitably associated with migration remain the routes to integration that they have been in the past rather than a trap or a means of avoiding integration.

Poverty reduction is now the main goal of development assistance

Policy actions to ensure sustained increases in Australian living standards have to be placed in the context of low incomes elsewhere in the world. Australia cannot neglect the implications of economic and social instability in neighbouring countries. Many of these benefit from Australia's official development assistance programme, which has markedly changed its orientation over the past five years. There has been a welcome increase in programmes aimed at improving the governance structure in partner countries, both through improving economic and financial management, and strengthening law, justice and democratic institutions. Expenditure on basic health and education has risen, while spending on major projects has dropped. Improvements could still be made to the allocation of funds. The benefits of further redirecting aid spending from University scholarships in Australia toward strengthening the education infrastructure in source countries, should be considered. As importantly, outlays aimed at improving basic transport infrastructure and the governance of neighbouring countries should continue to rise. Such increases may better place the economies of its partners to take advantage of the unilateral reduction in tariffs that Australia continues to put in place.

Markets can help secure sustainable water use

Water use is becoming unsustainable in a number of areas where agricultural usage is high. Stress affects only about a quarter of river systems, but they account for almost 70 per cent of water extraction. Urban consumers now pay for the full cost of the distribution and treatment of water. However, neither urban nor rural consumers pay for the right to extract water from rivers. All jurisdictions have put in place legislation that provides for full cost recovery, and allows water to be separated from land title and hence traded to its most profitable use. All states now need to complete their water resource plans in order to assess sustainable extraction caps, bearing in mind the need of ecosystems, and then let markets allocate water to its most economical use. There is, however, less scope to use economic instruments to overcome the problem of excess salinity of water and soil. Rather, it is important to use cost-benefit analysis to establish the extent of the resources that government policies should devote to containing soil and water salinity, which is very costly to reverse. Some degree of soil salinity may be an acceptable price to pay for improving large areas of land. Indeed, the value of the overall stock of land has been increasing, as has the value of remaining mining resources, thereby increasing the value of the natural capital stock in the Australian balance sheet faster than the stock of physical assets over the past decade.

Summary

Australia's current and recent economic outcomes place it among the top performers in the OECD. This owes much to a good combination of prudent, medium-term oriented fiscal and monetary policies, and far-reaching reforms to labour, product and financial markets in the past two decades. In current circumstances, there seems to be no reason to change the overall stance of demand policies. Previous structural reforms are likely to continue bearing their fruits for some years. The Government's commitment to reform, its willingness to commission expert advice and to heed it, to try new solutions, and to patiently build constituencies that support further reforms, is also something that other countries could learn from. Nonetheless, the success of past reforms is not grounds for complacency. The Government needs to remain focussed on implementing its current policy reforms and to work assiduously to address other existing and emerging policy challenges. In particular, ongoing and new policy reforms in the areas of welfare, private pensions, education, competition and labour markets would encourage more people to participate in the workforce, and raise their productivity. This will help support longer-run growth prospects, with increases in participation being particularly helpful to counteract the fiscal impact of age-related expenditure in future decades. Australia's immigration policy has delivered economic benefits, in part because of its emphasis on skills and its successful approach to integration. Long-term sustained rises in Australian living standards will be further assured by foreign aid programmes that help improve both economic development and political stability in neighbouring countries, and by policies that encourage more parsimonious and more efficient use of domestic natural resources.

I. Recent trends and short-term prospects

Overview

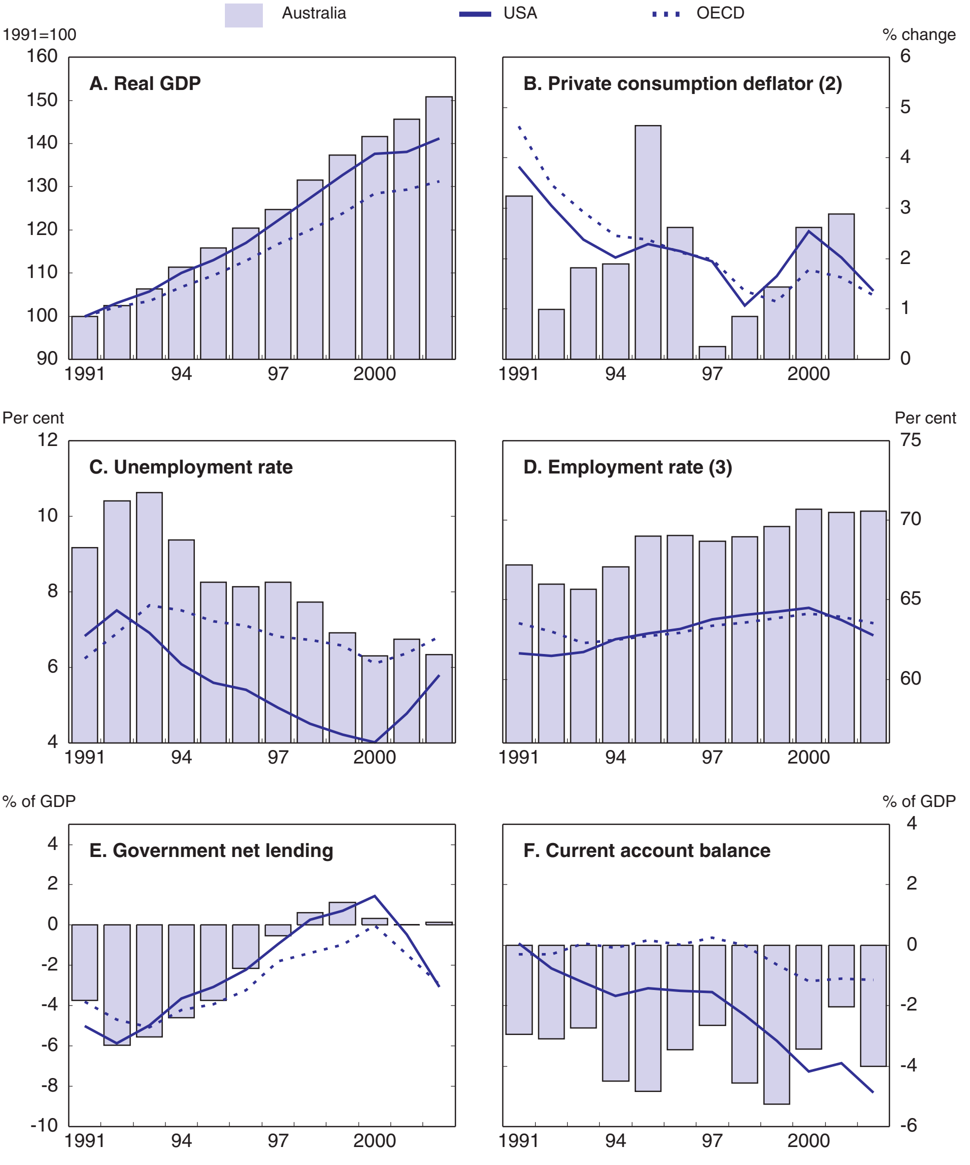
The Australian economy has continued to grow strongly, despite the cyclical downturn which hit most OECD countries in the second half of 2001 and in 2002. GDP is estimated to have grown by 3¾ per cent in 2002, up from 2.7 per cent in 2001. The expansion in 2002 was led by buoyant domestic demand, which entailed a widening of the current external deficit to around 5 per cent of GDP in the second half of the year, although even larger external deficits were registered in the late 1990s. Part of the buoyancy of domestic demand owes to the loosening of the fiscal stance, which brought the move to general government surpluses to a temporary halt. Economic activity was further supported by distinctly easy monetary conditions, brought about by a series of interest rate cuts by the Reserve Bank in 2001 and a low Australian dollar. Notwithstanding robust growth and a lower exchange rate, consumer price inflation – adjusted for the effect of the introduction of the goods and services tax (GST) in mid-2000 – has been kept in line with the Reserve Bank's 2 to 3 per cent inflation target. However, the employment gains made during the past two years have sufficed to reduce the average unemployment rate to around 6¼ per cent (Figure 1). This still leaves a small margin of cyclical unemployment.

In the middle of 2002, the current economic expansion completed its eleventh year, with GDP growth averaging 3.6 per cent, thus exceeding the average growth performance of OECD countries by more than 1 percentage point. Strong growth had even persisted during the late 1990s' financial crisis in a number of East Asian countries, which had caused a marked slowdown of world economic growth in 1998 and 1999. This has helped to make the current economic upswing longer and steadier than other post-war expansion periods. Although the pace of job creation in the current expansion has been somewhat slower than in the upswing of the 1980s, it stands out by large gains in labour productivity (Figure 2). The economy appears well placed to again outperform growth of the OECD area by a substantial margin in 2003 and 2004.

Factors shaping domestic demand

Household consumption remained a major driving force of domestic demand buoyancy in 2001 and 2002 (Table 1). It was supported by solid growth in real

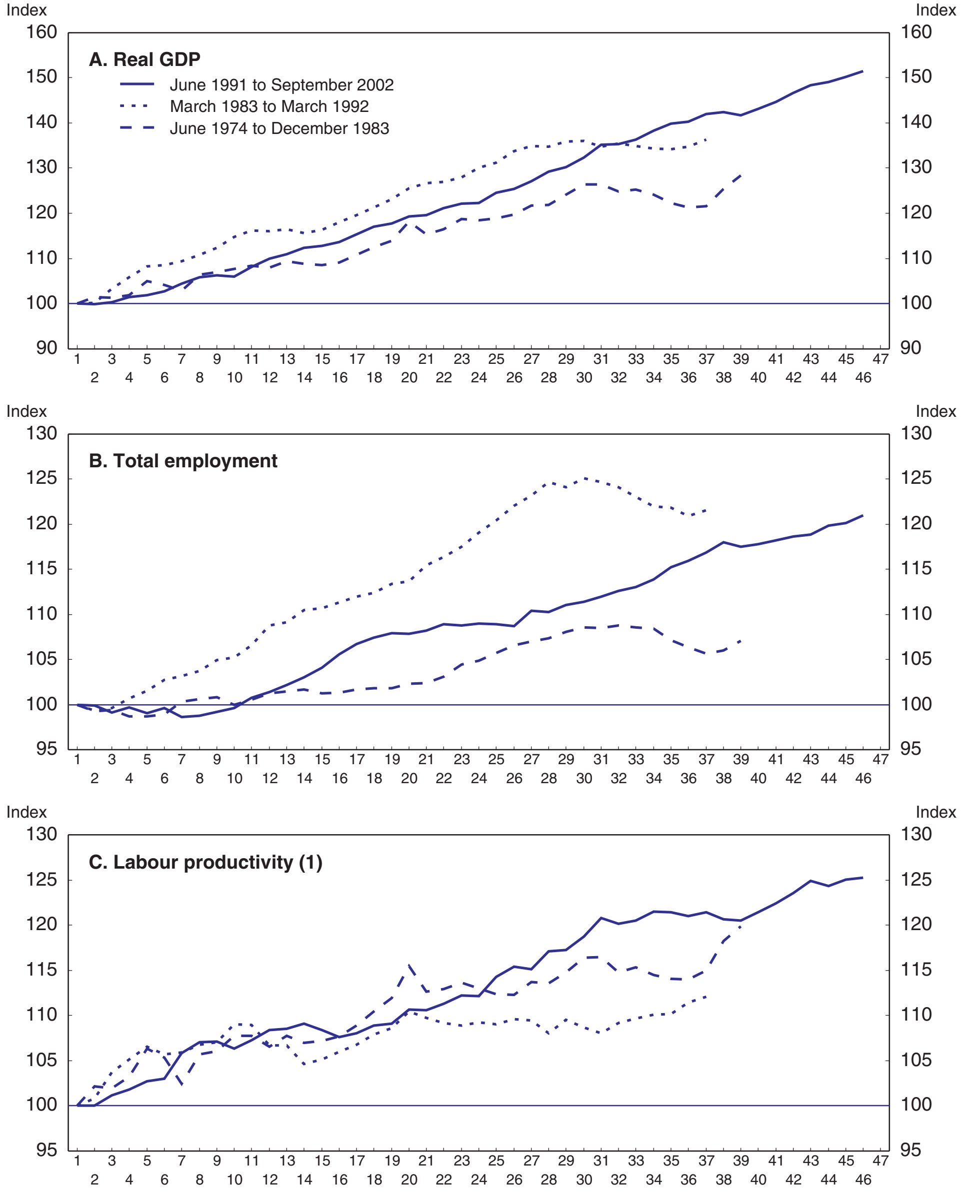
Figure 1. **Key indicators in international perspective**[1]



1. Figures for 2002 are OECD estimates.
2. OECD excludes high inflation countries. For Australia, CPI inflation adjusted for changes in taxation.
3. Total employment as a per cent of working-age population (aged 16-64).

Source: OECD.

Figure 2. **The current expansion compared**



1. GDP per employee.
Source: OECD.

Table 1. **Demand and output**

Percentage changes, FY 2000-01 prices

	From previous year				From previous period, seasonally-adjusted annual rate					
	Calendar years		Fiscal years[1]		2001		2002			
	2000	2001	2000-01	2001-02	S1	S2	S1	Q1	Q2	Q3
Consumption										
Private	3.2	3.0	3.0	3.5	3.1	2.8	5.2	5.6	6.0	1.6
Public	4.9	1.5	2.2	3.7	0.8	4.0	6.1	8.5	0.3	0.9
Gross fixed capital formation	–0.1	–1.0	–7.7	9.9	–2.0	15.4	11.7	2.2	20.5	7.0
Public sector	–1.1	5.5	–0.2	7.9	3.1	12.1	4.6	–15.1	2.6	–12.9
General government	6.9	0.3	0.6	–4.6	–5.7	0.8	–13.7	–18.4	–23.8	18.5
Public enterprises	–13.2	15.1	–1.8	30.4	20.8	32.7	34.9	–10.6	46.0	–39.5
Private sector	–0.3	–2.5	–9.5	10.3	–3.2	16.2	13.2	6.3	24.6	11.3
Dwellings[2]	3.9	–10.9	–20.9	19.5	–8.5	34.8	22.1	12.7	30.0	14.0
Other building and structures	–21.3	–7.8	–22.6	10.4	–18.0	21.5	22.6	47.2	50.0	43.6
Machinery and equipment an intangible fixed assets	7.0	2.7	3.6	2.5	3.4	0.5	5.8	–9.8	18.9	5.8
Machinery and equipment	4.9	0.7	0.6	3.0	1.0	1.4	8.1	–9.2	18.3	4.1
Intangible fixed assets	17.0	11.2	17.9	0.9	13.9	–3.1	–3.0	–12.3	21.3	13.1
Livestock and transfer costs	3.0	7.0	–7.7	23.1	12.5	38.3	6.8	11.3	–1.7	–19.8
Livestock	–0.1	14.1	–3.2	31.9	0.0	74.0	0.0	0.0	0.0	–61.2
Ownership transfer costs	3.7	5.4	–8.7	21.0	15.7	30.7	8.6	14.4	–2.1	–5.4
Final domestic demand	2.7	1.8	0.3	4.9	1.5	5.7	6.8	5.3	8.1	2.7
Increases in stocks[3]	–0.8	–0.3	–0.4	0.0	–1.5	–0.7	–0.0	0.6	0.0	0.1
Total domestic demand	1.9	1.6	0.0	4.9	0.1	6.6	6.5	4.7	6.8	3.7
Exports of goods and services	11.1	1.2	7.2	–1.5	0.1	–4.1	2.1	10.1	2.1	–2.8
Imports of goods and services	7.4	–4.1	–1.3	2.3	–6.2	–0.2	16.9	16.1	18.7	3.1
Change in foreign balance	0.6	1.3	1.9	–0.9	2.0	1.8	0.2	–1.3	–2.7	–3.1
Statistical discrepancy[3]	0.3	–0.1	0.0	–0.1	0.2	0.3	–0.5	–0.4	–0.2	0.5
GDP	2.8	2.7	1.8	3.9	2.4	5.0	3.5	2.8	3.3	3.5
Farm	3.8	1.3	–0.5	5.3	4.6	1.6	13.6	23.4	–2.0	–40.6
Non-farm	2.6	2.6	1.7	3.9	2.2	5.1	3.2	2.2	3.5	5.4

1. Fiscal years begin 1 July.
2. Including real estate transfer expenses.
3. Contributions to changes in real GDP (as a percentage of real GDP in the previous year).

Source: Australian Bureau of Statistics.

disposable household incomes, which reflected further gains in employment and wage increases, robust growth in household wealth underpinned by strong increases in house prices, and high levels of consumer confidence. The increase in house prices in recent years more than offset the decline in equity wealth so that the value of total household assets grew by more than 10 per cent annually on average over the past five years (Table 2). Higher household asset values, low financing costs and the continuing impact of financial deregulation on the availability of credit have induced strong growth of household borrowing. Although most of it serves the financing of the acquisition of dwellings, new financial instruments such as home-equity loans and redraw facilities have widened the scope of households to borrow against their equity in property in order to finance consumption.

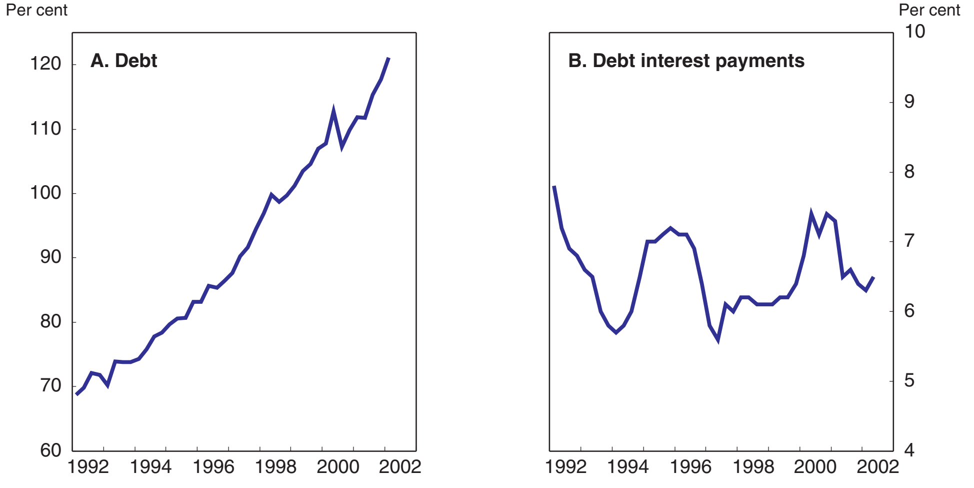
Accordingly, the stock of household debt continued its sharp rise, exceeding 120 per cent of household disposable income in 2002[1] (Figure 3, Panel A). *Prima facie*, this would be a matter of concern if household indebtedness reached levels which would require balance sheet restructuring, as this would brake private consumption and economic growth. However, owing to the strong increase in asset values, the household debt-to-asset ratio only rose by about ½ percentage point from 2001, to around 15 per cent in 2002, implying little change in the leverage of households; this compares with a ratio of about 14 per cent in 1990. Moreover, the household debt interest burden has even declined somewhat since late 2000, bringing the share of household debt interest payments in disposable incomes to a level of about 5½ per cent in mid-2002 (Figure 3, Panel B), which is the average of the "low inflation regime" in place since 1992. This was partly as a result of monetary relaxation, some of which has been reversed – as discussed in

Table 2. **Household assets**[1]
June 2002

	Level	Share of total	Growth per cent	
	A$ billion	Per cent	Year to June 2002	Average June 1996-June 2001
Housing	1 939	59.9	19.2	10.6
Consumer durables	186	5.7	14.0	5.0
Financial assets	1 113	34.4	1.6	11.9
Superannuation and life offices	524	16.2	–0.7	13.2
Equities and unit trusts	250	7.7	–3.9	21.6
Currency and deposits	299	9.2	13.3	5.7
Other	39	1.2	–7.9	0.2
Total	3 237	100.0	12.2	10.7

1. Includes unincorporated sector but excludes unfunded superannuation and prepayment of insurance.
Source: Reserve Bank of Australia.

Figure 3. **Household debt and debt-service burden**
Per cent of household disposable income

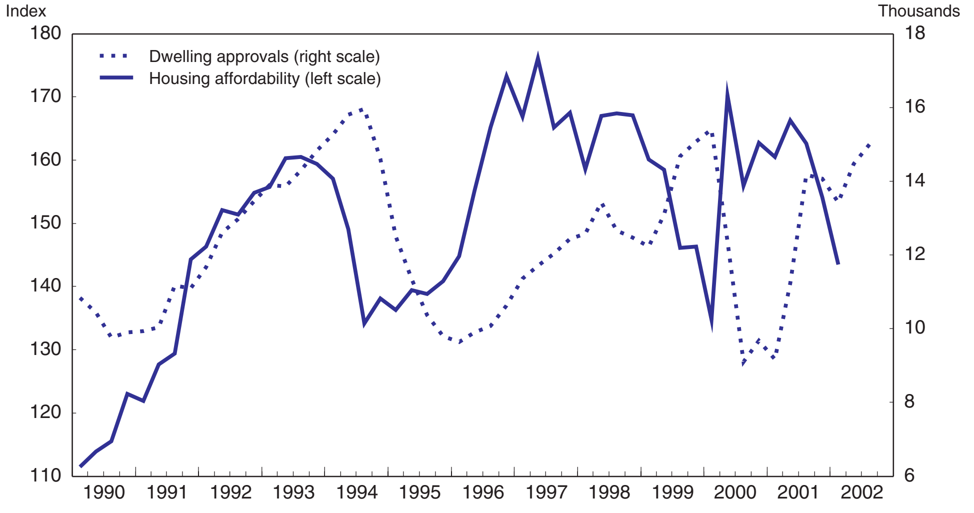


Source: Reserve Bank of Australia; OECD.

Chapter II – but which does not yet show in available household debt data. But even if lending interest rates rise further, households could keep their monthly debt interest payments constant by reducing their excess principal repayments, an option taken up (in the other direction) by many borrowers when interest rates declined in 2001.

Although *housing investment* accounts only for about 5 per cent of GDP, its vigorous recovery from the slump[2] in the second half of 2000 contributed markedly to the strength of domestic demand in 2002. In addition to the factors which have stimulated private consumption, such as robust disposable incomes and low credit interest rates, a generous subsidy to first-time home buyers[3] assisted the very sharp recovery of dwelling investment as from the June quarter of 2001. All this has helped to make residential investment more "affordable" in recent years, although the affordability index[4] has declined since September 2001 (Figure 4), mainly on account of sharply rising house prices. This may indicate that activity in the detached housing market, which is predominantly owner-occupied, is close to its peak and will weaken in the near future. A slowdown in the demand for owner-occupied dwellings would be accentuated if interest rates were to move up further.

Figure 4. **Housing affordability and dwelling approvals**

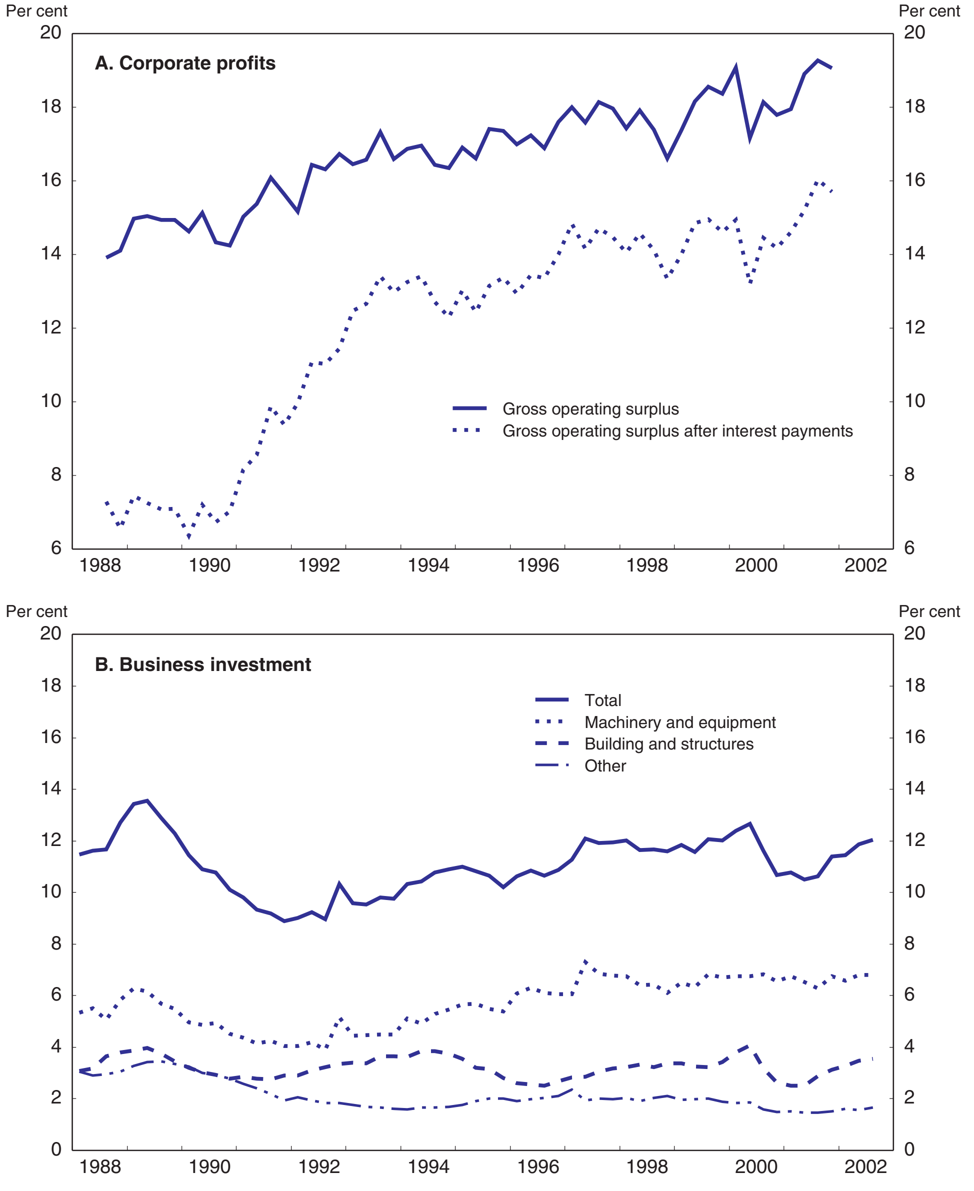


Source: Australian Bureau of Statistics.

An important factor which has increased the attractiveness of dwelling investment is the relatively poor performance of the equity market. Indeed, over the past twelve months to November 2002, housing loan approvals *to investors* have risen by more than 38 per cent (and construction approvals for multi-unit housing were up by 19 per cent) while loan approvals *for owner occupation* have fallen by around 5.4 per cent. This has occurred against the background of increases in house prices[5] over the past four fiscal years[6] of 72 per cent in capital cities (hence 14.5 per cent per year) and to 57 per cent for total Australia (some 12 per cent *per annum*). In the twelve months to September 2002, house prices have risen by 24.2 per cent nationally and by 24.6 per cent in capital cities. Average house price increases are thus well in excess of annual average earnings growth of 4½ per cent over the past four years.

There is a risk that large increases in property prices may have led some investors to assume that these will continue in the future, which could imply the build-up of a price "bubble", which eventually would burst. However, data on rising residential property vacancy rates indicate that there is excess supply building up in the investor property market, which should dampen speculative investment and future price increases. Indeed, there are first signs that in some segments of the housing market, such as apartments, the pace of price increases is slowing.

Figure 5. **Corporate profits and business investment**
As a percentage of GDP

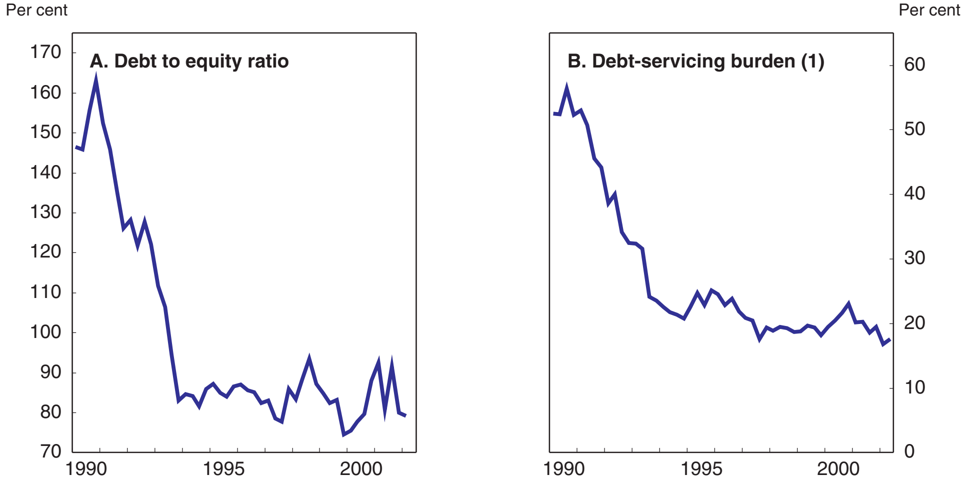


Source: Australian Bureau of Statistics.

Another factor that works against a continuation of soaring house prices is the ongoing fall in rental yields (the ratio of average rent to the average price of a dwelling) as rent increases have not kept up with price gains. Nevertheless, the strong increase in house prices in recent years may also reflect the longer-term adjustment from a macroeconomic setting of high and volatile inflation to a regime of low and stable inflation, which has brought about low and stable interest rates and increased the capacity of households to borrow.[7]

Business investment had been weak throughout 2000 and in the first half of 2001, in part as a result of series of one-off contractionary factors. Among them were the completion of several large engineering projects in the mining sector, the fading of Olympics-related private infrastructure investment, the rebound effect from the preparation of IT equipment for the "Y2K problem", as well as a number of major corporate collapses in 2001. Another major negative influence was the earlier decline in company profitability, which had contributed to depressed business confidence.[8] However, business investment picked up in the second half of 2001 and has remained strong, underpinned by historically low interest rates, a competitive exchange rate, high capacity utilisation, a recovery in domestic demand and company profitability (Figure 5), and both company debt levels and the corporate debt-interest burden very low by historical standards (Figure 6). It was reflected in a turnaround in business borrowing from financial intermediaries

Figure 6. **Corporate gearing**



1. Interest payments as a per cent of corporate gross operating surplus.
Source: Reserve Bank of Australia.

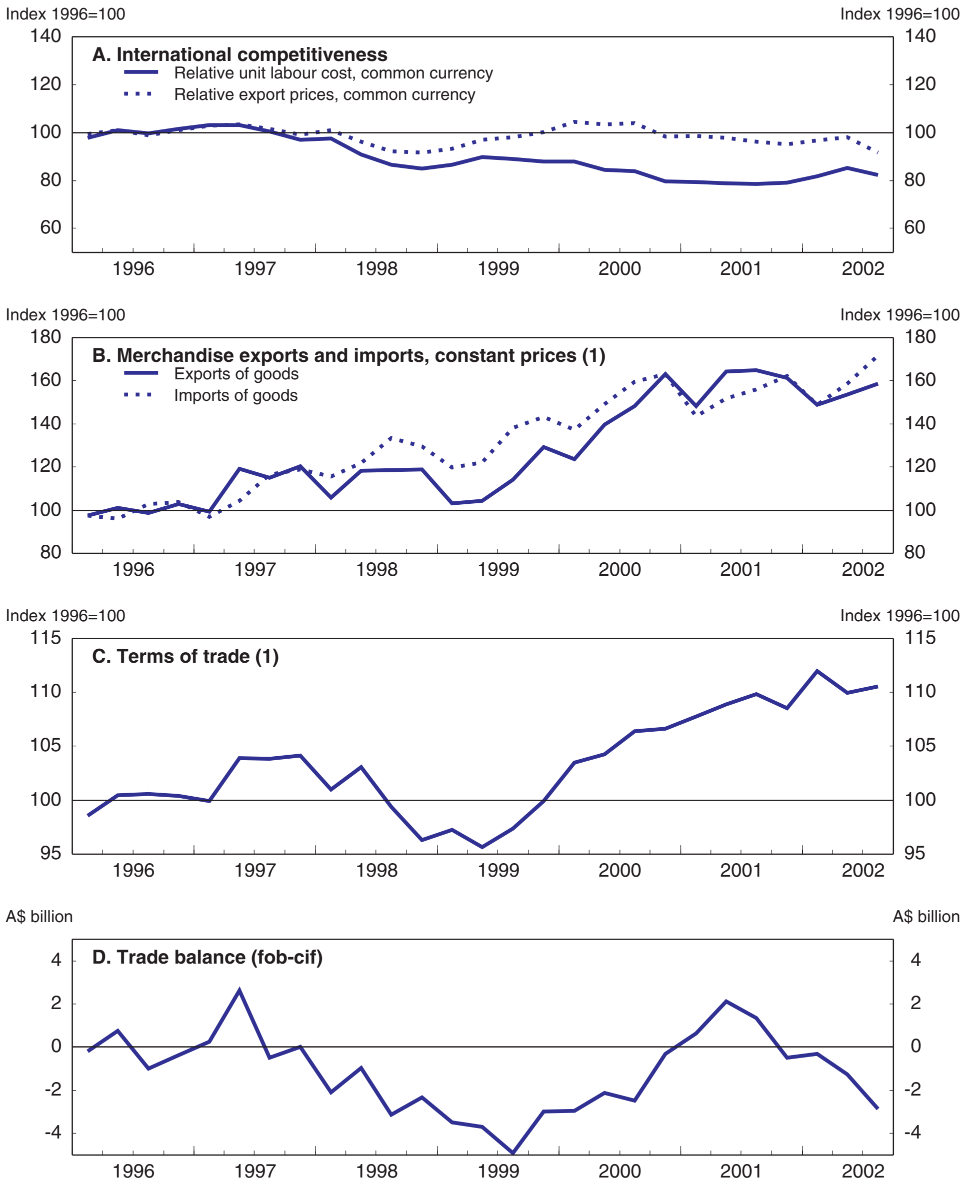
(see Chapter II). Nevertheless, the share of business investment in GDP is well below historical highs, which bodes well for the investment outlook.

Foreign trade and the current external account

Australia's export markets are estimated to have picked up again in 2002, albeit only mildly, following their contraction in 2001.With the weak global environment, a severe drought and a decrease in tourism, real exports of goods and services are likely to have only stagnated in 2002, following a decline in the second half of 2001. Exports were supported by a still competitive exchange rate in terms of relative unit labour costs (Figure 7), resulting from the Australian dollar's trend depreciation since the late 1990s combined with moderate wage increases and strong labour productivity growth. In response to surging domestic demand, real imports of goods and services grew by around 9 per cent in the first three quarters of 2002. This implied a marked swing from positive to negative in the contribution of the real foreign balance to GDP.

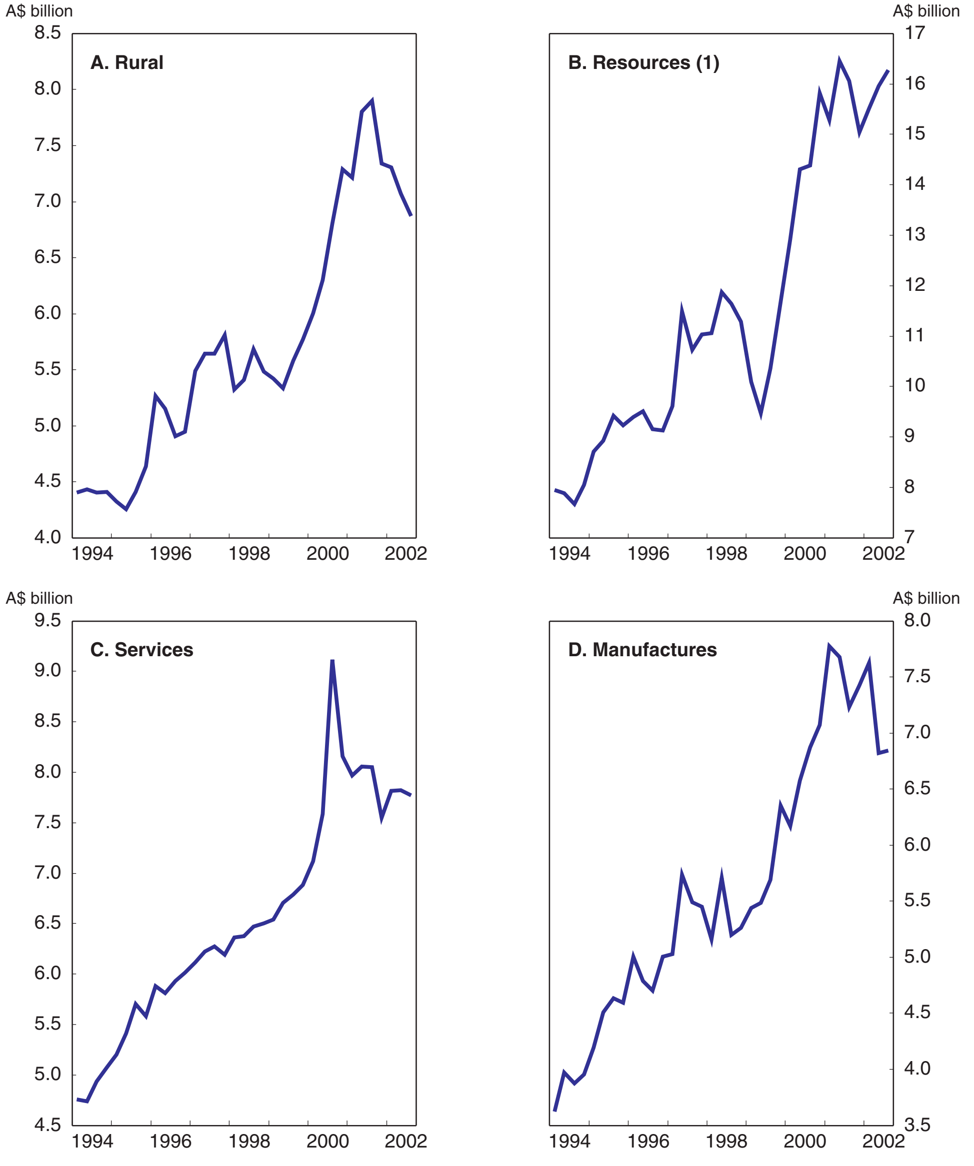
The subdued demand in major export markets has induced a decline in export prices in the second half of 2001 and into 2002. This led to a decrease in export revenues, which was particularly pronounced for exports of farm products and of services, while export values of manufactures held up well (Figure 8). But with import prices falling even more steeply, the terms of trade continued to improve, to reach in the course of 2002 their highest level since the early 1990s. Much of the terms-of-trade gain owes to the striking difference between the rising prices received for a number of commodity exports on the one hand and the declining prices paid for imported electronic equipment on the other. Nevertheless, the trade balance moved from surplus in 2001 into deficit in 2002 (Table 3). With lower global interest rates broadly offsetting the effect of the higher level of net foreign liabilities, the net investment income deficit-to-GDP ratio remained at just under 3 per cent, while the deficit in the current external account widened from a low of around 2 per cent of GDP in mid-2001 to over 4 per cent of GDP in the course of 2002. However, this compares with a current external deficit of over 6 per cent of GDP in 1999, when the growth differential between Australia and the total OECD area was much smaller than in 2002. While Australia's current account deficit has been a cause for concern in the past, projected developments do not provide grounds for alarm. With structural reform having stripped out most distortions from the economy, private sector saving and investment decisions are likely to be efficient, with capital flows reflecting informed decisions about relative investment opportunities. That said, market expectations are at times subject to large swings so that large ongoing deficits can become a source of vulnerability. The authorities should therefore continue to ensure the Government does not add to aggregate external financing requirements. Net foreign liabilities remain around their long-term trend of 50-55 per cent of GDP.

Figure 7. **Foreign trade indicators**



1. Seasonally adjusted balance of payments basis.
Source: Australian Bureau of Statistics and OECD.

Figure 8. **Value of exports**
Seasonally adjusted, A$ billion



1. Includes non rural-commodity exports (including sugar) plus non-monetary gold.
Source: Australian Bureau of Statistics.

Table 3. **Current account of the balance of payment**[1]

A$ billion

	1998	1999	2000	2001	2001		2002		2002		
					I	II	I	II	Q1	Q2	Q3
Trade balance	–10.0	–16.6	–7.1	3.0	2.0	1.1	–2.5	..	–0.4	–2.1	–2.6
Exports	114.8	113.6	142.5	154.9	78.2	76.6	75.9	..	38.3	37.7	37.8
Imports	–124.8	–130.2	–149.6	–151.8	–76.3	–75.5	–78.5	..	–38.7	–39.8	–40.4
Income balance	–18.0	–18.0	–18.5	–19.8	–9.9	–9.9	–10.3	..	–5.1	–5.2	–5.8
Compensation of employees, net	–0.1	–0.1	–0.1	–0.2	–0.1	0.0	–0.1	..	0.0	0.0	0.0
Investment income, net	–18.0	–17.9	–18.4	–19.7	–9.8	–9.9	–10.2	..	–5.1	–5.2	–5.8
Current transfers, net	–0.5	0.0	–0.1	0.0	0.1	0.0	0.0	..	0.0	0.0	0.0
Current balance	–28.6	–34.5	–25.8	–16.7	–7.7	–9.0	–12.8	..	–5.5	–7.3	–7.9
As a percentage of GDP											
Trade balance	–1.3	–2.7	–1.1	0.4	0.6	0.3	–0.7	..	–0.2	–1.2	–1.4
Investment income, net	–3.1	–3.0	–2.9	–2.9	–2.9	–2.9	–2.8	..	–2.8	–2.8	–2.8
Current balance	–4.9	–5.7	–4.0	–2.4	–2.3	–2.6	–3.5	..	–3.1	–4.0	–4.3

1. Seasonally-adjusted.

Source: Australian Bureau of Statistics.

The labour market

Employment recovered in 2002 from its weak performance in 2001 (Table 4), to increase by 3 per cent through 2002. As in previous years, part-time employment was more dynamic than full-time employment, which even declined towards the middle of 2002 before picking up again. Stronger growth of part-time employment continues to be favoured by the ongoing shift in the composition of production away from manufacturing, where full-time employment dominates, to services, where the proportion of part-time jobs is much higher. In general, sectoral employment has moved in line with value added. For example, strong employment in the retail and wholesale trade sectors was supported by the persisting strength in private consumption, while the decline in agricultural employment in the September quarter of 2002 already seems to have reflected the impact of the drought on farm activity. The recent decline in employment in the construction sector came as a surprise against the background of the unabated strength in housing investment, and may herald some cooling off of the housing construction boom. Forward-looking indicators of aggregate labour demand are for a continuation of favourable employment trends: for example, the ABS quarterly vacancy indicators continued to rise in September 2002, and the ANZ job advertisement series, while 2.6 per cent lower in November 2002, is 14.7 per cent higher than twelve months ago.[9]

Despite a solid increase in the labour force participation rate, the unemployment rate fell by around ¾ of a percentage point to 6.2 per cent in 2002, reflecting strong employment growth.[10] It thus fell below the OECD average after exceeding it substantially at the beginning of the present economic upswing (Figure 9). Unemployment is, however, still above current estimates of the non-accelerating inflation rate of unemployment (NAIRU) of around 5½ per cent, which have been revised downwards as the result of reforms in industrial relations and labour market assistance[11] since the second half of the 1990s. The proportion of long-term unemployed[12] in the total number of unemployed remained broadly unchanged, fluctuating around 22 per cent in 2002, somewhat below the long-term average of 26½ per cent. Another weak spot in the labour market remains the high unemployment among the 15 to 19 year olds looking for full-time work ("teenage unemployment"), which drifted down but stayed clearly above 20 per cent in 2002.[13]

Price and wage inflation

Following the increase in headline consumer price inflation to about 6 per cent in the four quarters to mid-2001 as a consequence of the introduction of the goods and services tax (GST), inflation fell back thereafter to its pre-GST rates.[14] Measures of underlying inflation, such as the trimmed mean and the weighted mean[15] of the CPI peaked a little above 3 per cent in late 2001. But both indicators

Table 4. **The labour market**

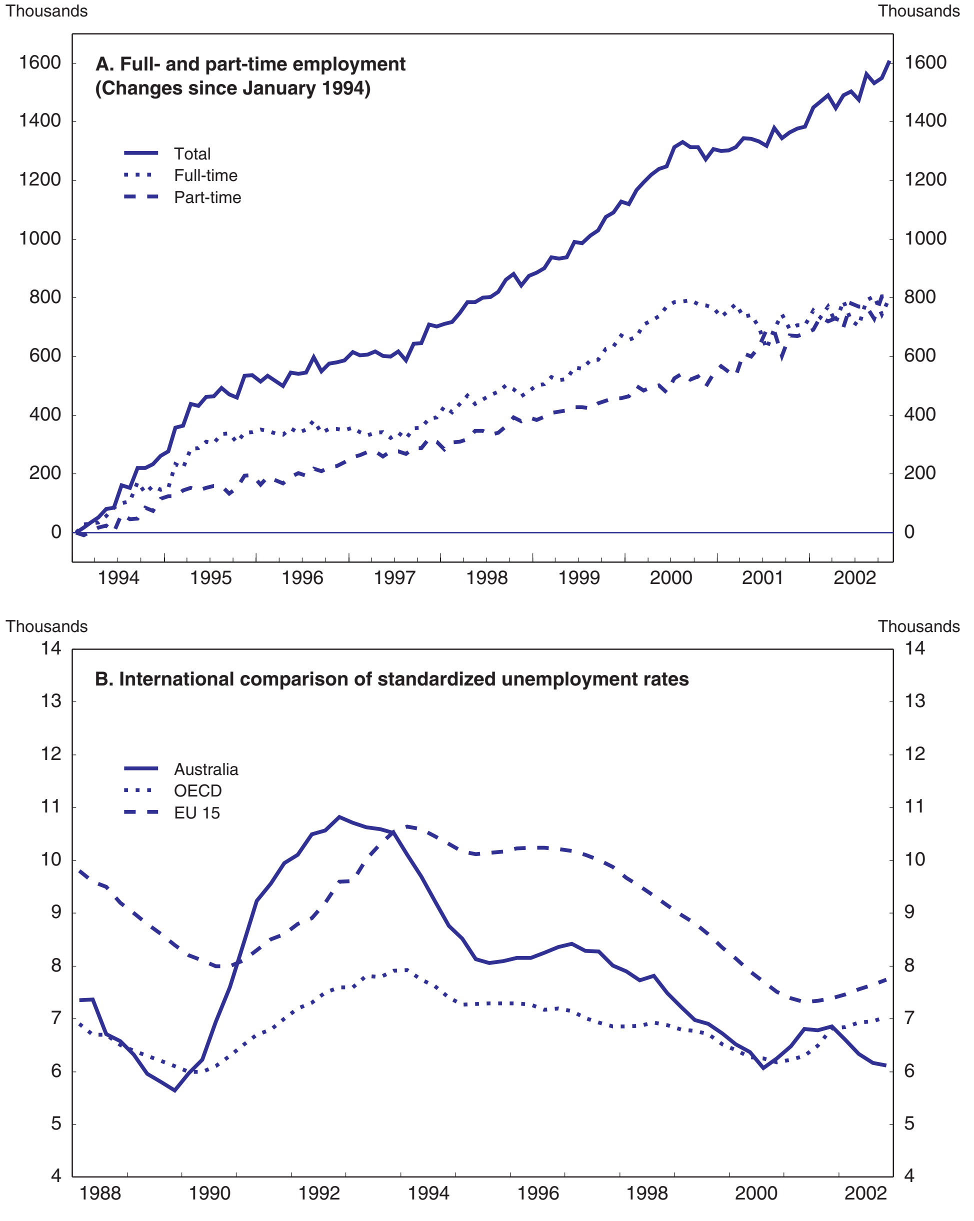
Seasonally-adjusted

	1998	1999	2000	2001	2000	2001		2002	2002		
					II	I	II	I	Q1	Q2	Q3
Employed persons[1]	2.1	2.2	3.0	1.0	2.5	0.3	0.9	2.5	4.1	0.5	1.9
Full-time	1.8	1.7	2.7	–0.4	2.1	–1.2	–1.4	1.6	3.1	–0.6	1.5
Part-time	2.9	3.7	3.6	4.9	3.4	4.6	7.0	4.7	6.7	3.4	3.0
Labour force[1]	1.5	1.4	2.2	1.5	1.8	1.4	1.3	1.7	3.0	–0.6	1.2
Males	1.2	1.2	1.6	1.0	1.6	0.4	1.5	1.7	2.4	0.4	–0.7
Females	1.8	1.6	3.1	2.0	2.1	2.5	0.9	1.7	3.8	–1.9	3.7
Unemployment rate[2]	7.7	7.0	6.3	6.7	6.2	6.6	6.8	6.5	6.6	6.4	6.2
Males	8.0	7.1	6.5	7.0	6.4	6.9	7.0	6.7	6.9	6.6	6.3
Females	7.4	6.7	6.1	6.4	5.8	6.3	6.6	6.2	6.3	6.0	6.1
Job vacancies[1]	16.5	2.3	14.7	–19.8	–3.7	–28.8	–15.7	12.6	14.3	28.4	14.7
Participation rate[2]	63.2	63.1	63.6	63.7	63.7	63.7	63.7	63.8	63.9	63.6	63.5
Males	72.9	72.6	72.6	72.3	72.6	72.3	72.3	72.4	72.5	72.3	71.9
Females	53.9	53.9	54.9	55.3	55.0	55.3	55.2	55.3	55.6	55.1	55.3
Average weekly hours worked[3]											
total	34.6	34.5	34.6	33.6	35.2	32.9	34.4	33.3	33.4	33.2	34.2
Full-time	41.3	41.2	41.3	40.4	42.0	39.3	41.5	40.2	40.1	40.2	41.5
Part-time	15.6	15.6	15.7	15.7	15.9	15.6	15.9	15.7	15.7	15.7	16.1

1. Percentage change from previous period at annual rates.
2. Per cent.
3. Not seasonally adjusted.

Source: Australian Bureau of Statistics.

Figure 9. **Employment and unemployment**



Source: Australian Bureau of Statistics and OECD.

also moved back inside of the Reserve Bank's 2 to 3 per cent inflation target range, and have been near its mid-point since mid-2002 (Figure 10). However, an alternative measure of "core" inflation, the CPI excluding volatile items (fruit, vegetables and automotive fuels) stayed outside of the 2 to 3 per cent range from late 2001 until the September quarter of 2002, returning within the band in the December quarter 2002.

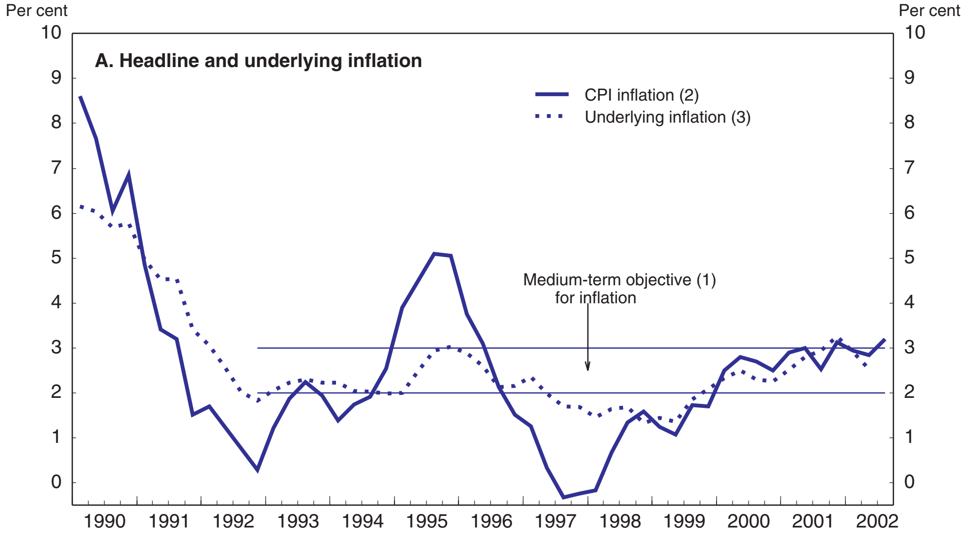
The generally high degree of price stability is remarkable in view both of the strength of economic activity since early 2001 and the persisting low Australian dollar. However, these potential inflation pressures were offset by, *inter alia*, downward pressures from the weak global economy on world prices of manufactures, intensified competition in domestic product markets and, in particular, moderate wage increases – best reflected by the wage cost index[16] – which kept labour costs under control (Table 5). In combination with strong gains in labour productivity, wage moderation has held the growth of unit labour costs in the non-farm sector at 0.9 per cent in fiscal year 2001-02. However, wage costs accelerated during the first half of 2002, consistent with the pick-up in employment, and with business surveys which reported companies finding it less easy to attract suitable labour. Wages were boosted in addition by the decision of the Australian Industrial Relations Commission in May 2002 to raise minimum wages by 4.4 per cent as a result of its "Safety Net Review". On the other hand, data from the Department of Employment and Workplace Relations on enterprise bargaining agreements continue to show an easing in the pace of wage growth. And the latest *Mercer Quarterly Salary Review* shows increases in executives' base salaries at the lower end of the 4½ to 5 per cent range recorded over most of the past four years. Together with a continuation of strong labour productivity growth, this helped to keep the growth in non-farm unit labour costs of 1.5 per cent in the first three quarters of 2002.

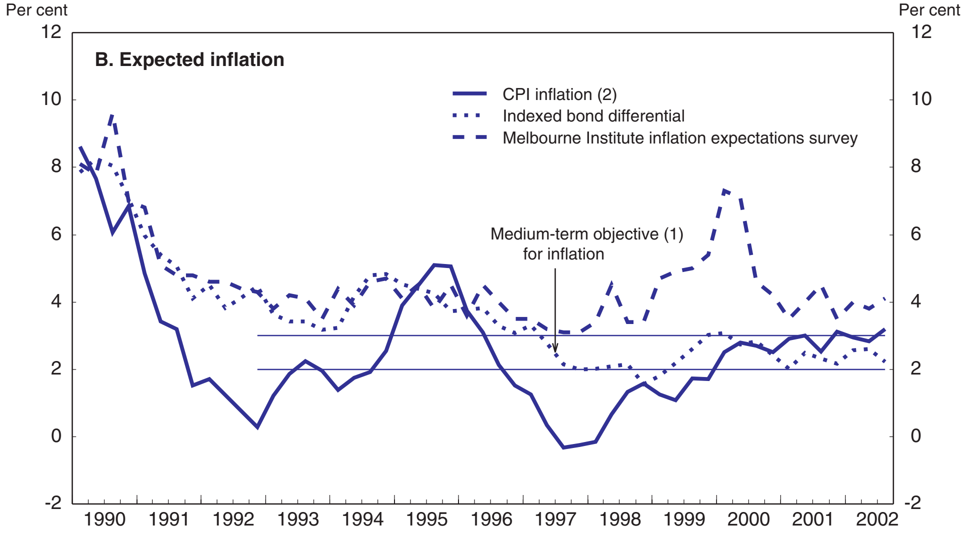
The prevailing low inflation pressures also became visible in measures of inflation expectations. Recent business surveys[17] are generally for modest expected inflation in both retail and final product prices in the near term. The Melbourne Institute's survey of consumers' median inflation expectations is for broadly unchanged inflation for the year ahead[18] (Figure 10, lower Panel). Longer-term inflation expectations of investors in capital markets – as measured by the difference between nominal and indexed ten-year government bond yields – continued to move in the lower part of the RBA's inflation target range. Moreover, financial market economists surveyed by the Reserve Bank also expect CPI inflation to remain at about 2½ per cent up to mid-2003.[19] All this augurs well for the inflation outlook.

The outlook to 2004

Both consumer sentiment and business confidence surveys are for a continuation of the favourable climate for private spending in the near term

Figure 10. **Actual and expected inflation**





1. The inflation target was expressed in terms of the "Treasury underlying inflation rate" up to late 1998. Following the move from an outlays to an acquisitions approach to measuring consumer prices, the inflation target is now expressed in terms of the new "headline" CPI.
2. Adjusted for changes in taxation.
3. Underlying inflation is defined as the trimmed mean of the CPI, adjusted for tax changes.

Source: OECD; Reserve Bank of Australia; University of Melbourne, Institute of Applied Economic and Social Research.

Table 5. **Costs and prices**

Percentage change from corresponding period of previous year

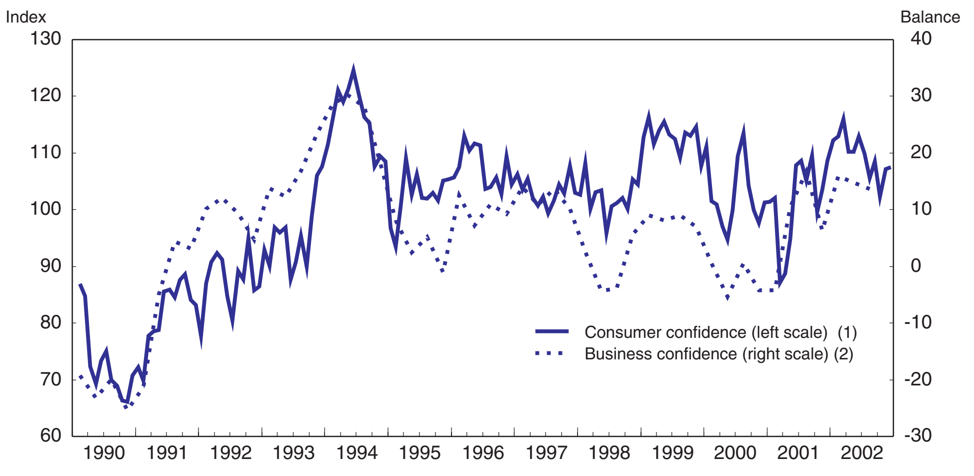
	1998	1999	2000	2001	2001 Q3	2001 Q4	2002 Q1	2002 Q2	2002 Q3
National accounts deflators									
Private consumption	1.3	1.0	3.2	3.7	2.5	2.4	2.2	1.6	2.4
Total domestic demand	1.4	0.7	3.0	3.2	2.4	2.3	1.7	1.3	2.0
GDP	0.5	0.7	4.1	3.5	2.7	2.5	2.5	1.9	2.5
Exports of goods and services	2.4	–5.2	12.9	7.4	7.0	0.1	0.9	–4.7	–2.7
Imports of goods and services	6.9	–4.4	7.1	5.8	5.8	–1.2	–2.5	–6.9	–4.6
Consumer price index	0.8	1.5	4.5	4.4	2.5	3.1	2.9	2.8	3.2
Underlying inflation[1]	1.5	1.7	2.3	2.9	2.9	3.3	2.9	2.5	2.5
Wage cost index (excluding bonuses)									
Total	. .	3.1	3.0	3.6	3.6	3.4	3.1	3.1	3.3
Private sector	. .	2.8	3.1	3.6	3.6	3.4	3.1	3.1	3.4
Public sector	. .	3.7	2.8	3.7	3.7	3.5	3.4	3.2	3.3
Average weekly earnings									
All employees	2.8	1.6	4.7	4.7	4.0	4.9	4.2	3.7	3.6
Full-time work	4.2	2.9	4.9	5.2	5.1	5.7	6.2	5.2	4.9
Private: full time	4.0	2.7	5.1	5.4	5.3	6.1	6.9	5.4	5.1
Public: full time	5.0	4.2	4.4	5.1	4.8	5.1	4.2	4.4	4.9
Nominal non-farm unit labour costs	–0.0	1.0	3.3	2.5	2.2	–0.2	1.1	1.3	2.0

1. Underlying inflation is defined as the trimmed mean of CPI, adjusted for tax changes.
Source: Australian Bureau of Statistics and Reserve Bank of Australia.

(Figure 11). Monetary conditions continue to be accommodating (see Chapter II), which should support activity throughout 2003 and into 2004, based on estimates of the mean lag between monetary policy changes and the response of economic activity.[20] A return to a more neutral monetary policy stance is expected to take place once the international economic outlook improves. However, in line with the government's objective of budget balance over the economic cycle, fiscal policy is assumed to be mildly contractionary over the projection period, following the loosening of the fiscal stance in 2001.

Consumer confidence and private consumption should be further supported by the improving labour market, rising real-estate wealth and comparatively low debt-servicing costs for households. Dwelling construction is expected to start falling in 2003 (Table 6), given reduced subsidies to first-time home buyers, rising housing construction prices, higher vacancy rates and falling rental yields. But its adverse impact on activity should be more than offset by a continuation of robust growth of business investment, which is consistent with the latest results of the ABS Capital Expenditure Survey. Strong business investment activity will be underpinned by low financing costs, healthy company profitability, low corporate debt and a very low debt-servicing burden. Investment will also be boosted by the implementation of a large number of major engineering construction projects planned in the transport and utilities industries. In the near term,

Figure 11. **Confidence indicators**



1. Defined as Westpac-Melbourne Institute consumer sentiment index.
2. NAB business confidence index, net balance not seasonally adjusted.
Source: Reserve Bank of Australia.

Table 6. **Short-term prospects**

Percentage changes

	Percentage share of GDP in 1999 at current prices	2000	2001	2002	2003	2004
A. Demand and output at constant 2000-01 prices						
Private consumption	60.1	3.2	3.0	4.3	3.5	3.2
Public consumption	18.0	4.9	1.5	3.2	2.5	4.0
Gross fixed capital formation	23.8	–0.1	–1.0	12.9	6.3	5.5
of which:						
Government	2.4	6.9	0.3	2.8	9.4	2.0
Private[1]	21.4	–0.3	–2.5	14.1	6.0	5.9
Dwellings[2]	5.3	3.9	–10.9	22.0	–3.8	–3.0
Other building and structures	4.2	–21.3	–7.8	22.0	13.0	6.0
Machinery and equipment and intangible fixed assets	8.7	7.0	2.7	10.2	11.4	11.0
Public enterprises	1.6	–13.2	15.1	12.0	7.3	7.8
Final domestic demand	101.9	2.7	1.8	6.0	4.0	3.9
Increase in stocks[3]	1.0	–0.8	–0.3	0.1	0.1	0.0
Total domestic demand	102.9	1.9	1.6	6.0	4.1	4.0
Exports of goods and services	18.7	11.1	1.2	0.0	4.5	7.6
Imports of goods and services	21.4	7.4	–4.1	9.7	7.8	8.1
Change in foreign balance[3]	–2.7	0.6	1.3	–2.1	–0.8	–0.3
Statistical discrepancy	–0.2	0.3	–0.1	0.2	0.0	0.0
GDP	100.0	2.8	2.7	3.7	3.3	3.8
B. Other items						
Private consumption deflator	. .	3.2	3.7	2.5	2.5	2.6
Employment (LFS definition)	. .	3.0	1.0	1.7	1.7	1.8
Unemployment rate (per cent)	. .	6.3	6.7	6.3	6.1	5.8
General government financial balance (per cent of GDP)	. .	0.3	0.0	0.1	0.3	0.4
Current balance (per cent of GDP)	. .	–3.9	–2.5	–4.1	–4.0	–3.8

1. Including public trading enterprises.
2. Including real estate transfer expenses.
3. Contribution to changes in real GDP (as a percentage of real GDP in the previous period).

Source: Provisional update to the projections of the OECD *Economic Outlook* No. 72, as of 21 February 2003.

however, investment in the agricultural sector is likely to weaken as an effect of the current drought, which will curtail farm output and incomes in the first half of 2003. Looking further ahead, a number of large-scale engineering projects are in prospect to meet commitments ensuing from a recently concluded long-term contract on the supply of large amounts of liquid natural gas to China.

With export markets expected to recover and the Australian price and cost competitiveness high, exports of goods and services are projected to pick up in 2003 and 2004. Rural exports in 2003 will be depressed from the drought-induced reduction in agricultural production, but are expected to surge in 2004, as grain production typically bounces back when the drought breaks. Helped by further terms-of-trade gains, this may keep the current account deficit at around 3¾ to 4 per cent of GDP in 2003-04. GDP may grow at a rate of around 3¼ per cent in 2003 and 3¾ per cent in 2004, hence insufficient to close the output gap. Because of this gap, and underpinned by wage moderation and strong labour productivity growth, CPI inflation is likely to stay inside the Reserve Bank's 2 to 3 per cent inflation target band. The continuation of robust economic growth is expected to be accompanied by solid employment gains. However, growth of the labour force is also projected to accelerate somewhat, so that the reduction in the average annual unemployment rate may be small. This would keep unemployment at around 6 per cent of the labour force in 2004.

The risks attached to the economic outlook are weighted to the downside. The key downside risk to the outlook for the Australian economy remains the uncertainty surrounding the outlook for world growth, in particular, since the outlook for the domestic economy is expected to be underpinned by ongoing strong growth in business investment. There are also a number of domestic risks to the outlook which, by themselves, are unlikely to derail the positive outlook, but which could see the economy falter should they coincide with a further global deterioration. One of the key domestic uncertainties is the length and severity of the drought.In addition, the high level of debt has made households more vulnerable to increases in interest rates. Hence, the tightening of monetary policy incorporated in the projection could lead to a somewhat sharper restructuring of household finances if house prices declined in response to excess supply in the property market or if the recent price rises indeed turned out to be a speculative bubble. But the jury is still out as to whether the house price boom is a bubble that will burst, or whether it represents an adaptation to an era of high income growth and low interest rates. If the latter were the case, the projected weakening of residential investment could turn out to have been too pessimistic. Although the global recovery is generally seen to be slow and uncertain, economic growth in major trading-partner countries[21] is projected to be robust and could gain additional momentum, thus generating somewhat stronger demand for Australian exports. There is also an upside risk of stronger than projected consumption, fuelled by equity withdrawals from housing assets.

II. Macroeconomic policies

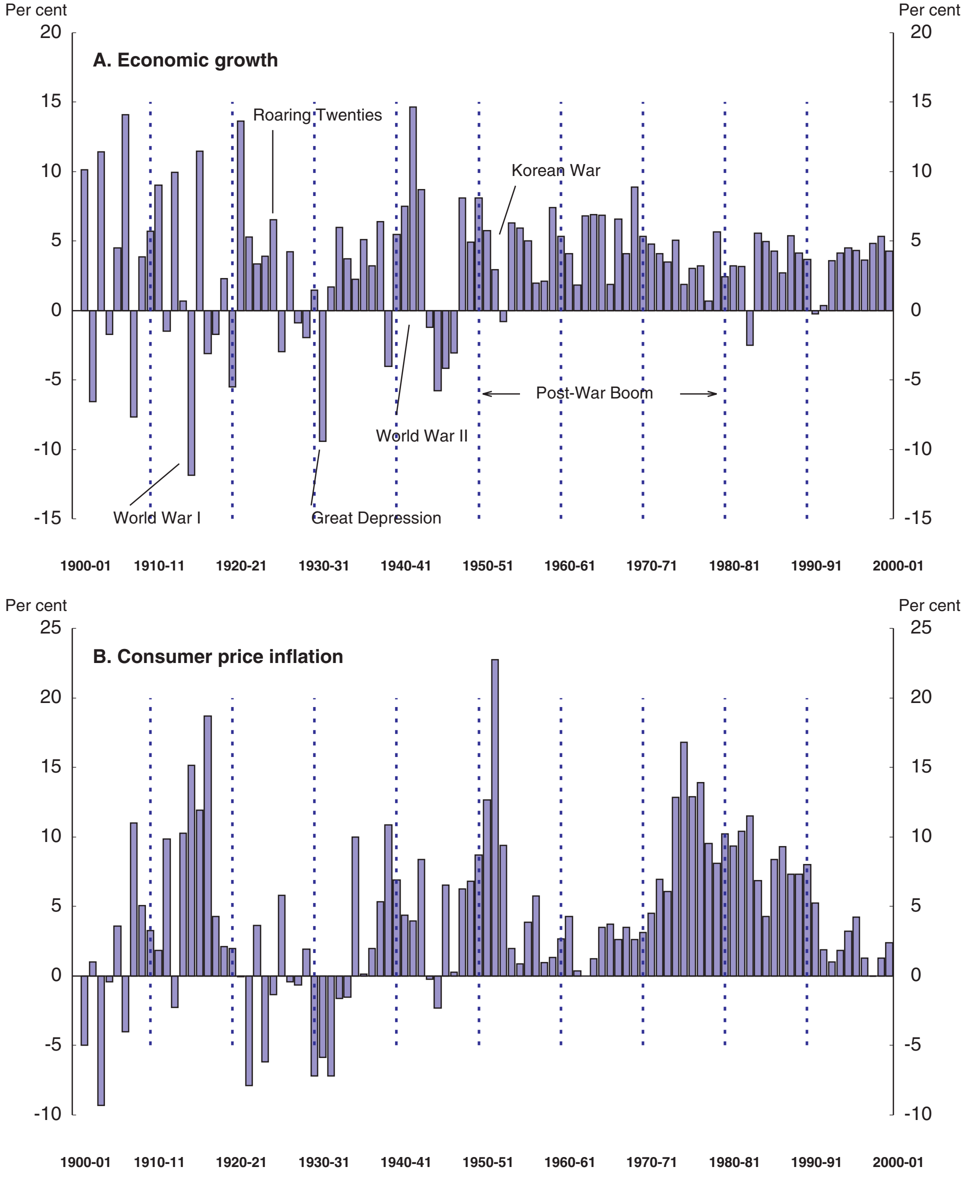
The effect of monetary and fiscal policies on long-term economic growth

Australia's monetary and fiscal policies are set in a medium-term framework. The objective of the Reserve Bank (RBA) is to maintain the inflation rate on average at around 2 to 3 per cent over the course of the business cycle while keeping monetary conditions conducive to sustainable growth in output and employment. At the Commonwealth level of government, fiscal policy aims at a balanced budget, also on average over the economic cycle. The medium-term orientation of economic policies has helped to achieve a degree of macroeconomic stability which is reflected in lower inflation and lower variability of inflation and output growth since the early 1990s (Figure 12). Together with the structural reforms discussed in the next chapter, this has provided a supportive framework for sustained growth.

The OECD Growth Project (2001f) found evidence for a significant impact of macroeconomic policy settings on output per capita across countries and over time. There is robust empirical support for the hypothesis that high inflation is negatively associated with the accumulation of physical capital in the private sector and through this channel, has a negative bearing on output. Also, the variability of inflation was found to be an important negative influence on output per capita. This supports the hypothesis that uncertainty about price developments affects growth *via* its impact on economic efficiency, for example by leading to a shift in the composition of investment towards less risky but also lower-return projects. All this assigns monetary stabilisation policy *inter alia* a growth-enhancing role over the long term.

The OECD Growth Project also found empirical evidence for the beneficial effects of sound fiscal policies on long-run economic performance. For example, the analysis lent some support to the notion that the overall size of government in an economy may reach levels which impair long-term growth. The comparatively small government share in Australia's GDP thus favours high trend growth, probably because it leaves more room for private initiative. The Growth Project's estimates also suggest that the lower overall tax burden in Australia than in most other OECD countries has a positive impact on output per capita in the long run.

Figure 12. **Economic growth and inflation in a long-term perspective**[1]



1. Variations are calculated on fiscal years.
Source: Australian Bureau of Statistics.

However, when controlling for the overall tax burden, a negative effect on growth has been found for tax structures with a heavy weight on direct taxes, which act as disincentive on saving and investment. *Ceteris paribus*, this would make the higher share of direct taxes in Australia relative to the OECD average an impediment to growth. However, the *New Tax System* reform package, which was implemented on 1 July 2000, provided for cuts in the personal income and company tax rates, and has shifted the tax mix somewhat towards indirect taxation. Nevertheless, marginal effective tax rates remain high for many low-income earners and the highest marginal income tax rates come into effect at relatively modest income levels, distorting the work/leisure trade-off and savings incentives.

Fiscal policy can also have an effect on growth *via* its impact on the level of real long-term interest rates. A pooled regression study by Orr, Edey and Kennedy (1995) for a number of countries including Australia suggested that a fiscal stimulus of 1 per cent of GDP may on average raise the real ten-year bond rate by 15 basis points. The study by Comley, Anthony and Ferguson (2002) arrives at a higher short-run effect of budget balances on the ten-year bond rate differential between Australia and the United States.[22] They also found that an increase in the public debt by 1 per cent of GDP is associated with a widening in the Australia-US long-term interest spread by 15 basis points in the long run. Hence, the fiscal consolidation policy pursued in Australia since 1996 should have contributed to the observed *trend* reduction in long-term interest rates *vis-à-vis* the United States and should have stimulated investment and growth during a transitory period. All told, therefore, the evidence suggests that the macroeconomic policies pursued rather consistently over 10 or more years will have contributed to Australia's improved economic performance.

Macroeconomic policies in the short run

The medium-term framework for setting monetary and fiscal policies allows flexibility in the short term when needed. Hence, from mid-2000 onward, the domestic economic slowdown and the weakening international economic environment suggested the adoption of expansionary macroeconomic policies. Accordingly, interest rates were cut and budgetary policies were relaxed throughout the course of 2001. However, as the domestic economic situation improved, the expansionary influence of macroeconomic policies was wound back, though not yet wholly removed given the less sanguine outlook for the international economy.

The first part of this chapter reviews monetary developments during the renewed acceleration of economic growth in 2001 and 2002 while the global economy remained weak. The second section discusses the current fiscal policy stance, the planned profile of future consolidation and the policy implications of eliminating net government debt. This is followed by a discussion of the emerging trends in age-related spending and their impact on public finances. The final section reviews the progress achieved so far in reforming the business tax system.

Monetary policy

Cash rate management

Operating on the basis of central bank independence and a floating exchange rate regime, the RBA pursues a 2 to 3 per cent medium-term inflation objective. This approach, which uses as main policy instrument the cash rate – the overnight money market interest rate – has delivered low inflation over the past decade .[23] As the economy weakened in late 2000 and into 2001, partly as a reflection of global weakness, and with price and wage inflation under control and measures of inflation expectations signalling a benign inflation outlook, there was ample scope for monetary easing. Accordingly, the RBA cut the cash rate in six steps between February and December 2001 by altogether 200 basis points to 4.25 per cent (Table 7). This was the lowest level since the beginning of Australia's

Table 7. **Changes in official interest rates**
1994-2002

	Change in cash rate	New cash rate target
	Percentage points	Per cent
A. Tightening		
17 August 1994	+0.75	5.50
24 October 1994	+1.00	6.50
14 December 1994	+1.00	7.50
B. Easing		
31 July 1996	–0.50	7.00
6 November 1996	–0.50	6.50
11 December 1996	–0.50	6.00
23 May 1997	–0.50	5.50
30 July 1997	–0.50	5.00
2 December 1998	–0.25	4.75
C. Tightening		
3 November 1999	+0.25	5.00
2 February 2000	+0.50	5.50
5 April 2000	+0.25	5.75
3 May 2000	+0.25	6.00
2 August 2000	+0.25	6.25
D. Easing		
7 February 2001	–0.50	5.75
7 March 2001	–0.25	5.50
4 April 2001	–0.50	5.00
5 September 2001	–0.25	4.75
3 October 2001	–0.25	4.50
5 December 2001	–0.25	4.25
E. Tightening		
8 May 2002	+0.25	4.50
5 June 2002	+0.25	4.75

Source: Reserve Bank of Australia, *Bulletin*.

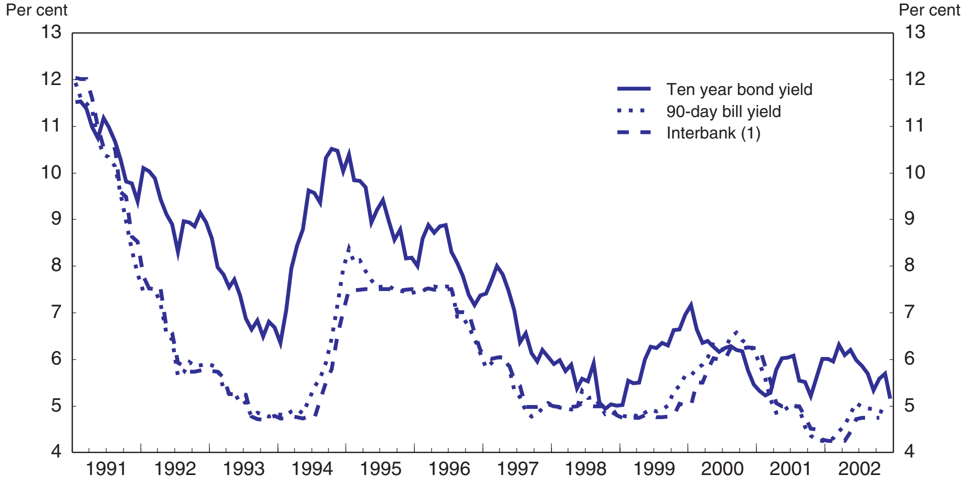
low inflation regime in 1992. The increased global uncertainty following the September 11 terrorist attacks strengthened the case for further monetary easing in the second half of 2001.

With the improvement in the outlook for the world economy in the first half of 2002 and with inflation around the top of the inflation target range, the historically low level of the cash rate was no longer appropriate.Hence, to avoid the emergence of inflation risks and of other imbalances that could jeopardise a continuation of the current expansion, the RBA decided to move to a less expansionary policy setting. It raised the cash rate in two steps in May and June 2002 by altogether 50 basis points to 4.75 per cent, which corresponds to the previous cyclical low points attained in mid-1993 and in late 1998. The actual cash rate also still seems to remain below a notional *neutral* cash rate, which may be put at 5½ per cent, with an error band of ½ percentage point around it.[24] In view of the weaker outlook for the global economy and the severe drought which has hit the farm sector, the Bank has subsequently abstained from further increases in the cash rate for the remainder of 2002.

Money and capital market interest rates

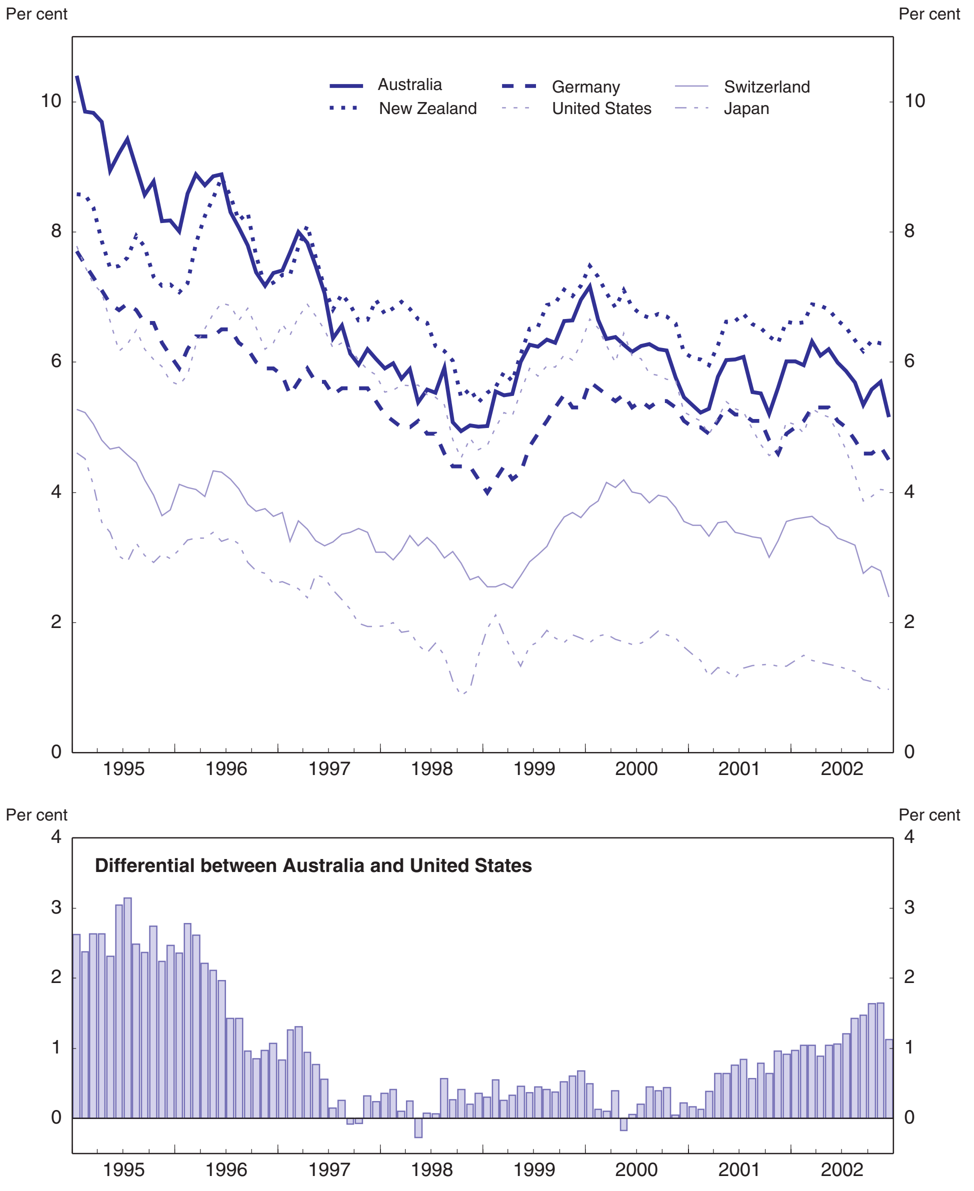
Three-month money market interest rates closely followed the six cuts in the cash rate in 2001 (Figure 13). With bond rates picking up in early 2001, the

Figure 13. **Money and capital market interest rates**



1. Cash market, 11 a.m. call rate.
Source: Australian Bureau of Statistics.

Figure 14. **International comparison of long-term interest rates**
Ten-year bond yield



Source: OECD.

interest differential between ten-year government bonds and three-month bank bills (the slope of the yield curve) turned from negative to positive, indicative of the changing monetary policy stance. Combined with the lower Australian dollar exchange rate, monetary conditions were thus clearly supportive of economic activity throughout 2001 and into 2002.

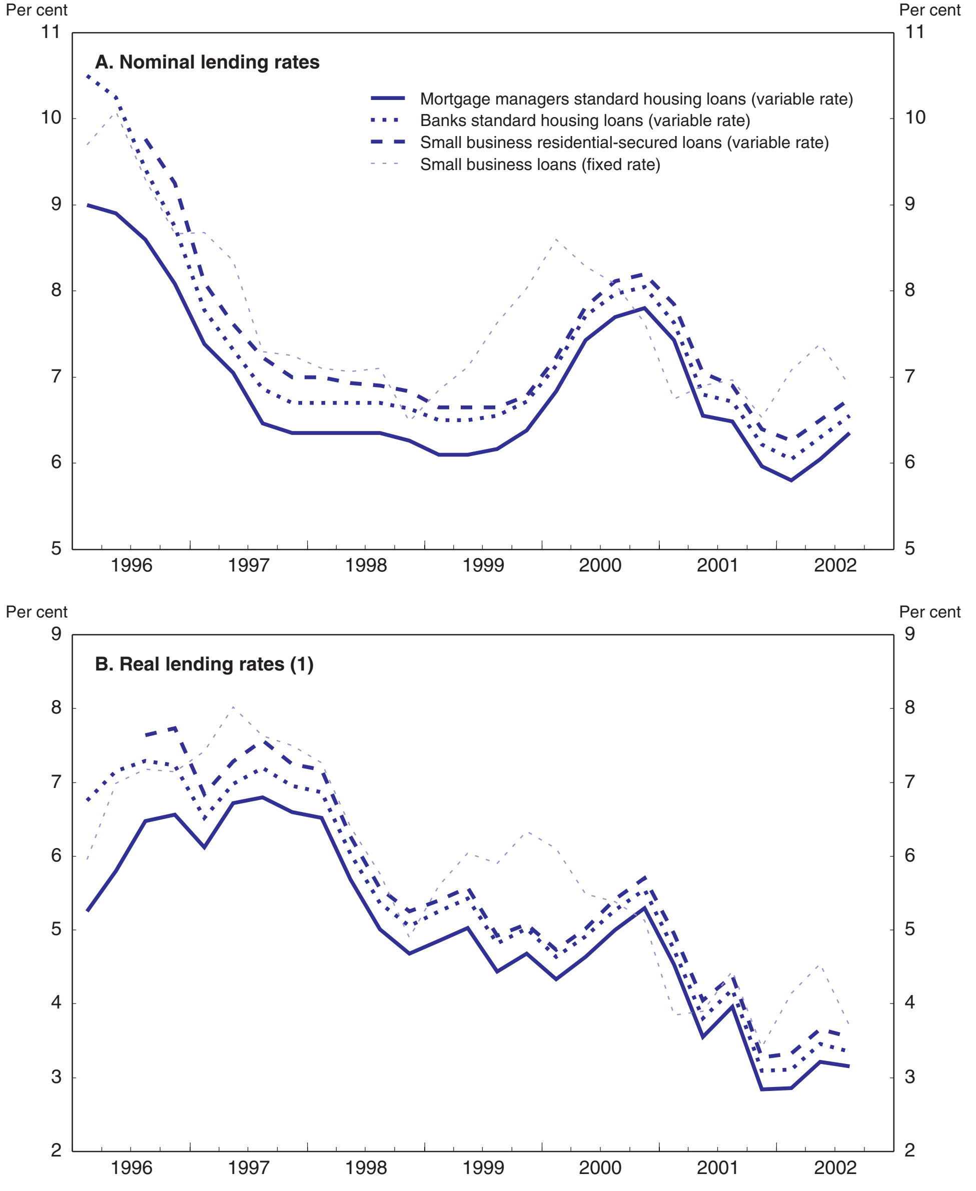
In response to the cash rate hikes of May and June 2002, the three-month money market interest rate rose to around 5 per cent in the second half of 2002. Conversely, long-term interest rates have declined since May 2002 (Figure 14), mirroring developments in global capital markets in the context of widely held perceptions of a worsening global economic outlook. By the end of 2002, ten-year government bond yields were close to their low level in the second half of 2001. The move to a less accommodating monetary policy stance is thus reflected in the rather flat, although still positively-sloped yield curve.

The fall in Australian bond rates was more muted than that in the United States, so that the spread between Australian and US ten-year bond yields widened, a process which had already begun in early 2001. In the second half of 2002, the average monthly spread amounted to about 1½ percentage points,[25] which is in striking contrast to the zero or even slightly negative yield differential recorded in the course of 2000. However, most of the recent rise in the spread can be attributed to the steeper fall in US bond rates, which seems to reflect financial market participants' concerns about the US growth prospects relative to those of Australia. It may also have been the result of increased risk aversion of US and international investors who shifted their portfolios from US equities into US bonds. Altogether, the widening yield spread seems largely to be a "US story" rather than being related to specific domestic factors in Australia.

Lending rates and financial intermediation

Interest rates on standard housing loans from banks, building societies and mortgage managers as well as on residential-secured loans for personal purposes and for small businesses all declined in line with money market interest rates throughout 2001 and into 2002 (Figure 15). Lending rates on some categories of banks' fixed-rate housing and business loans, which are usually funded in the capital market, edged up somewhat from late 2001 and during the first half of 2002, but declined thereafter, following movements in bond rates. If deflated by the GST-adjusted CPI, real lending interest rates in general were at a long-time low from late 2001 until early May 2002, further evidence of a supportive monetary policy stance. Borrowing has become somewhat more expensive both in nominal and in real terms since May 2002 as banks passed on in full the increase in the cash rate to their indicator lending rates. Nevertheless, lending rates remain at a low level by historical norms.

Figure 15. **Nominal and real lending rates**



1. Nominal rates less CPI inflation, adjusted for changes in taxation.
Source: Reserve Bank of Australia and Australian Bureau of Statistics.

Table 8. **Financial aggregates**
Per cent

	Twelve months to:		Three months to[1]:	
	March 2002	September 2002	June 2002	September 2002
Total credit	8.3	11.3	15.0	13.2
Personal	8.8	10.9	15.9	12.7
Housing	18.3	19.3	21.9	19.6
Business	–0.3	4.3	8.6	7.5
M3	13.8	11.4	3.3	12.1
Broad money	9.8	10.0	5.3	13.1
Memorandum item:				
GDP	7.0	..	3.8	..

1. Seasonally adjusted, at annual rate.
Source: Reserve Bank of Australia.

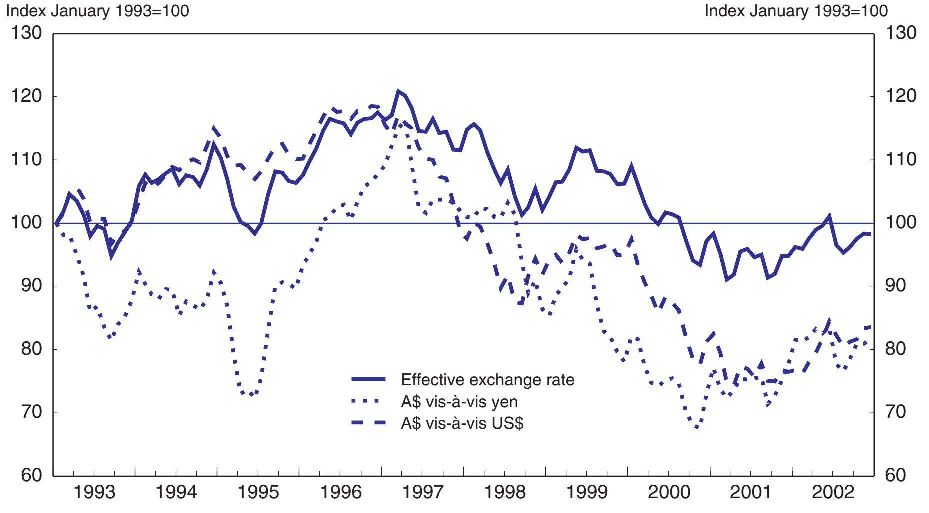
Combined with robust consumer and business confidence, the low nominal and real cost of credit have led to vigorous growth of financial intermediaries' lending to the private non-financial sector. The twelve-monthly rate of total credit growth accelerated to above 10 per cent during 2002, mainly on account of the rapid growth of housing loans (Table 8), in particular to investors. Annual growth in the broader monetary aggregates has been similar to that of credit,[26] with M3 and broad money[27] growing at two-digit rates during the twelve months to September 2002. Altogether, the rapid credit expansion well in excess of the growth rate of nominal GDP also points to an accommodative stance of monetary policy.

Exchange rate behaviour and monetary conditions

The downward trend of the Australian dollar exchange rate against both the US dollar and in (trade-weighted) effective terms which already had set in by mid-1999, continued in 2000 and 2001 (Figure 16). Hence in 2001, the average exchange rate depreciation of the Australian dollar amounted to 5¾ per cent (following 6½ per cent in 2000) in effective terms and to 11 per cent (10 per cent in 2000) against the US dollar. Together with an improvement in the terms of trade of a cumulative 7 per cent over the 2000 to 2001 period, this has added to the degree of monetary ease from the lowering of official interest rates.

There was some strengthening in the Australian dollar exchange rate in the course of 2002 which may have resulted in an average effective appreciation of around 3 per cent. Based on estimates of inflation in Australia's main trading partners as published in the OECD *Economic Outlook* 72, this implies an effective real

Figure 16. **Exchange rates**



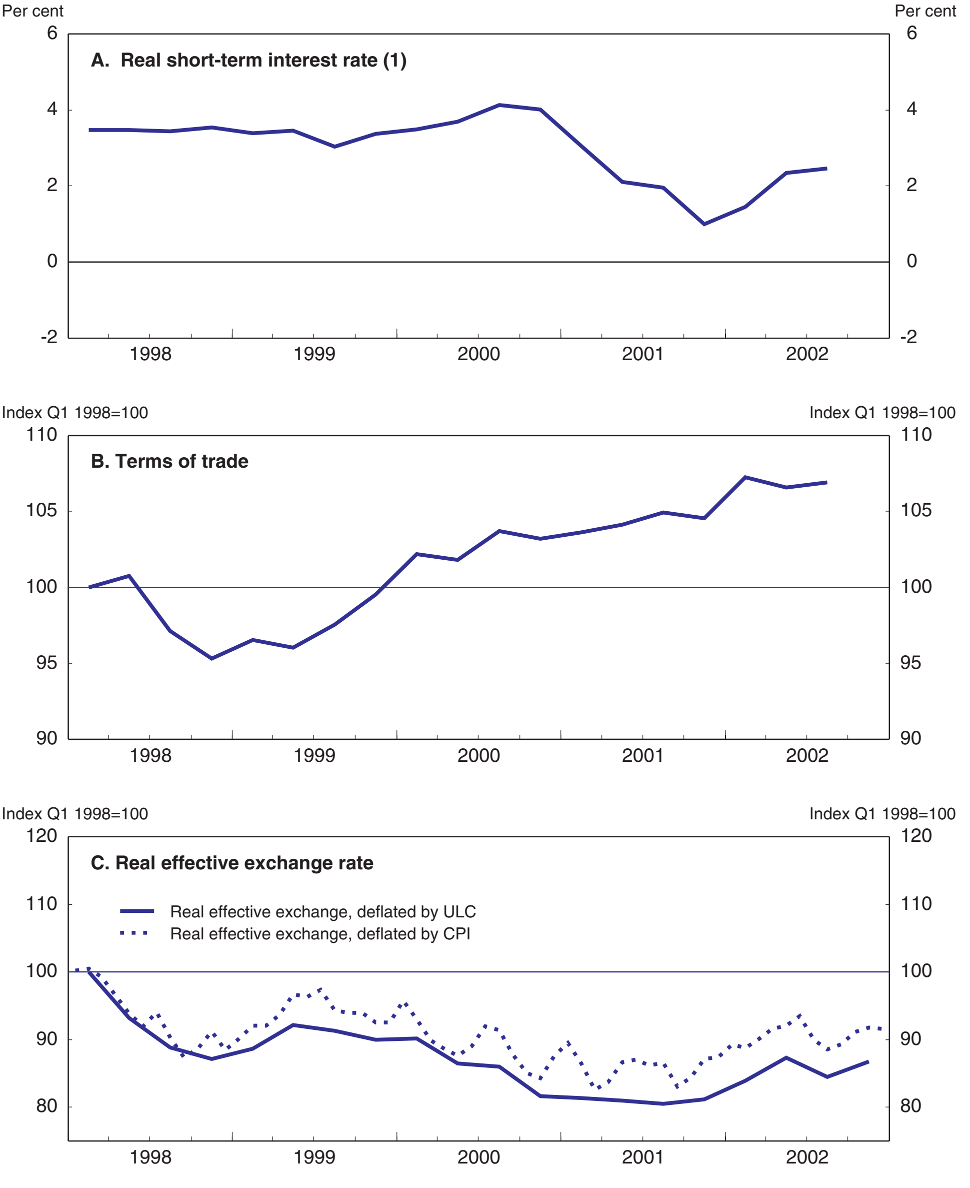
Source: OECD.

appreciation of the Australian dollar in terms of relative consumer prices in 2002, which more than offsets the real effective depreciation in 2001 (but not the real depreciation of 2000). Together with the policy-induced rise in real short-term interest rates in 2002, this has taken away some, but probably not all, of the stimulus from the earlier accommodating monetary conditions. On the other hand, the trend improvement in the terms of trade in 2002 on average has continued to have a stimulatory effect on the economy (Figure 17). Hence, the overall assessment of current monetary conditions depends heavily on the weight that is being attached to different influences. Application of a simple Taylor rule[28] would suggest that the current three-month money market interest rate is broadly consistent with the Reserve Bank's inflation target range (Figure 18).

Fiscal policy

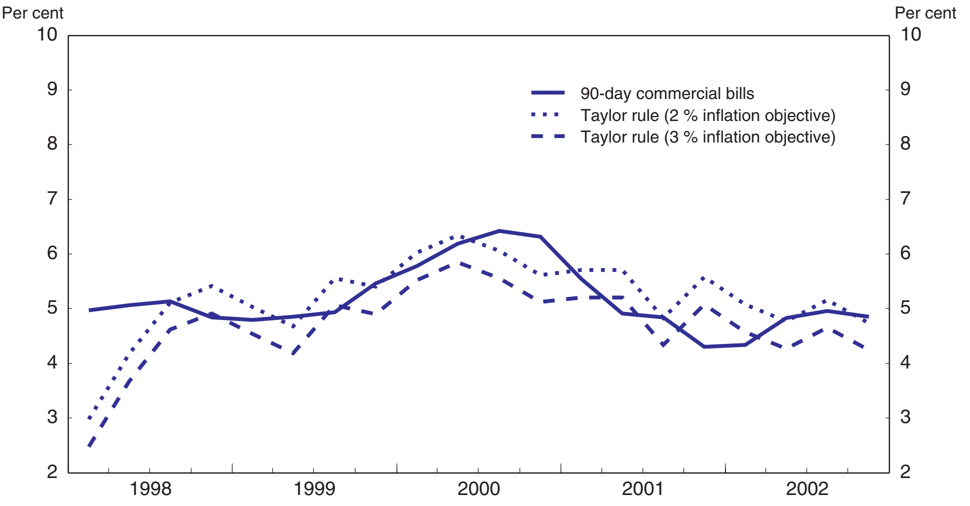
Fiscal policy in Australia was orientated towards consolidation from the mid to late 1990s, with an improvement in the net lending position of the general government standing well above the OECD average, in both actual and cyclically-adjusted terms (Figure 19).[29] A Commonwealth surplus was achieved in 1997-98[30] – one year ahead of the official target – and the objectives of halving the net debt

Figure 17. **Factors affecting monetary conditions**



1. Deflated by underlying inflation defined as the trimmed mean of CPI, adjusted for changes in taxation.
Source: OECD.

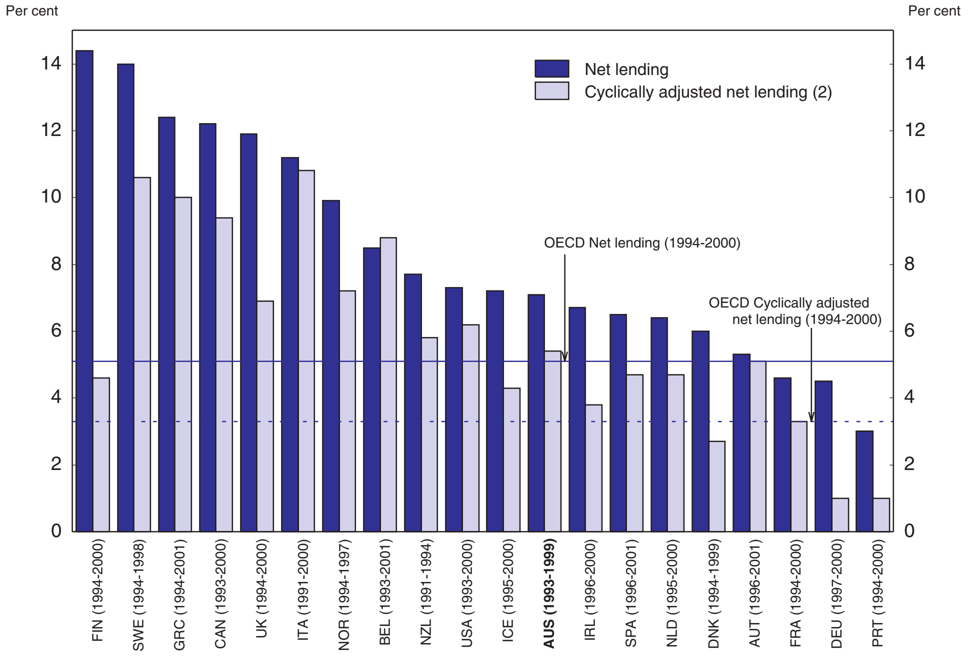
Figure 18. **The Taylor rule**



Source: OECD.

to GDP ratio, from its 1995-96 level of 19.1 per cent, by the turn of the century, and reducing the ratio of public expenditure to GDP were also realised, while the tax burden has not been increased from its 1996-97 level. These outcomes were facilitated by the reform of fiscal institutions that began with the *Charter of Budget Honesty Act* 1998.[31] The Charter requires the Commonwealth government to lay out its medium-term fiscal strategy and short-term objectives and targets in each budget, with both strategy and objectives based on the principles of fiscal management embodied in the Charter.[32] The medium-term orientation of fiscal strategy is designed to reduce the risk of slippage, while helping to lock in the gains from fiscal consolidation. The other major institutional reform has been the shift to accrual accounting in 1999-2000, which supports the principles of sustainability and sound fiscal management outlined in the Charter. Accrual accounting enhances transparency by providing a more accurate view of the total activity of government and its long-term repercussions. The move to accrual budgeting is also a crucial element for reforms aimed at improving the efficiency of public expenditures, as the full cost of providing public services becomes more apparent, and managers can more easily be held accountable for the performance of their agencies in contributing to the achievement of government objectives. It also allows for a better comparison of the costs of internal provision of services relative to outsourcing.

Figure 19. **Fiscal consolidation in selected OECD countries**[1]
Changes in general government net lending in per cent of GDP, 1990-2001



Note: Fiscal consolidations are defined between 1990 and 2001 as periods of protracted (more than three years) improvements in the annual general government's net lending position in per cent of GDP, as compared to the previous year, where such periods are allowed to be interrupted if the worsening of that balance does not exceed 0.5 per cent of GDP and does not last for more than one year.
1. Value in the last year of the consolidation minus the value in the year before the consolidation.
2. Excluding interest payments.
Source: OECD, *Economic Outlook* No. 72, December 2002.

The objective of the Commonwealth's medium-term fiscal strategy is to maintain budget balance, on average, over the course of the economic cycle. This is to ensure that, over time, the Commonwealth makes no net call on private sector saving, and so does not directly impact on the aggregate saving-investment balance (*i.e.* current account). The medium-term fiscal policy framework safeguards the sustainability of public finances over time. It allows policy to react to short-term economic fluctuations to support growth, while ensuring that additional government spending in periods of weaker activity is made possible by savings during periods of stronger growth. An important policy question in this regard is how effective fiscal policy is as a demand management tool. Recent empirical evidence suggests the presence of significant private sector savings offsets in Australia, which imply that the size of any fiscal stimulus will need to be correspondingly larger to have the same impact on aggregate demand. The significant interest rate offsets, discussed earlier, may also limit the effectiveness of fiscal policy as a demand management tool. The empirical findings also reveal that automatic stabilisers may be a more effective option for managing aggregate demand than discretionary policy actions – although such a result needs to be treated with caution (Comley *et al.*, 2002).[33] The cyclical sensitivity of the budget, in any case, is below the OECD average, a 1 per cent change in the output gap leads to a change of 0.3 per cent in net lending as a percentage of GDP, compared with 0.5 per cent for the OECD average (van den Noord, 2000).

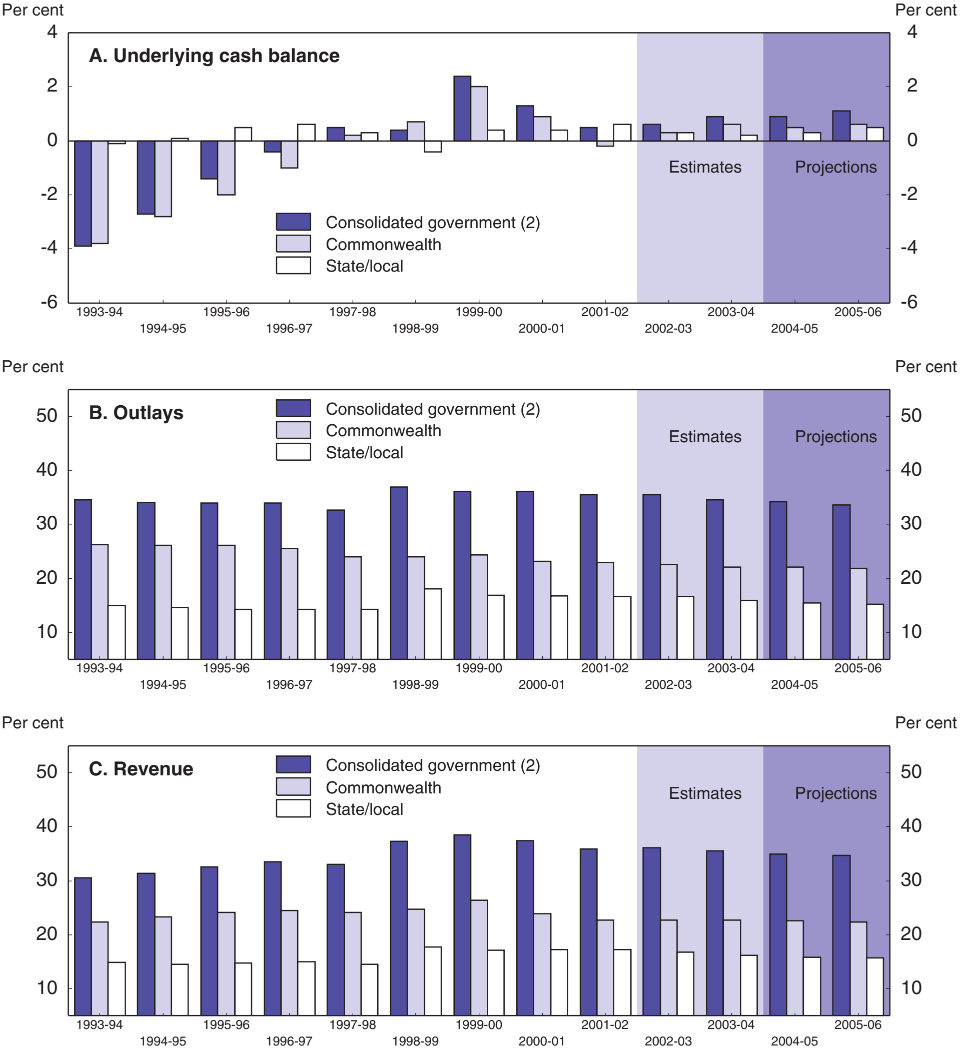
Adherence to the fiscal objective of balancing the budget on average over the economic cycle further contributes to other important goals, including lower levels of Commonwealth net debt relative to GDP over time and stabilisation of the tax burden.[34] The fiscal strategy sub-objective (introduced with the transition to accrual budgeting) of improving the net worth[35] position over the longer term is based on the view that intergenerational equity considerations should be taken into account when formulating fiscal policy. A stronger net worth position would enable the Commonwealth to better manage emerging fiscal pressures more adequately, notably those arising from the ageing population.

The 2001-02 Commonwealth Budget outturn

Following a period of strong consolidation since the mid-1990s, fiscal policy became more expansionary after the turn of the century, when economic growth slowed (Figure 20). At the Commonwealth level, the underlying cash balance recorded a surplus of 2 per cent of GDP in 1999-2000 and 0.9 per cent of GDP in 2000-01, followed by a small deficit in 2001-02. These have resulted in an estimated economic stimulus of around 1 per cent of GDP in both 2000-01 and 2001-02[36] (Table 9). The earlier easing mainly reflected the introduction of income tax cuts under *The New Tax System* in July 2000; while in 2001-02, the stimulus was largely related to the impact of unanticipated non-cyclical expenditure, in defence, domestic security and border protection.

The unanticipated slowdown in output growth in the second half of 2000 and new policy decisions[37] worsened the starting point for the initial 2001-02 Budget position.[38] In the event, and although economic growth proved stronger than originally anticipated,[39] the 2001-02 Commonwealth Budget outturn under-performed expectations. The Commonwealth sector recorded an underlying cash deficit of 0.2 per cent of GDP in 2001-02 – the first since 1996-97 – rather than an expected surplus of the same size.[40] The slippage mainly reflects the effect of new policy decisions among them unanticipated increased expenditure on defence, domestic security and border protection; the provision of a safety net arrangement for entitlements for employees of the collapsed Ansett company, with large immediate

Figure 20. **Government finance**[1]
As a percentage of GDP



1. As at the end of financial year. There is a break in the series between 1998-99 and 1999-2000. Data for the years up to and including 1998-99 are consistent with the cash Australian Bureau of Statistics (ABS) Government Finance Statistics (GFS) reporting requirements. From 1999-2000 onwards, data are derived from an accrual ABS GFS framework.
2. Consolidated general government includes Commonwealth, and State/local governments and universities.

Source: Commonwealth Treasury of Australia.

Table 9. **Commonwealth government budget developments**[1]

(A$ billion)

	2000-01	2001-02		2002-03			2003-04		2004-05		2005-06	
	Outcome	2001-02 Budget	Outcome	2001-02 MYEFO estimates[3]	2002-03 Budget	2002-03 MYEFO[3] estimates	2002-03 Budget	2002-03 MYEFO[3] estimates	2002-03 Budget	2002-03 MYEFO[3] estimates	2002-03 Budget	2002-03 MYEFO[3] estimates
GFS Revenue[2]	**161.5**	**158.8**	**162.4**	**166.3**	**169.6**	**169.6**	**179.6**	**180.1**	**189.4**	**188.8**	**199.3**	**198.1**
(*per cent of* GDP)	24.0	22.6	22.7	22.6	22.6	22.5	22.6	22.6	22.5	22.4	22.3	22.3
Total tax revenue	151.2	146.8	149.8	155.5	158.5	158.5	168.6	169.3	178.0	177.9	187.6	187.2
Income tax	120.9	117.3	119.0	125.1	127.6	127.4	136.9	137.3	145.8	145.6	154.8	154.3
Total individuals[4]	78.1	84.3	86.4	90.8	93.0	92.0	100.2	100.1	107.0	106.9	114.2	113.7
Companies	35.1	27.2	27.1	28.0	28.4	29.2	30.3	31.0	32.3	32.7	33.9	34.6
Superannuation funds and other	7.7	5.7	5.5	6.3	6.2	6.1	6.4	6.1	6.5	6.0	6.7	6.1
Indirect tax	25.6	24.7	25.6	25.4	25.7	26.3	26.4	27.0	26.9	27.3	27.5	27.7
Fringe benefits and others	4.7	4.8	5.2	5.0	5.1	4.9	5.3	5.0	5.4	5.0	5.4	5.2
Non tax revenue	10.4	12.1	12.5	10.8	11.2	11.1	11.0	10.7	11.4	10.9	11.7	10.9
GFS expenses[2]	**156.8**	**160.9**	**166.5**	**168.6**	**170.2**	**170.7**	**177.6**	**177.2**	**184.9**	**185.2**	**192.0**	**192.7**
(*per cent of* GDP)	23.3	22.9	23.3	22.9	22.7	22.6	22.3	22.2	21.9	22.0	21.5	21.7
Social Security and Welfare	66.9	68.2	69.1	71.9	72.9	72.6	76.0	75.5	79.0	78.7	81.6	82.1
Health	25.2	26.8	27.6	29.1	29.1	29.4	30.5	30.7	32.2	32.4	33.8	34.0
Education	11.0	11.5	11.8	12.3	12.3	12.3	13.0	13.0	13.6	13.6	14.3	14.2
Defence	11.4	12.2	12.0	13.2	13.1	13.3	14.0	13.9	14.4	14.2	15.0	14.7
Other	42.3	42.2	46.0	42.1	42.8	43.2	44.0	44.1	45.6	46.2	47.4	47.6
Net operating balance	4.7	–2.0	–4.1	–2.3	–0.5	–1.0	2.0	2.9	4.5	3.6	7.3	5.4
Net capital investment	–1.2	–1.2	–0.4	–1.1	–0.7	–0.5	–0.6	–0.5	–0.5	–0.5	–0.4	–0.4
Fiscal balance (A$ billion)	**5.9**	**–0.8**	**–3.7**	**–1.3**	**0.2**	**–0.5**	**2.6**	**3.4**	**5.0**	**4.2**	**7.7**	**5.8**
(*per cent of* GDP)	0.9	–0.1	–0.5	–0.2	0.0	–0.1	0.3	0.4	0.6	0.5	0.9	0.7
Underlying cash balance (A$ billion)	**5.7**	**1.5**	**–1.1**	**1.0**	**2.1**	**2.1**	**3.7**	**4.9**	**4.6**	**4.2**	**7.1**	**5.4**
(*per cent of* GDP)	0.9	0.2	–0.2	0.1	0.3	0.3	0.5	0.6	0.6	0.5	0.8	0.6

1. On a Government Finance Statistics (GFS) consistent basis.
2. Excluding GST collections and equivalent payments to the States.
3. *Mid-Year Economic and Fiscal Outlook* estimates.
4. Other withholding tax is also included.

Source: Commonwealth Treasury of Australia.

accrual effects; and the additional funding provided for the First Home Owners Scheme (FHOS).[41] Total Commonwealth expenditure in 2001-02 exceeded the budgeted target by A$ 5.6 billion (or 3.5 per cent), compared with a smaller over-performance of total revenue by A$ 3.6 billion (or 2.3 per cent).

The Commonwealth Budget for 2002-03 and medium-term fiscal strategy

The 2002-03 Budget projects an underlying cash surplus of 0.3 per cent of GDP.[42] This implies a contractionary impact of around ½ per cent of GDP in 2002-03, in line with the expected strong continuing growth of domestic demand and recovery in international activity. In addition to the primary objective of maintaining budget balance, on average, over the course of the economic cycle, the supplementary objectives of the medium-term fiscal strategy as set out in the 2002-03 Budget[43] are:

– maintaining surpluses over the forward estimates period while economic growth prospects remain sound;

– no increase in the overall tax burden from its 1996-97 level; and

– improving the Commonwealth's net asset position over the medium to longer-term.

The Commonwealth budget projected a rise in the surplus (in both accrual and cash terms) in the outer years, reaching about 1 per cent of GDP by 2005-06. The projected surpluses represent a neutral to mildly contractionary fiscal policy over the period 2003-04 to 2005-06.

At the time of the 2002-03 Budget (May 2002), prospective budget surpluses for 2002-03 and the outer years were revised upward relative to the October 2001 MYEFO estimates, largely because of stronger output forecasts which have increased Commonwealth revenue estimates[44] and lower unemployment benefit outlays. These variations are partly offset by additional spending on:[45] domestic security; border protection and defence; assistance to families through the introduction of the Baby Bonus; and the improvement of residential and community care for older Australians. On the other hand, the increase in user charges in the Pharmaceutical Benefits Scheme (PBS) and the tightening of the eligibility criteria for the Disability Support Pension (DSP), envisaged by the 2002-03 Budget, provide some offsetting expenditure reductions.[46] Moreover, the budget foresees a decline in housing expenses, largely reflecting the end of the additional First Home Owners Scheme grants.[47]

At the time of the 2002-03 *Mid-Year Economic and Fiscal Outlook* (MYEFO) estimates in November 2002, the growth outlook was revised downwards for 2002-03 (to 3 per cent from 3¾ at the May 2002-03 Budget time), largely because of the expected impact of the drought on the economy.[48] Nevertheless, the forecast for the underlying cash balance for 2002-03 remained unchanged, at 0.3 per cent of GDP

(A$ 2.1 billion).[49] Higher expected company and other individual tax revenue; an upward revision in forecast GST revenue; and lower spending on unemployment benefits have together offset the effect of new policy decisions that involve higher expenditure taken since the budget.[50] The impact of the new initiatives on expenditure was amplified by a legislative delay by the Senate in passing the Pharmaceutical Benefits Scheme co-payment increases announced in the 2002-03 Budget. The Government has reintroduced the legislation into the Senate but it has not yet been debated. The fiscal surplus (in both accrual and cash terms) is projected to rise over the medium term to around 0.7 per cent of GDP in 2005-06.

The prospects for States/local government and general government finances

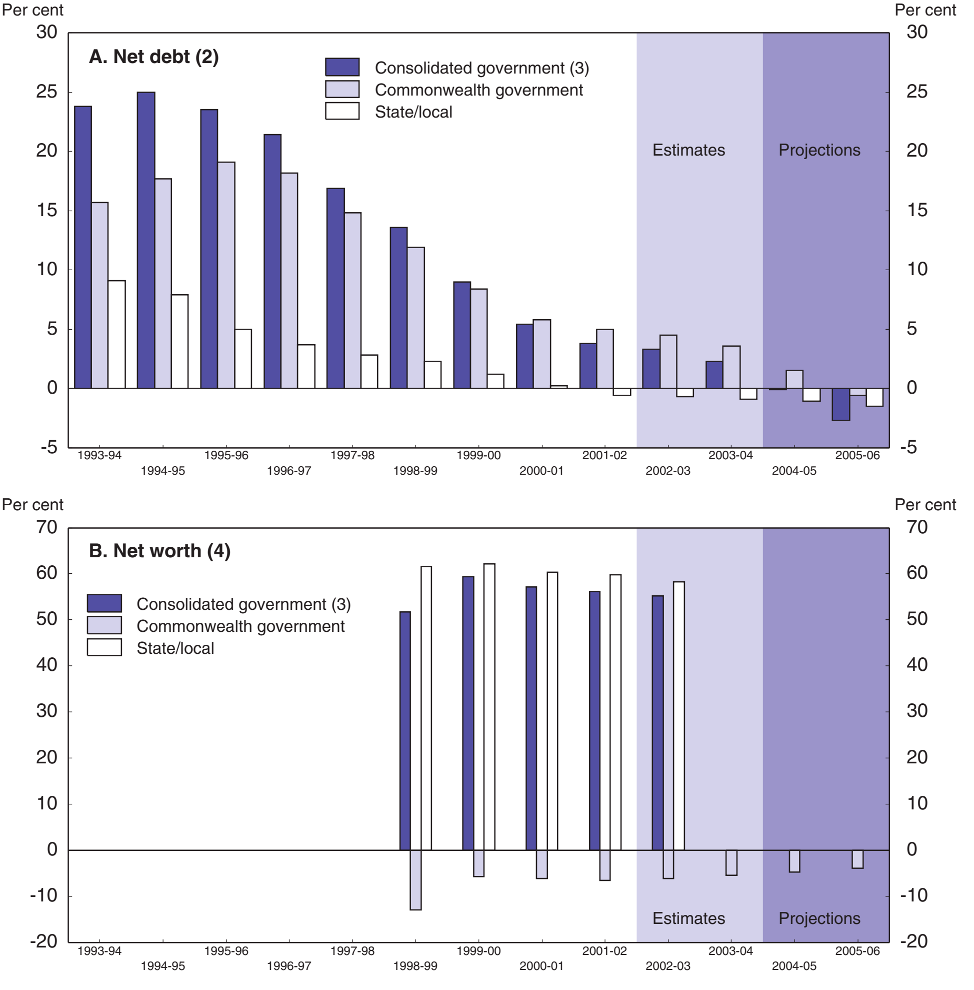
Apart from a brief hiccup in 1998-99, reflecting initiatives by the governments of New South Wales and Victoria to fund unfunded superannuation liabilities, the State/local sector registered a sustained improvement from the early 1990s (Figure 20). The local government sector has been relatively stable in recent fiscal years and is forecast to remain so. In aggregate, the State/local sector's cash surplus is forecast, on the basis of official estimates, to decline to 0.3 per cent of GDP in 2002-03, from 0.6 per cent of GDP in 2001-02, with slightly larger surpluses envisaged in the outer years.[51] Taking all levels of government together, the underlying cash surplus of the general government is projected to remain around 0.6 per cent of GDP in 2002-03, rising to 1.1 per cent of GDP in 2005-06.

Debt developments and medium-term issues

Commonwealth government net debt peaked at 19.1 per cent of GDP in 1995-96, declining since then to an expected 4½ per cent of GDP in 2002-03. Around two-thirds of this reduction results from asset sales, which have in general been used to retire debt, with the remaining third reflecting a continuous series of significant primary surpluses. The downward path in Commonwealth net debt is expected to continue in the forward estimates period (until 2005-06) because of the underlying cash surpluses and further sales of the Commonwealth shareholding in the telecommunications company Telstra. The 2002-03 Budget projected an elimination of the Commonwealth net debt by 2005-06, which was also confirmed by the MYEFO of November 2002.[52] The net worth position of the Commonwealth government is also envisaged to improve over the projection period, consistent with the projected increase in cash and accrual surpluses from 2002-03.[53] Similarly, the net debt of the State/local government has fallen markedly, from a high of 10.3 per cent of GDP in 1992-93 to an estimated –0.7 per cent in 2002-03. Net assets are forecast to grow to 1.5 per cent of GDP by 2005-06. Reflecting these developments, the general government net debt has declined as a percentage of GDP from a peak of 25 per cent in 1994-95 to an estimated 3.3 per cent of GDP in 2002-03, swinging into a net asset position by 2004-05 (Figure 21).

Figure 21. **Commonwealth general government net debt and net worth position**[1]

As a percentage of GDP



1. As at the end of financial year.
2. Includes the impact of the further sale of the government's shareholdings in Telstra.
3. Consolidated general government includes Commonwealth, and State/local governments and universities.
4. Net worth is calculated as assets minus liabilities. There is a break in the asset series in 1999-2000 as a result of the revaluation of Telstra at market value and the reclassification of expenditure on defence weapons platforms in that year.

Source: Commonwealth Treasury of Australia.

The reduction of net debt since the mid-1990s has been managed while maintaining depth and liquidity in the Commonwealth Government Securities (CGS) market.[54] This has involved lagging the decline in CGS on issue behind that in the net debt, mainly by holding surplus budget proceeds not used to retire debt as financial assets. Mechanisms used by the government to support CGS liquidity include:

– maintaining a modest gross debt issuance programme in the form of gross Treasury Bonds;
– undertaking bond conversion tenders to ensure that CGS outstanding are concentrated in liquid maturities; and
– holding some surplus funds as deposits with the Reserve Bank of Australia rather than repurchasing outstanding CGS.

Notwithstanding the government actions, the decline in Commonwealth net debt has been accompanied by a decline in gross debt, with the level of CGS on issue falling from around 18 per cent of GDP in 1996-97 to 9 per cent of GDP in 2001-02.

The significant reduction of the net debt, along with the prospect of its elimination in a few years time, has raised concerns among some market participants about the future viability of the CGS market and the likely effects on the broader financial markets and the functioning of the overall economy. Such concerns are based, to a large extent, on the reasoning that the private securities cannot easily replicate the core functions performed by the government bond market. A recently released discussion paper by the Commonwealth government[55] – in acknowledgement of these concerns –outlines the costs and benefits of maintaining such a market, identifying three possible options available to the government: *i*) winding down the CGS market, either by re-purchasing all debt over a short period as budget surpluses and asset sales proceeds are realised, or by allowing all outstanding debt to mature; *ii*) consolidating the CGS market with the state government markets; and *iii*) maintaining the CGS market and funding the Commonwealth's unfunded superannuation liabilities to its employees (estimated at A$ 84 billion in 2002-03)[56] (see Box 1). The government's decision on the issue of the CGS market is expected to be taken prior to the May 2003-04 Budget, after consultation with the interested parties.

The Commonwealth discussion paper recognises the important roles that the government debt securities may play in financial markets including: providing a benchmark for the pricing and referencing of other financial products; facilitating management for financial risks; providing a low-risk, long term, investment vehicle; assisting the implementation of monetary policy; and acting as a "safe haven" during periods of financial instability. It argues, however, that some of these roles could be undertaken by the private sector, outlining potential private sector substitutes. The bond markets' traditional role as a price base for other debt-market instruments, for example, could be replaced over time by corporate bonds or interest rate swaps. The paper also highlights the 'significant risks' associated with the option of

Box 1. Options available to the Commonwealth government for the CGS market: An overview*

The withdrawal of the government from the CGS market by repaying the outstanding debt over time – as implied by the first option considered by the Commonwealth discussion paper *Review of the Commonwealth Government Securities Market* – would effectively result in an elimination of all risks currently related to the debt portfolio. This needs to be assessed, however, against the re-issuance risks and possible costs of having to re-build the GCS market. As it is pointed out by the paper, while it is not in the government's intention to proceed to significant borrowing in the future, it would still need to consider the likely cost of re-entering the market, as a range of unforeseen events may affect significantly the budget and increase financing requirements. However, the potential costs (including adverse returns from asset positions) of the alternative case – *i.e.* maintaining the market in the absence of a debt requirement – should also be taken into account. Transition issues also seem to be important in assessing the option of winding down the CGS market. The discussion paper considers that a quick withdrawal of the government from the market, by repurchasing all debt as budget proceeds materialise, could involve the risk of unsettling financial markets by bidding up the price of the debt and creating substantial repurchase premiums. In addition, this approach may not provide enough time for private sector to develop the necessary financial instruments and undertake some of the functions currently operated by the CSG market. These shortcomings could be avoided by allowing all outstanding debt to mature which would maintain the Treasury bond portfolio until at least the middle of next decade. The additional interest cost involved in this approach would be largely offset by the accumulation of financial holdings over the period, given the ongoing, and expected, budget surpluses and asset sale proceeds.

An alternative option that the paper considers is to issue CGS to maintain the market and use the proceeds to fund the Commonwealth's unfunded superannuation (pension) liabilities. This option, however, is seen as increasing the government's exposure to financial risks and possibly distorting the asset markets. Moreover it could raise governance concerns related to the costs of shifting scarce public sector management resources or public scrutiny from core government functions. The discussion paper further suggests that using proceeds from issuing CGS to fund Commonwealth's superannuation liability is likely to be intergenerationally neutral. This is because the costs to future generations of the debt that must be incurred to acquire the assets used to capitalise the fund are in principle equivalent to remuneration of the fund's assets accruing to these future generations. Finally, regarding the option of merging Commonwealth and State government debt markets, this would increase the liquidity of the Commonwealth bond market, at the expense of the States. The significant reduction of transparency and incentives for jurisdictions to maintain sound financial positions are key problems of consolidation. In any case, such an option may not provide a long-term solution to the future of the CGS market if the fiscal discipline exhibited at all levels of government in recent years continues. The Commonwealth and State governments rejected this alternative in August 2001.

* The Box draws on Commonwealth of Australia (2002d), *Review of the Commonwealth Government Securities Market*, Discussion Paper, Canberra, November.

maintaining the CGS market, pointing to the financial risks that the government may be exposed to, the potential distortion in asset markets, as well as to governance concerns arising from the accumulation of a sizeable portfolio of financial assets.

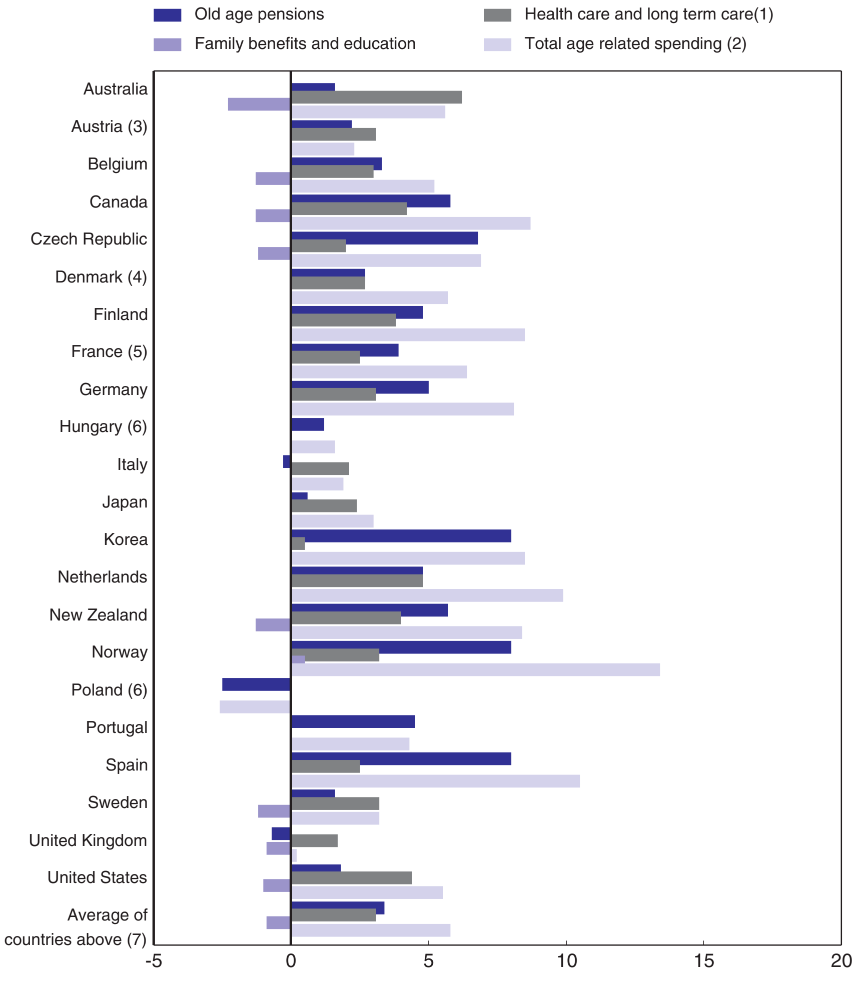
Internationally, opinions are divided with regard to the benefits and costs of fully paying down public debt, and as to whether private debt can fulfil all the desirable functions of public debt (see Annex I). The lack of international precedent for winding down the government bond market makes it difficult to assess such an option.[57] Driven to a large extent by inter-generational equity considerations, the common practice of OECD countries with budget surpluses, even those that have moved to a net asset position, such as Norway and Sweden, is to acquire financial assets and retain a government debt market. The established portfolios differ across countries in size, as well as regulation and administration across countries, raising a number of relevant issues.[58] The main challenge for governments with budgetary surpluses is to manage the envisaged decline in debt in such a way as to maintain, to as large an extent possible, the benefits of the public debt markets that currently exist, provided that by so doing, they do not incur costs or create an unacceptably high level of distortions and vulnerabilities elsewhere. The need for government debt would be less compelling if other financial securities could either achieve the same risk status, or fulfil similar functions despite a different risk status.[59] Otherwise, maintaining a minimum level of gross debt, despite the reduction of the net debt, might be advisable, for example by moving to a "golden rule" for fiscal policy. This would result in balance on the recurrent budget and an overall budget deficit reflecting the financing of capital expenditure such as infrastructure investment (with social returns higher than estimated long-term real interest rates) *via* issuance of debt.

Issues of fiscal sustainability

An ageing population and technology driven advances in health care are two key elements which will affect the government's financial position over the longer term. Compared with most OECD countries, Australia seems to be well placed to cope with the challenges of an ageing population as it faces a relatively lower potential pension burden and has low levels of public debt (Figure 22).[60] However, the predicted budgetary pressures are not negligible. Based on the baseline projections of the first official I*ntergenerational* R*eport* (IGR),[61] incorporated in the May 2002-03 Budget, Commonwealth spending is expected to exceed revenue in about 15 years, under unchanged policies and likely developments in productivity and participation rates, with the gap growing to around 5 per cent of GDP by 2041-42[62] (Figure 23). This mainly reflects rising outlays on health, aged care services, and age pensions, while unemployment allowances, payments to families with children, and to a lesser extent, education spending,[63] are all projected to decline as a proportion of GDP (Table 10). The emerging strains in public

Figure 22. **Age-related spending in selected OECD countries**

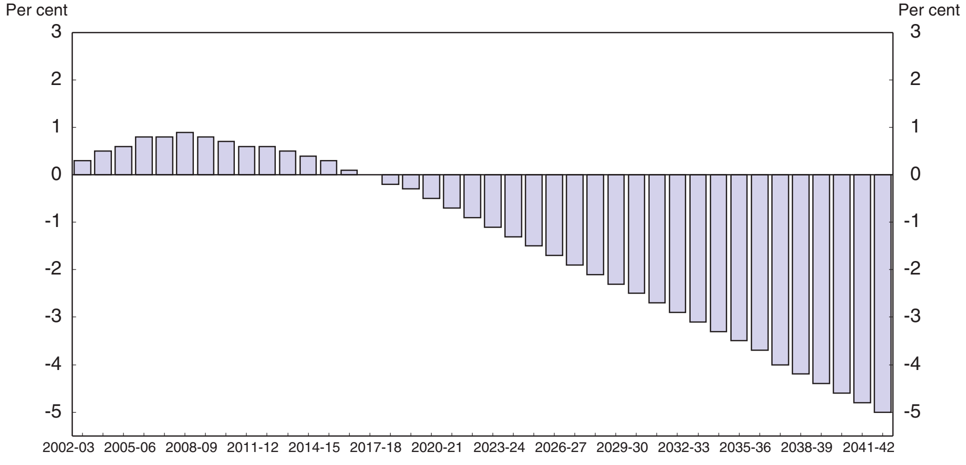
Changes in percentage points over 2000-50



1. Health care and long term care, for Austria, France, Germany, Italy and Spain are estimations from Economic Policy Comittee of the European Union (2001).
2. Total also includes early retirement programmes.
3. Total pension spending includes other age-related spending which does not fall within the identified sub components, represents 0.9 per cent of GDP in 2000 and rises by 0.1 percentage point in the period to 2050.
4. Total includes other age-related spending not classifiable under the other headings, which represents 0.6 per cent of GDP in 2000 and increase by 0.2 percentage point from 2000 to 2050.
5. The latest available year is 2040.
6. Total includes old-age pension spending and early retirement programmes only.
7. Average excludes countries where information is not available and Portugal.

Source: Dang *et al.* (2001); Economic Policy Committee of the European Union (2001).

Figure 23. **Commonwealth fiscal balance position in the longer term**
Percentage of GDP



Source: Commonwealth Treasury of Australia (2002), Intergenerational Report 2002-2003, Budget 2002-03, Budget Paper No. 5.

Table 10. **Commonwealth demographic spending in the longer term**
Per cent of GDP

	2001-02	2006-07	2011-12	2021-22	2031-32	2041-42
Total health and age care	4.7	4.8	5.1	6.2	7.9	9.9
Total health	4.0	4.0	4.3	5.2	6.5	8.1
of which:						
Pharmaceutical benefits scheme	0.6	0.6	0.8	1.3	2.1	3.4
Total aged care	0.7	0.8	0.8	1.0	1.4	1.8
of which:						
Residential care	0.6	0.6	0.7	0.8	1.1	1.4
Total payments to individuals	6.8	6.3	6.2	6.8	7.2	7.4
of which:						
Age and Service Pension	2.9	2.8	2.9	3.6	4.3	4.6
Unemployment allowances	0.8	0.8	0.7	0.6	0.5	0.4
Family Tax benefit	1.6	1.3	1.2	1.1	1.0	0.9
Total Education	1.8	1.8	1.7	1.6	1.6	1.6
Unfunded government superannuation	0.6	0.5	0.5	0.5	0.4	0.3
Total demographic spending	**13.9**	**13.3**	**13.6**	**15.1**	**17.1**	**19.2**

Source: Commonwealth Treasury of Australia (2002), *Intergenerational Report* 2002-03, *Budget* 2002-03, *Budget Paper* No. 5.

finances reinforce the need for continued prudent fiscal management to ensure that the government will be well prepared to meet the emerging structural challenges promptly and effectively, in order to avoid the need to significantly increase the tax burden on future generations.

Pension outlays[64]

Public pension outlays in Australia are projected to increase by around 1.6 percentage points of GDP by the middle of this century, reaching around 4.6 per cent of GDP. This is both a lower level and lower increase than in most OECD countries, reflecting the fact that the tax-funded public pension (the "Age Pension") in Australia covers only the first pillar of retirement income arrangements and is means tested, while the compulsory private pension scheme (known as the Superannuation Guarantee), is slowly maturing, thereby reducing average entitlements to the Age Pension. The projected rise in pension outlays could be moderated – or even avoided altogether – through policy initiatives to increase labour force participation of older workers and encourage private savings for retirement so as to reduce future demand for the Age Pension. Both policy options are considered by the government as key priorities for ensuring fiscal sustainability. A further option would be to reduce average Age Pension entitlements through an increase in compulsory superannuation contributions – given the government's commitment to maintain the single rate of Age Pension at 25 per cent of Male Total Average Weekly Earnings.[65] Alternatively, the budgetary impact of increased pension outlays could be offset if high enough surpluses could be sustained through the remainder period. There is also an upside risk to pension outlays if a greater proportion of superannuation assets were taken earlier and dissipated in order to maximise Age Pension entitlements (*i.e.* increase in "double dipping"). As discussed in previous OECD *Surveys*, such risk could be reduced by raising the preservation age for superannuation benefits to that required for access to the Age Pension entitlements.[66] In addition, individuals should be encouraged to take at least the bulk their superannuation benefits as an income stream, rather than lump-sum, maximising self-reliance.Whether this could be done without making annuation compulsory is, however, problematic given the asymmetric information problems that bedevil a voluntary annuity market.[67]

Health care expenditure

The greatest challenge to public finances from ageing populations is expected to come from public health and long-term care spending, which could rise by as much as 5 to 6 percentage points of GDP by the middle of the century. These estimates are significantly higher than those reported by other OECD countries that have official projections. Projections of health care spending are surrounded by far larger margins of error than the pension ones, as health and long-term care costs will be affected by a range of factors in addition to ageing, in particular technology, increases in supply (hospitals and medical personnel) and incentives facing suppliers and patients (Dang 2001 *et al.*). These additional factors, especially demand for new technology and treatments, have explained the bulk of the real growth (of around 5 per cent per annum) in health spending in Australia over the last decade, with population growth and changes in the age structure accounting for only the one-third (Commonwealth 2002a). The Australian authorities prudently assume that similar trends will continue impacting on health spending over the next 40 years. One of the pressures highlighted by the Intergenerational Report is the continuing high rates of growth in the Pharmaceutical Benefits Scheme (PBS), reflecting the increased availability of new and more expensive drugs, which increase the total volume of prescriptions and cost to the government per prescription. PBS spending is projected to rise by around 3 percentage points by 2041-42, to around 3½ per cent of GDP, although such projections are subjected to a high degree of uncertainty.[68]

Another issue arising in the context of population ageing concerns the prospective increases in aged care expenditure and the potential budgetary costs of such a development. The government plays the leading role in planning and funding residential aged care and a range of community care services. The Commonwealth spending on the aged care was equivalent to around 0.7 per cent of GDP in 2001-02, and is expected to rise to 1.8 per cent of GDP by 2041-42, mainly as a result of an increase in residential care spending. Such a development by itself would not contribute an unmanageable load on public finances. However, as pointed out in the previous *Survey*, it would take place in the context of other increased social expenditure and would add to already increased costs of health care services.[69]

Health care reforms

A range of reform initiatives have been introduced over the years to contain expenditure on health care and ensure the viability and efficiency of Medicare – Australia's universal public health system – in the long-term.[70] Recent reform efforts have aimed at fostering participation in private health insurance, in order to ease the financial burden on Medicare, while providing consumers with more choices and universal access to high quality health care. Two major initiatives[71] to pursue this objective, discussed in detail in the 2001 *Survey*, included the introduction, in January 1999, of a 30 per cent non-means-tested rebate on the full costs of private insurance premiums, to improve the affordability of private health insurance; and the implementation, from July 2000, of the "Lifetime Health Cover" scheme,[72] which changes the way private insurance operates. The scheme enables health care funds to charge different premiums, depending on the age at which individuals first buy health insurance. As such, it encourages people to join a health fund early in life and maintain their membership, addressing, to an extent, the intergenerational problem of an ageing population. The incentive schemes introduced by the government have increased participation in private health insurance to 44 per cent at end-June 2002, from a low of 30 per cent in December 1998.[73] Subsequently, the growth in the use of public hospitals has slowed.

As a step towards addressing pressures on public finances arising from health care spending, the May 2002-03 Budget announced initiatives to control the rapid growth of the Pharmaceutical Benefit Scheme (PBS), which constitutes a key part of Medicare. These included an increase in the patient co-payments for prescriptions, with budgeted expenditure savings of A$ 1.1 billion over four years. However, as mentioned earlier, the necessary legislation has not yet approved by the Senate.[74] The budget also included a package of initiatives to improve the quality of use of PBS medicines – new and existing – and to ensure that these medicines are prescribed appropriately. These initiatives covered issues such as doctor shopping and pharmacy fraud.

Managing the costs of health care and aged care services remains a challenge, even if current and prospective public finances seem comparatively healthy. Essential for safeguarding health spending are further improvements in the efficiency and effectiveness of the health care system. Government initiatives – as has already been acknowledged by the Intergenerational Report – should aim at containing growth in the pharmaceutical spending and developing a more affordable and better targeted aged care system. Policy makers also need to find ways to monitor health care spending more closely, better balance the private/public mix of the financing and delivery of health and aged care, and improving the match between health care needs and the supply of services. Steps towards allowing private insurance to cover a more comprehensive range of mainstream health services, including out-of-hospital goods and services, might be advisable in this regard. Over the longer term, a wider range of policies and reforms will be required in order to meet the budgetary pressures arising from further technological advances in the health care area. In this context, the main policy challenge is how to manage the costs in health and aged care programmes without compromising the principal goal of providing access to affordable, high-quality, health care services. Recent steps towards this goal include: financial incentives for General Practitioners (GPs) by increasing patient rebates for GP services, with a focus on longer consultation times; the implementation of a national health information network; improved access to health services for rural and regional communities; and initiatives to address medical workforce shortages, with the longer term goal of ensuring a sufficient number of appropriately trained professionals to sustain health and aged care services in the future.

Progress towards reforming the tax system

There has been a comprehensive overhaul of the taxation system in recent years,[75] the first major step of which came into effect in July 2000, with the implementation of *A New Tax System* (ANTS). The key feature of ANTS was the introduction of the broad-based 10 per cent goods and services tax (GST), imposed on a value added basis, to replace the former wholesale sales tax and a range of inefficient State taxes (Annex II). In addition to harmonising the tax treatment for different goods and services, the shift under ANTS from specific indirect taxes to a general indirect tax broadened the tax base and increases the efficiency of the taxation system. The GST also eliminates distortions in consumer choice between imported and domestically-produced goods and services that would otherwise arise from international tax rate differentials. The accrual of the GST revenue to the State governments provides them with a more secure and buoyant source of revenue.[76]

As noted in previous *Surveys*, the gains from reforms could have been greater if – in the compromise required to get the Senate's approval – the basic food sector had not been exempted from the GST, and the abolition of some harmful State indirect taxes, especially the tax on bank account debits, had not been delayed. Debits tax will now be abolished by 1 July 2005, subject to review by the Ministerial Council. In addition, the Ministerial Council will by 2005 review the need for a range of other inefficient State taxes. If these taxes are abolished, Australia's indirect tax system will be much improved. Efforts towards reforming the narrowly-based and exemption-ridden payroll tax, which is under the jurisdiction of the States, would also be helpful.[77] In addition to its focus on indirect tax system, ANTS also incorporated income tax cuts, to compensate for the introduction of the GST, and measures to reduce high marginal effective tax rates, improving the incentives for work. The tax reform package also entailed a simplification of tax administration, which should enhance the flexibility of business tax payments and reduce the scope for tax avoidance by making easier the cross-matching between GST and income tax information. Overall, ANTS has the potential of boosting growth over the longer term, as a result of the lower effective income tax rates and less distorting indirect and business income taxes although, as also noted by the government, such benefits are difficult to quantify. The new tax system needs also to be assessed in terms of its potential for lower administration and compliance costs.

While it is still early to fully analyse and evaluate the long-term economic benefits of ANTS, some direct benefits of the tax reform can be easily observed. These include a growing revenue base for the States, and a fall in the prices of most investment goods and services faced by business due to the removal of the cost on business inputs entailed in the previous indirect tax system. Such benefits need to be assessed against the overshooting in the initial administration costs of GST, compared with the official estimates,[78] reflecting a larger than expected number of registered business, although the amount of time spent by companies on GST administration seems to have fallen. The government has not provided revised estimates (in comparison with the regulation impact statement that accompanied the GST legislation), in the case of the compliance costs of the GST. Nevertheless, the significant changes to streamline the GST payment and reporting arrangements for small business, introduced in February 2001,[79] provide some evidence on concerns raised by such business with regards to compliance costs. Recent findings suggest that compliance costs have eased, as anticipated, in line with increasing familiarity of business with the new tax system.[80]

Significant progress has also been achieved towards implementing the business tax reform, in response to the recommendations of the Ralph Committee.[81] As discussed in previous *Surveys*, the main problem with the pre-existing arrangements was the inconsistent treatment of business entities and the investment they conduct. It was proposed to address these issues by: *i*) applying company tax consistently to certain companies and trusts; and *ii*) possibly, by reconsidering the tax treatment of certain forms of business investment. The additional revenue from these base-broadening initiatives would be available to finance a reduction in the company tax rate and provide relief from capital gains tax. The *New Business Tax System* introduced a phased reduction of the company tax rate from 36 per cent in 1999-2000 to 30 per cent in 2001-02 and subsequent income years; the counterpart to this is the removal (except for small business) of accelerated depreciation arrangements and adoption of an effective life system (Annex III). The new system also introduced a simpler and internationally competitive capital gains tax (CGT) regime, which should remove impediments to efficient management and improve capital mobility. The main provisions of the *New Business Tax System* which came in effect since 1st July 2001 include a simplified tax system for small firms; a uniform capital allowances system; new thin capitalisation rules to prevent an excessive allocation of debt to Australian operations of multinational firms; and a new test of debt and equity. These measures are expected to reduce the compliance burden for the overwhelming majority of business and improve the quality of investment and economic efficiency. Moreover, the new thin capitalisation arrangements should ensure that the country raises its fair share of tax. The business tax system will be improved further with the implementation of a consolidated income treatment for groups of wholly-owned companies,[82] which is expected to simplify the corporate tax code, delivering significant savings in tax administration and compliance costs incurred by corporate groups (Commonwealth of Australia 2000).

A major review in the pipeline is that of the international tax system.[83] The objective of the review is to examine whether current international tax arrangements impede Australian companies expanding offshore, whether they impede the attraction of domestic and foreign equity, and how they affect holding companies and conduit holdings being located in Australia. A Treasury paper, released in August 2002,[84] sets out a number of reform options available. The paper provides a basis for public consultation, to be conducted by the Board of Taxation.[85] Other envisaged reforms include a continuing redesign of the taxation of financial arrangements, and further changes in tax exempt leasing.

Although there has thus been quite some progress in reforming business taxation, the government decided, however, in agreement with the Board of Taxation, not to proceed with the radical recommendation of the Ralph Review to introduce the "tax value method" (TVM) for determining taxable income.[86] This was because after consultation with business and tax practitioners it was concluded that the benefits of TVM could not be reliably determined.[87] Nevertheless, the government remains committed to developing, in consultation with the business community, a systematic treatment of rights and so called "black hole" expenditure (business expenditure which currently does not qualify for deduction over an appropriate period of time) with a view to implementing the changes by July 2005. It is regrettable that the expected costs of adopting the TVM outweighed the expected benefits. Ideally, such a reform would have provided greater structural integrity to the income tax law, reducing avoidance opportunities and the need for long-term amendments in the law. Moreover, the implementation of the TVM could have significantly reduced the length and complexity of the law, implying lower compliance costs and greater transparency and certainty for taxpayers. As noted in the previous *Survey*, the government has also decided, following the advice of the Board of Taxation and considerations of submissions received, not to proceed with the draft legislation on entity taxation legislation – another important recommendation of the Ralph Review.[88] Instead, the Board of Taxation was tasked in February 2001 to conduct consultations on the principles which can protect legitimate small business and farming arrangements, whilst addressing any tax abuse that exists in the trust area. The enquiry focussed on the potential tax abuse in the discretionary trust area, which consists the main area of concern on the issue.[89] The Board's report considered that there are no "compelling arguments" for a broad based reform to the taxation of discretionary trusts[90] and a move towards a company tax model.[91] It further concluded that, in view of the changes to the taxation of trusts in recent years, concern about the use of trusts for tax planning does not justify by itself fundamental reform.[92]

While the introduction of ANTS and the ongoing reform in the business tax system represents a substantial improvement over the previous system, some important policy issues remain unresolved. One of these is the large gap between the top personal marginal income tax rate and the company tax rate,[93] which risks increasing the incentives for tax deferral and avoidance, through the redefinition of personal income as company income.In addition, the top marginal income tax rates come into effect at relatively low income levels, raising concerns about equity, as well as work and savings incentives, with potential adverse effects on output growth. Moreover, marginal effective tax rates remain high for many low-income earners, which tends to create poverty traps. The ongoing reform of the welfare system (discussed in Chapter III), along with recent measures to address tax avoidance opportunities arising in part as a result of the difference between the company tax rate and the top personal marginal rate, go in the right direction.

III. Policies to maintain high output growth

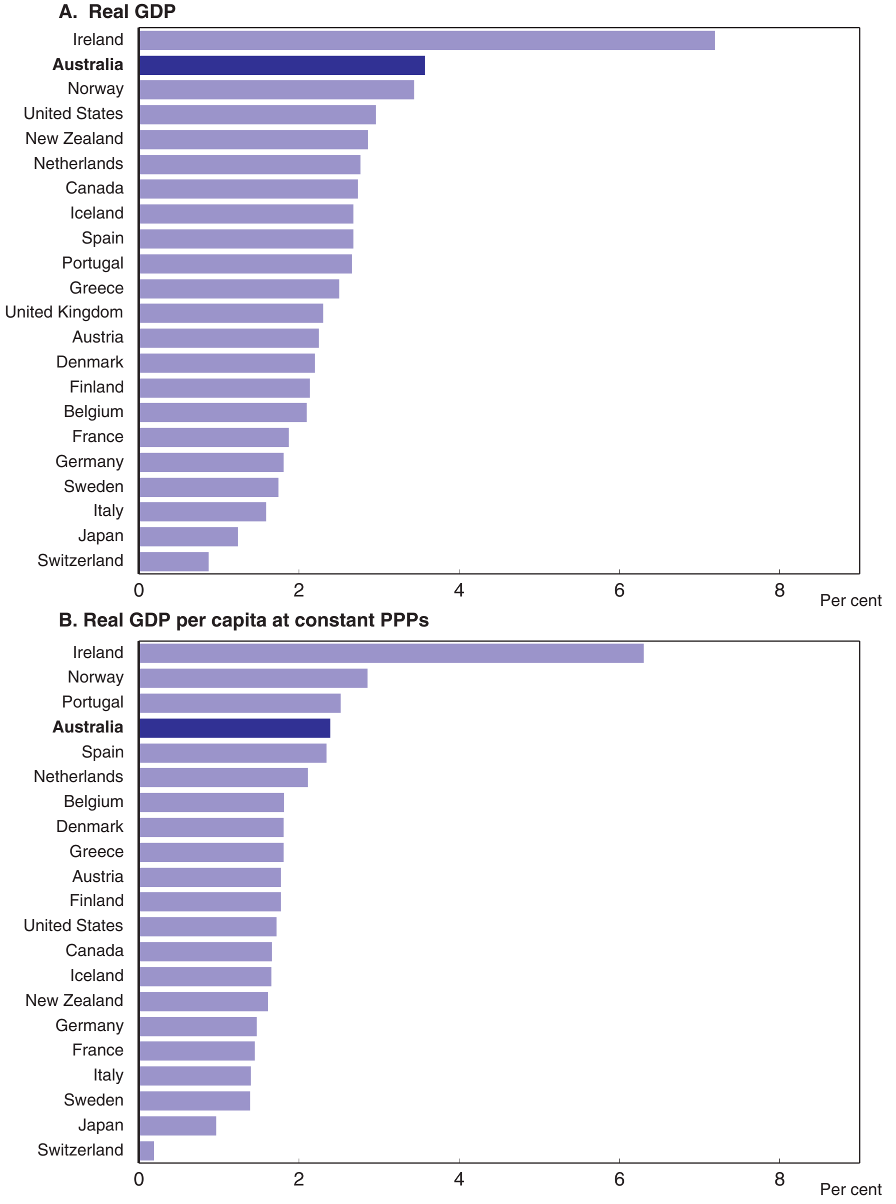
Rapid economic growth was underpinned by strong productivity gains

Australia's growth performance during the 1990s in overall terms and per capita has exceeded that of most other OECD countries, and is still on a rising trend (Figure 24). This is all the more remarkable as in recent years the Australian economy could have been potentially more affected than other OECD countries by two major external shocks, the 1997-98 East Asian crisis, and the global economic slowdown in 2001-02, which was associated with a slump in primary commodity prices as well as world equity prices. Nevertheless, Australia has experienced an only mild version of the sharply reduced business and consumer confidence in OECD countries. During both episodes, Australia's GDP growth stayed well ahead of nearly all other OECD countries.[94] This chapter throws some light on the reasons for the improved growth performance, and suggests ways in which it could be maintained or even strengthened.

There are compelling indications that the combination of sound macroeconomic policies and long-standing structural reforms have greatly enhanced the Australian economy's capacity to grow more quickly and respond more flexibly to shocks.[95] The absence of mounting inflation pressures during the recent long expansion period suggests an improvement in potential output growth (Figure 25). A production-function based analysis of Australia's potential[96] (or trend) GDP growth along the lines of standard growth accounting[97] exercises confirms this and helps identify the underlying sources of economic growth (Table 11). The decomposition suggests that most of the acceleration in potential output in the 1990s relative to the 1980s owes to improved labour productivity while the relative contribution of labour inputs declined somewhat, albeit from a relatively high level (see below). Indeed, the rate of growth in labour productivity over the latest productivity cycle[98] (1993 to 2000) was 3.0 per cent per year, up from 2.0 per cent during the cycle from the late 1980s to the early 1990s.

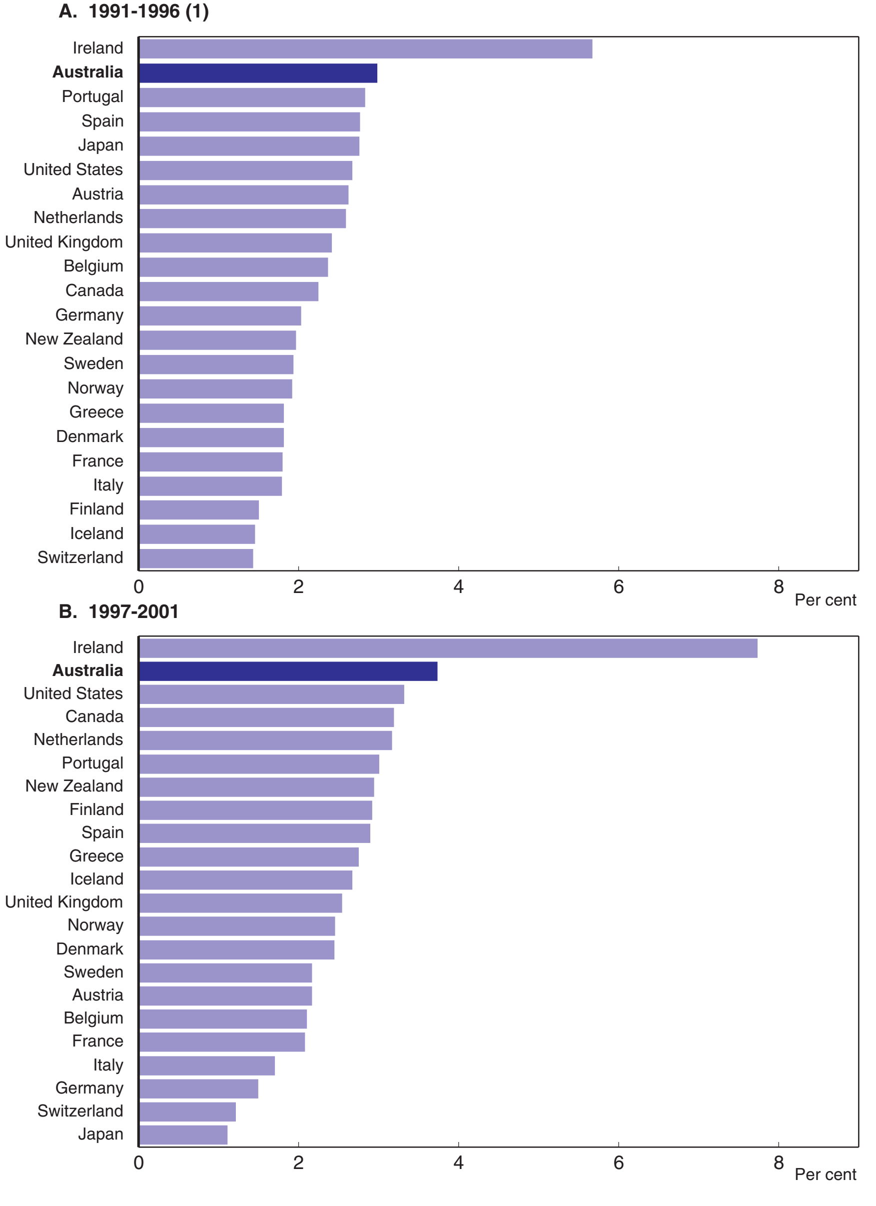
Much of the long-term trend gain in labour productivity can be ascribed to the increased use of capital equipment per unit of labour ("capital deepening"). However, a decomposition suggests that in more recent years, the growth of labour productivity[99] was primarily driven by higher growth of multi-factor productivity, hence by the more efficient use of resource inputs, and less by capital deepening. Figure 27

Figure 24. **Growth performance: an international comparison**
Annual average percentage changes over 1991-2001



Source: OECD.

Figure 25. **Estimates of potential output growth**
Annual average percentage changes over period



1. For Germany 1992 to 1995.
Source: OECD.

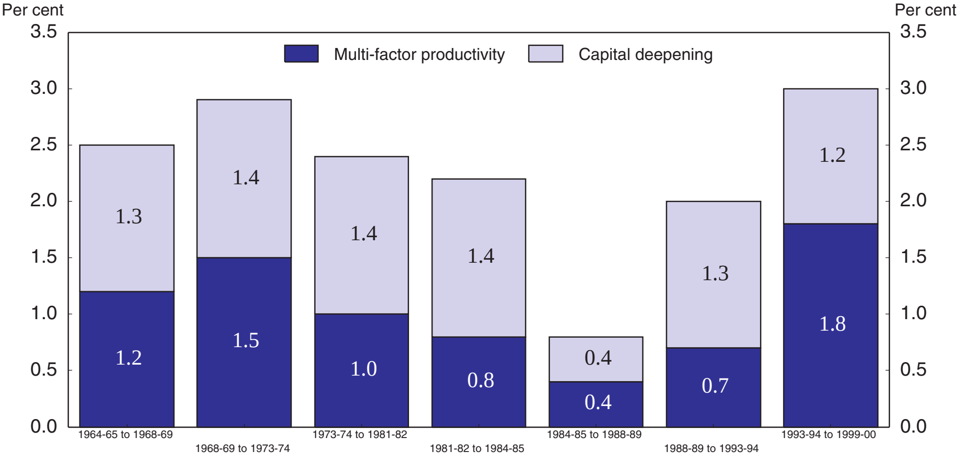
Table 11. **Decomposition of potential output growth**[1]

	Potential GDP	Labour productivity	Labour input	Decomposition of labour input: Working age population	Participation rate	Structural unemployment rate[2] (–)	Hours per person
Australia							
1981-85	3.2	1.6	1.5	1.8	0.3	–0.2	–0.3
1985-90	3.7	1.3	2.3	1.8	0.6	–0.1	–0.0
1990-95	3.0	1.5	1.4	1.1	0.4	–0.1	0.0
1995-98	3.6	2.1	1.5	1.3	0.2	0.1	–0.1
1998-01	3.9	2.3	1.6	1.4	0.1	0.3	–0.2
New Zealand							
1981-85	1.9	1.5	0.3	1.4	–0.1	–0.7	–0.2
1985-90	1.6	1.6	0.0	0.8	–0.2	–0.4	–0.2
1990-95	1.9	0.5	1.4	1.6	–0.0	–0.2	–0.0
1995-98	3.3	1.0	2.3	1.6	0.2	0.6	–0.0
1998-01	2.8	1.6	1.1	0.7	0.3	0.2	–0.1
United States							
1981-85	3.0	1.2	1.8	1.2	0.5	0.1	0.0
1985-90	3.0	1.2	1.7	1.2	0.5	0.0	0.0
1990-95	2.7	1.1	1.6	1.1	0.5	–0.0	0.0
1995-98	3.2	1.6	1.6	1.1	0.5	–0.0	0.0
1998-01	3.4	1.9	1.5	1.1	0.4	0.1	–0.0
Canada							
1981-85	2.8	1.1	1.7	1.2	0.8	–0.1	–0.3
1985-90	2.5	1.1	1.4	1.0	0.4	0.0	–0.1
1990-95	2.3	1.1	1.2	1.2	–0.0	–0.0	–0.0
1995-98	3.1	1.3	1.7	1.2	0.1	0.3	0.1
1998-01	3.5	1.5	1.9	1.2	0.3	0.3	0.1
OECD							
1981-85	2.8	1.9	0.9	1.1	0.3	–0.1	–0.3
1985-90	2.8	1.9	0.9	0.9	0.4	–0.1	–0.3
1990-95	2.6	1.5	1.2	1.1	0.5	–0.0	–0.3
1995-98	2.5	1.7	0.8	0.6	0.5	0.0	–0.3
1998-01	2.6	1.7	0.9	0.6	0.4	0.1	–0.2

1. Contributions (in percentage points) to the growth of potential output. Trend growth rates are used for all variables except population.
2. A decline in structural unemployment raises labour input.
Source: OECD.

Figure 26. **Growth in labour productivity over productivity cycles, 1964-65 to 1999-2000**[1]

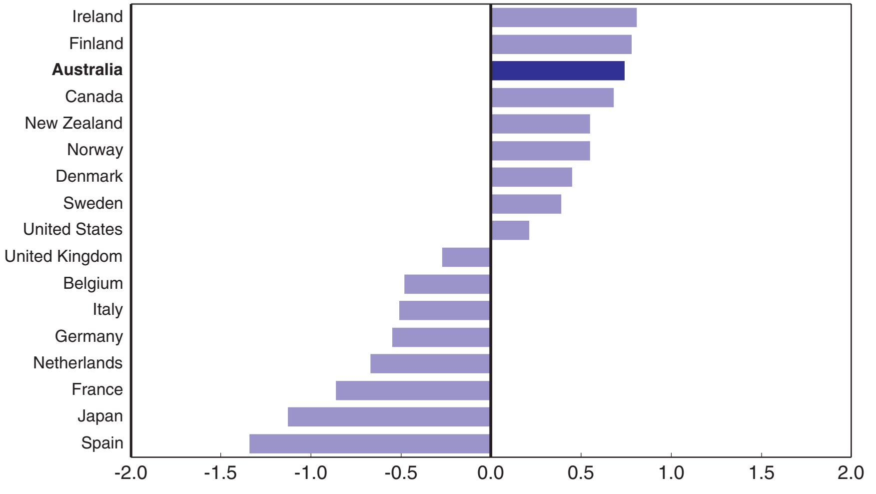
Percentage changes at annual rates



1. Productivity cycles are the intervals between productivity peaks, as identified by the Australian Bureau of Statistics.
Source: Productivity Commission.

Figure 27. **Changes in multi-factor productivity growth in selected OECD countries**

Average annual percentage change from 1980-90 to 1990-2000



Source: OECD, based on data for the OECD *Economic Outlook* June 2002; see Scarpetta *et al.* (2000) for details.

shows that the rate of growth in multi-factor productivity in the latest productivity cycle was 1.8 per cent per year, up from 0.7 per cent in the preceding cycle.[100] Accordingly, Australia moved to the group of better performing OECD countries in terms of multi-factor productivity growth in the 1990s (Figure 27).

There was a rapid uptake of information and communication technology...

Higher growth of trend productivity (and of GDP) in the 1990s was associated with the heavy use of information and communications technology (ICT) in Australia[101] (Box 2). The uptake of the new technology in Australia was encouraged by the relatively low prices of ICT investment and the comparatively low internet access costs (Figure 28). It is reflected in the strong increase in ICT investment[102] (Table 12) and, *inter alia*, the rapid development of electronic commerce.[103] It was the high degree of product market competition[104] that drove down the costs of ICT investment goods in Australia. OECD (2001d) shows that countries that moved early to liberalise their telecommunications industry now have much lower communications costs, and consequently, a wider usage and diffusion of ICT technologies than those that followed later on. ICT investment alone is not sufficient for faster growth – other OECD countries also had this strong investment in ICT, but did not experience an acceleration in productivity. This suggests that other factors were important in this growth acceleration.[105]

Box 2. ICT and productivity acceleration in Australia and the United States in the 1990s

The recent growth-decomposition analysis by Parham (2002b) attributes to ICT an impact contribution of 0.4 percentage point to the one percentage point *acceleration* of labour productivity growth in the recent productivity cycle compared with the preceding cycle (Table 13). However, the decomposition also shows that the more intense use of information technology in Australia was wholly offset by slower growth in the use of other forms of capital, thus a reduced "other-capital"-to-labour ratio. Hence, if taken at face value, the growth accounting exercise indicates that total capital deepening did not contribute at all to the *acceleration* in labour productivity in the latest productivity cycle, although there may have been a positive contribution in the second half of the 1990s (last column of Table 13).

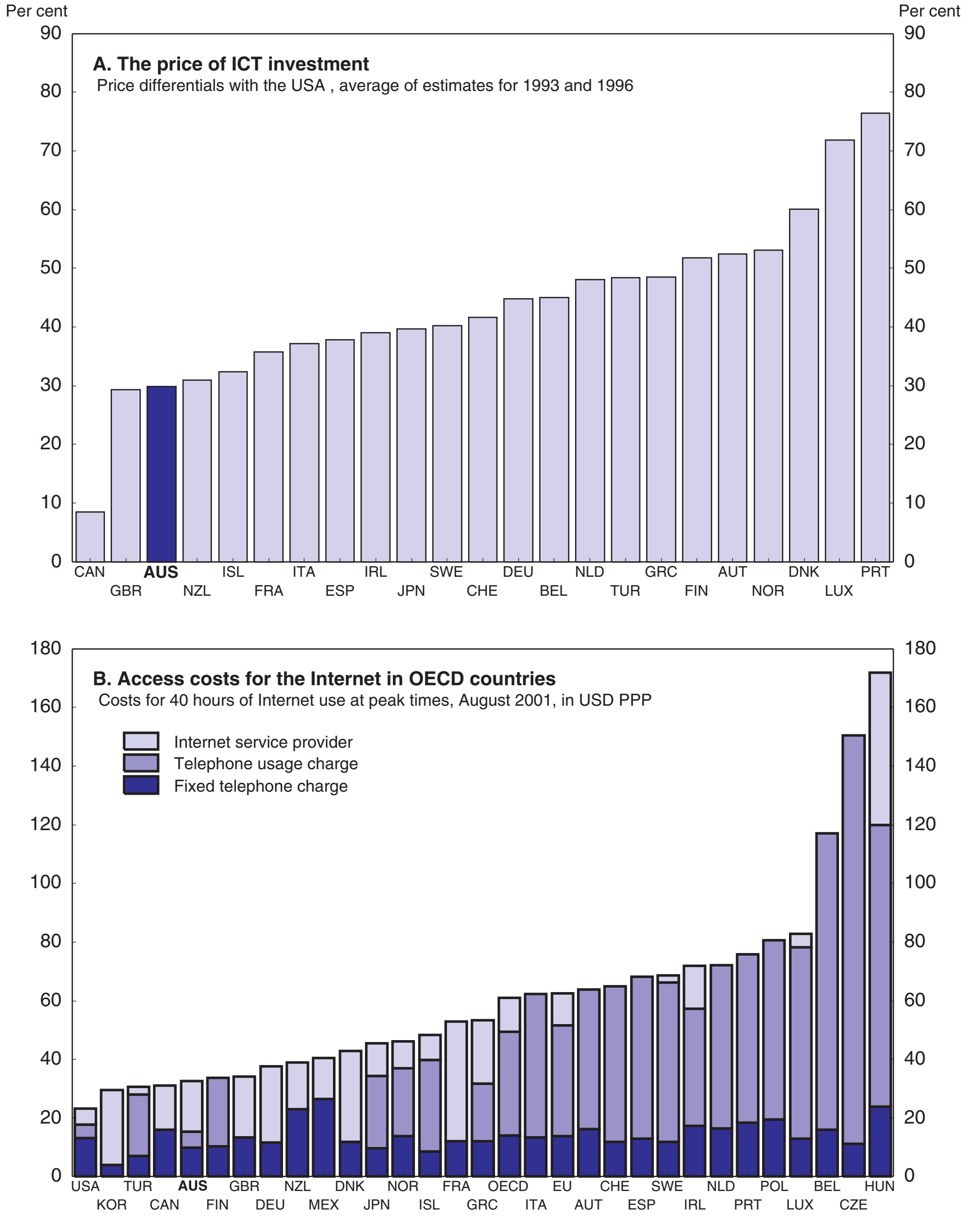
The results of an alternative growth accounting exercise for eight OECD countries including Australia were shown in OECD (2001d) and updated later on by Colecchia and Schreyer (2001). Rather than focussing on productivity gains, the analysis aims at quantifying the contribution of ICT investment to GDP growth from the 1980s to the 1990s. For Australia, the study suggests a GDP-growth contribution

Box 2. ICT and productivity acceleration in Australia and the United States in the 1990s (*cont.*)

from ICT of 0.5 percentage point both in the second half of the 1980s and in the first half of the 1990s, hence no ICT-induced growth acceleration. During the second half of the 1990s, when average GDP growth amounted to 4.1 per cent as compared to 2.8 per cent in the first half, the ICT contribution rose to 0.8 percentage point. Hence, of the acceleration of real GDP growth of 1.3 percentage points, the decomposition attributes one-third of a percentage point to the intensified use of ICT. Accordingly, this leaves unexplained a substantial average growth residual of 1 percentage point per year. Colecchia and Schreyer also conclude that microeconomic reforms have helped the adoption of ICT, and that ICT diffusion is interacting with organisational and innovation factors in generating a positive impact on productivity and output growth. To sum up, ICT seems to have been to some extent one of the sources of the productivity surge of the 1990s. This leaves open the question as to the other sources; the most plausible appears to be the microeconomic reforms since the mid-1980s, a view which is supported by a growing number of studies. These reforms addressed financial markets, industry assistance, taxation, government enterprises, regulation, labour markets and industrial relations, competition policy, innovation and education and training. All of them aimed at improving the allocation of resources and raising overall productivity by encouraging flexibility in the economy on a broad basis, and fostering a more outward-oriented business culture.

1. Parham's (2002b) estimate of the contribution of ICT capital deepening to the acceleration of average labour productivity in the United States in the 1986 to 1992 cycle to the 1992 to 2000 cycle is 0.3 percentage point, hence of the same magnitude as for Australia. This appears remarkable as the United States is a major producer of ICT, while Australia ranks at the low end of OECD countries in terms of the size of its ICT equipment production sector. It is supportive of the view that it is primarily the use of ICT and not so much its production that counts for the effect on productivity and economic growth. This is demonstrated by the examples of Australia and Japan: whereas the former has a very small ICT producing sector and benefited markedly from ICT capital services, the latter has one of the largest IT hardware producing sectors of OECD countries, but did not exhibit above-average productivity or GDP growth contributions from ICT equipment in the 1990s.
2. Table 11.
3. Their analysis uses a newly compiles database of investment in ICT equipment and software based on the System of National Accounts 1993 (SNA93). They conclude that ICT diffusion plays a key role and depends on the right framework conditions, not necessarily on the existence of an ICT producing sector.
4. See Parham (2002c) who addresses and rejects alternative explanations of the recent productivity surge such as measurement errors in output and labour inputs, higher work intensity, cyclical effects etc. See also the studies by the Productivity Commission (1999b), Bean (2000), Dowrick (2000), Forsyth (2000) and Parham (2002a, b).

Figure 28. **Factors promoting the use of ICT**



Source: OECD, *Communications Outlook* 2001.

Table 12. **Share of ICT investment in total non-residential investment**

Current prices, 1980-2000[1]

		Australia	Canada	Finland	France	Germany	Italy	Japan	United Kingdom	United States
IT equipment	1980	2.2	3.9	2.0	2.5	4.6	4.1	3.3	2.9	5.1
	1990	5.5	4.5	3.6	3.5	5.5	4.2	3.8	6.0	7.0
	1995	8.4	5.7	4.0	3.9	4.6	3.5	4.6	8.6	8.7
	2000	7.2	7.9	2.9	4.4	6.1	4.2	5.2	8.4	8.3
Communications equipment	1980	4.0	3.0	3.2	2.9	3.9	4.0	3.4	1.6	7.1
	1990	3.8	3.8	3.9	3.2	4.8	5.7	4.0	2.0	7.5
	1995	4.7	4.0	9.3	3.5	4.2	6.7	5.3	3.6	7.3
	2000	5.6	4.2	15.3	3.9	4.3	7.2	6.9	3.6	8.0
Software	1980	1.1	2.2	2.6	1.3	3.6	1.7	0.4	0.3	3.0
	1990	4.6	4.9	5.2	2.6	3.7	3.8	3.1	2.1	8.0
	1995	6.4	7.1	9.2	3.5	4.5	4.3	4.0	3.5	10.1
	2000	9.7	9.4	9.8	6.1	5.7	4.9	3.8	3.0	13.6
ICT equipment and software	1980	7.3	9.1	7.8	6.8	12.2	9.7	7.0	4.8	15.2
	1990	13.9	13.2	12.7	9.4	13.9	13.7	10.8	10.1	22.5
	1995	19.5	16.8	22.5	10.8	13.3	14.4	13.8	15.6	26.1
	2000	22.5	21.4	28.0	14.4	16.2	16.3	16.0	15.0	29.9

1. 1999 for Finland, Italy and Japan.

Source: Colecchia and Schreyer (2001).

Table 13. **Contribution of ICT to labour productivity acceleration in Australia and the USA in the 1990s**

	USA[1]	USA[2]	Australia[3]	Australia[2]
Labour productivity acceleration	**0.5**	**1.2**	**1.0**	**1.3**
Capital deepening	**0.2**	**0.6**	**–0.1**	**0.3**
ICT capital	0.3	0.5	0.4	0.5
Other capital	–0.2	0.1	–0.5	–0.1
MFP contribution[4]	**0.3**	**0.6**	**1.1**	**1.0**

1. Growth from 1992 to 2000 less growth from 1986 to 1992.
2. Growth from 1995 to 2000 less growth from 1990 to 1995.
3. Growth from 1993-94 to 1999-00 less growth from 1988-89 to 1993-94.
4. MFP growth for the US includes the contribution to labour productivity growth from labour quality.

Source: Parham (2002b).

… but structural reforms have played a key role in raising Australia's economic potential

The comparatively rapid uptake in Australia of ICT has moved Australia from a technological laggard[106] to the forefront of new technology. It is plausible to ascribe this in part to policies which strengthened competition and thus sharpened the incentives to be more productive. Among these policies were the major unilateral reductions in tariffs and quotas on imports of manufacturers, the reduction of regulatory restriction in product markets and the introduction of more flexibility into the labour market. They also encouraged the adoption of new production processes and firm organisation, for example through multiskilling, performance-based remuneration, the introduction of split shifts and the reduced rigidity of job demarcations.[107]

The move to a more flexible industrial relations system

The reforms of industrial relations arrangements in Australia played a pivotal role in the adoption of new work practices, organisational procedures and modern technologies. Industrial relations reforms began already in early 1987 and were intensified through the implementation of the Commonwealth's *Workplace Relations Act* 1996 (WRA), which removed important barriers to decentralised bargaining, especially for small and medium-sized firms. Previously, labour relations were often highly adversarial, with the emphasis being on distributional issues rather than the efficiency of the work process. Wages and conditions of work for most categories of labour were specified by a complex system of highly prescriptive, centrally-determined awards,[108] based on compulsory arbitration by federal or State Industrial Relations Commissions. The focus of these awards at the industry or occupational level served to promote a relatively high degree of uniformity across enterprises.

With wage increases bearing little relation to the performance of the either the firm or the employee, there were few incentives for workers to co-operate in the removal of inefficient work practices. This was embedded in a business culture that did not emphasise performance improvement, with management generally focussing on the domestic market and often employing outdated technologies.

The reforms introduced a large measure of regulatory flexibility in the industrial relations system[109] especially by facilitating and encouraging the setting of wages and employment conditions at the enterprise level. Among the many provisions designed to support decentralised bargaining were increased protection for freedom of association, a ban on union preference clauses in agreements and awards and a strengthening of the Australian Industrial Relations Commission's powers to give directions to stop or prevent unprotected industrial action.

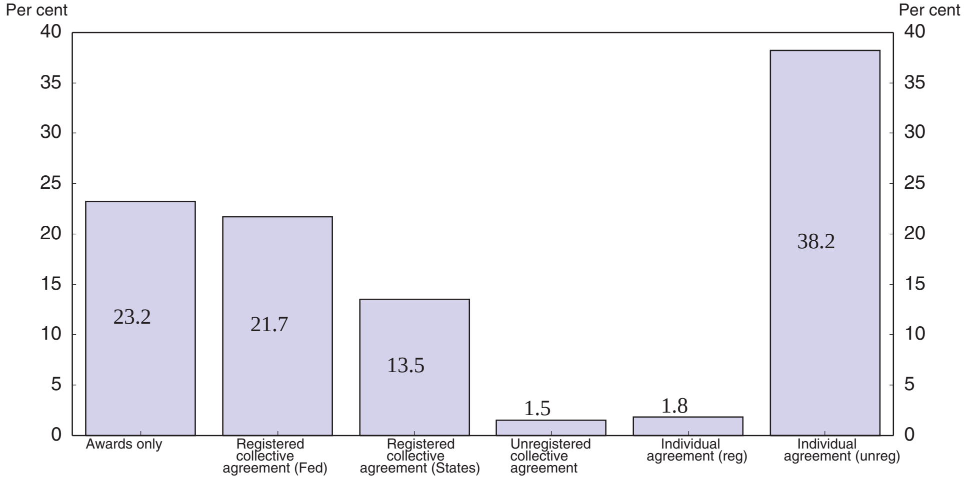
The move to decentralised agreement making was underpinned by fundamental changes to the award system, which aim at restricting its role to a safety net of *minimum* wages and other core conditions of employment, rather than, as previously, detailed prescriptions of *actual* wages and conditions. Legislation was introduced which confined the formerly comprehensive coverage of awards to twenty "allowable matters", with all other terms of employment being settled at enterprise or workplace level. Thus, "paid rates" awards (determining pay rates exceeding the minimum award rate) were phased out. Workers on enterprise or individual agreements which are not comprehensive, that is, do not cover all conditions of employment, may still remain under an award with respect to particular conditions of employment. Employees who are not covered by collective or individual bargains, currently around a quarter of the labour force, retain access to minimum rates of pay and employment conditions *via* the award system. The Australian Industrial Relations Commission arbitrates claims to adjust the minimum safety net, but has little scope to set terms and conditions above the minimum. This restricted the power and the role of the Australian Industrial Relations Commission in agreement making.

The *Workplace Relations Act* 1996 also introduced legislation aimed at simplification of the highly complex award system, to make awards less prescriptive and more accommodating to the varying circumstances of different workplaces and enterprises. Award simplification goes together with a reduction in their overall number, by providing a convenient opportunity for the industrial parties to amalgamate or consolidate multiple federal awards applying in a particular industrial sector or a particular enterprise. Close to 1000 federal awards have been simplified since 1997, and over 850 have been set aside by the AIRC. At present there are some 4 500 awards in operation, 2 000 of them in the state jurisdictions.

Progress in implementing decentralised bargaining

The recent study of the Department of Employment and Workplace Relations (2002d) on *Agreement making in Australia under the Workplace Relations Act: 2000 and 2001* reports a marked fall in the proportion of employees who were reliant on arbitrated awards for pay rises, from 67 per cent of employees in May 1990 to 21 per cent in May 2002.[110] About 37 per cent of the labour force had their salaries set under the provisions of either federally or State registered collective agreements in May 2002, while 42 per cent of the workforce were covered by individual agreements (Figure 29). Most of the individual agreements were based on common law contracts, hence were not registered by federal or State industrial commissions. Only a small proportion of the labour force had their pay set by individual agreements registered by federal or State industrial commissions.[111] However, the sizeable share of the workforce covered by informal agreements is in line with the main intention of the reform, to create a system whereby employers and employees could determine their own agreements with as little involvement as possible from third parties. In the absence of a prescriptive system of awards, informal arrangements satisfy this objective even better than do registered agreements.[112] The proportion of employees whose pay was set by awards tended to fall as the occupation level became more skilled, and the shift towards individual agreements was most marked among the skilled to highly skilled occupations. The report also indicates that agreements are increasingly being tailored to the individual needs of organisations, as they include more provisions than before and cover a wider range of employment conditions.

Figure 29. **Workplace pay agreements**
All employees, May 2000



Source: Unpublished data from ABS cat. No. 6306.0, Employees earnings and hours (EEH), May 2000, final.

Faster growth and the role of labour

The decomposition of trend growth of labour inputs into potential output growth as shown in Table 11 suggests that a reduction of (estimated) structural unemployment – as approximated by the NAIRU – made a positive, albeit small contribution to economic growth in recent years. Given its still relatively high level – NAIRU estimates typically range between 5 to 6 per cent of the labour force – there is ample room for reducing structural unemployment through policies which enhance the flexibility of the labour market.[113] Apart from their direct positive social impact, such policies would promote potential output growth *via* increased labour utilisation.

There was also a positive, though recently declining contribution from the ongoing rise in labour force participation. Both employment-to-population ratios and labour force participation ratios are still on a rising trend and above OECD averages. The increasing integration of women in the labour force more than compensated for the trend decline in the labour force participation of men. Nevertheless, there are a number of OECD countries where both the employment to population ratio and participation rates are substantially higher (Table 14). Moreover, employment-to-population ratios and labour force participation of persons aged over 55 are substantially lower than those of persons of prime working age in Australia (and generally elsewhere). Hence, the ongoing move of the large "baby-boomer" cohort out of the high-participation prime-age group into the low-participation group over 55 risks lowering aggregate labour force participation if there are not counteracting factors. Policies to maintain high economic growth need to strengthen the incentives for labour force participation. This will be discussed below in the context of the implementation of the government's welfare reform package. Another factor to counter a trend decline in workforce participation is migration, which is discussed in Chapter IV.

The role of skills in the growth process

The OECD's analysis[114] of the causes of divergent growth performance noted that in Member countries in general, growth in labour productivity has been influenced, *inter alia*, by changes in the quality of labour. Growth regressions[115] over the past quarter of century (Table 15) gave a positive estimated effect of investment in human capital on per capita growth in Australia, probably reflecting the marked rise in education levels over the past two decades. The estimated coefficient for Australia was the fourth-highest of OECD countries,[116] which suggests particularly high returns to investment in education in Australia in the long run.[117]

However, recent research by Barnes and Kennard (2002) based on preliminary ABS data for "quality-adjusted" labour inputs, which take account of gender, educational attainment and workforce experience, found no *direct* contribution[118] of the increase in skills in the workforce to the productivity surge of the 1990s (Table 16). This

Table 14. **International comparison of employment/population ratios and participation rates**[1]

Persons aged 15-64 years

	Employment/population ratio (per cent)			Labour force participation rate (per cent)		
	1990	1998	2001	1990	1998	2001
Australia	67.9	67.2	68.9	73.0	73.0	73.8
Canada	70.3	68.9	70.9	76.6	75.2	76.5
France	59.9	59.4	62.0	66.0	67.4	68.0
Germany	64.1	64.7	65.9	68.4	71.4	71.6
Ireland	52.1	59.6	65.0	60.1	64.8	67.5
Japan	68.6	69.5	68.8	70.1	72.6	72.6
New Zealand	67.3	69.5	71.8	73.0	75.2	75.9
Spain[2]	51.1	52.4	58.8	60.9	64.5	65.8
Switzerland[3]	79.7	78.0	79.1	79.7	81.0	81.2
United Kingdom[2]	72.5	71.2	71.3	77.8	75.9	74.9
United States[2]	72.2	73.8	73.1	76.5	77.4	76.8
European Union	61.4	61.7	64.1	67.4	68.6	69.2
OECD Europe	61.0	60.6	61.1	66.7	67.0	66.8
Total OECD	65.1	65.2	65.3	69.4	70.1	69.8

1. Ratios refer to persons aged 15 to 64 years who are in employment or in the labour force divided by the working age population.
2. Refers to persons aged 16 to 64.
3. The first year refers to 1991.

Source: OECD *Labour Force Statistics*, 1981-2001, Part III, Paris.

Table 15. **Decomposition of country deviations from OECD average per capita output growth rates**[1]

1970s-1990s, annual percentage point growth rates

	Annual average growth rate	Growth differential	Initial conditions (real GDP/ population	Investment share	Human capital	Population growth	Variability of inflation	Government consumption	Trade exposure	Residual country specific effect
Australia	1.68	0.13	–0.37	0.20	0.52	–0.25	0.03	0.01	–0.41	0.40
Austria	1.57	0.02	–0.41	0.07	0.26	0.01	0.05	0.00	0.03	0.01
Belgium	1.66	0.11	–0.53	0.02	–0.15	0.20	0.03	–0.05	0.53	0.06
Canada	1.32	–0.23	–0.90	–0.21	0.62	–0.18	0.04	–0.07	0.14	0.32
Denmark	1.69	0.14	–0.57	0.28	0.21	0.12	0.02	–0.14	–0.05	0.27
Finland	1.82	0.27	0.51	0.05	0.02	0.15	0.00	–0.06	–0.26	–0.14
France	1.35	–0.20	–0.59	–0.09	–0.10	0.07	0.07	–0.08	0.05	0.48
Greece	1.15	–0.40	2.00	0.19	–0.56	–0.07	–0.16	0.17	–0.51	–1.48
Ireland	3.02	1.47	1.54	–0.18	–0.32	–0.18	0.01	0.09	0.17	0.34
Italy	1.73	0.18	0.22	–0.13	–0.69	0.13	0.02	0.01	0.14	0.48
Netherlands	1.26	–0.29	–0.47	–0.03	0.25	0.01	0.06	–0.13	0.52	–0.50
New Zealand	0.53	–1.02	0.34	–0.17	0.31	–0.29	–0.07	0.10	–0.36	–0.87
Norway	1.72	0.17	–0.12	–0.05	0.35	0.07	0.03	–0.06	–0.04	–0.01
Portugal	2.15	0.60	2.56	0.58	–1.20	0.07	–0.10	0.10	0.11	–1.52
Spain	1.28	–0.27	0.73	0.04	–1.12	0.00	0.03	0.07	–0.14	0.11
Sweden	1.20	–0.35	–0.60	–0.10	0.21	0.11	–0.10	–0.17	0.01	0.30
Switzerland	0.81	–0.74	–1.75	0.08	0.59	–0.04	0.00	0.15	0.02	0.21
United Kingdom	1.63	0.08	0.05	–0.21	0.17	0.15	–0.03	–0.02	0.31	–0.34
United States	1.93	0.38	–1.62	–0.34	0.63	–0.09	0.07	0.09	–0.25	1.89

1. Decomposition of cross-country differences in annualised growth rate (in per cent) from the average output per capita of 1974-77 to the average output per capita of 1994-97. See Bassanini A. and S. Scarpetta (2001) for details of the analytic approach behind these results.

Source: OECD.

Table 16. **Contribution of skill composition change to multi-factor productivity growth**[1]

	1984-85 to 1997-98 (a)	1984-85 to 1988-89 (b)	1988-89 to 1993-94 (c)	1993-94 to 1997-98[2] (d)	Acceleration (d)-(c)
Labour services	1.6	3.7	0.1	1.4	1.3
Equals:					
Labour quantity (hours worked)	1.3	3.3	–0.2	1.4	1.6
Plus					
Skill composition change[3]	0.3	0.5	0.3	0.1	–0.2
Conventional MFP growth	0.9	0.4	0.7	1.7	1.0
Skill-adjusted MFP growth	0.8	0.2	0.5	1.7	1.2
Contribution of skill composition change to conventional MFP growth	0.2	0.3	0.2	0.0	–0.2

1. Components may not add to total due to rounding.
2. 1997-98 is not a peak but later skill data are not available.
3. The period of most increase in skill, 1986-87 to 1990-91, crosses two MFP peak-to-peak periods.

Source: Barnes and Kennard (2002).

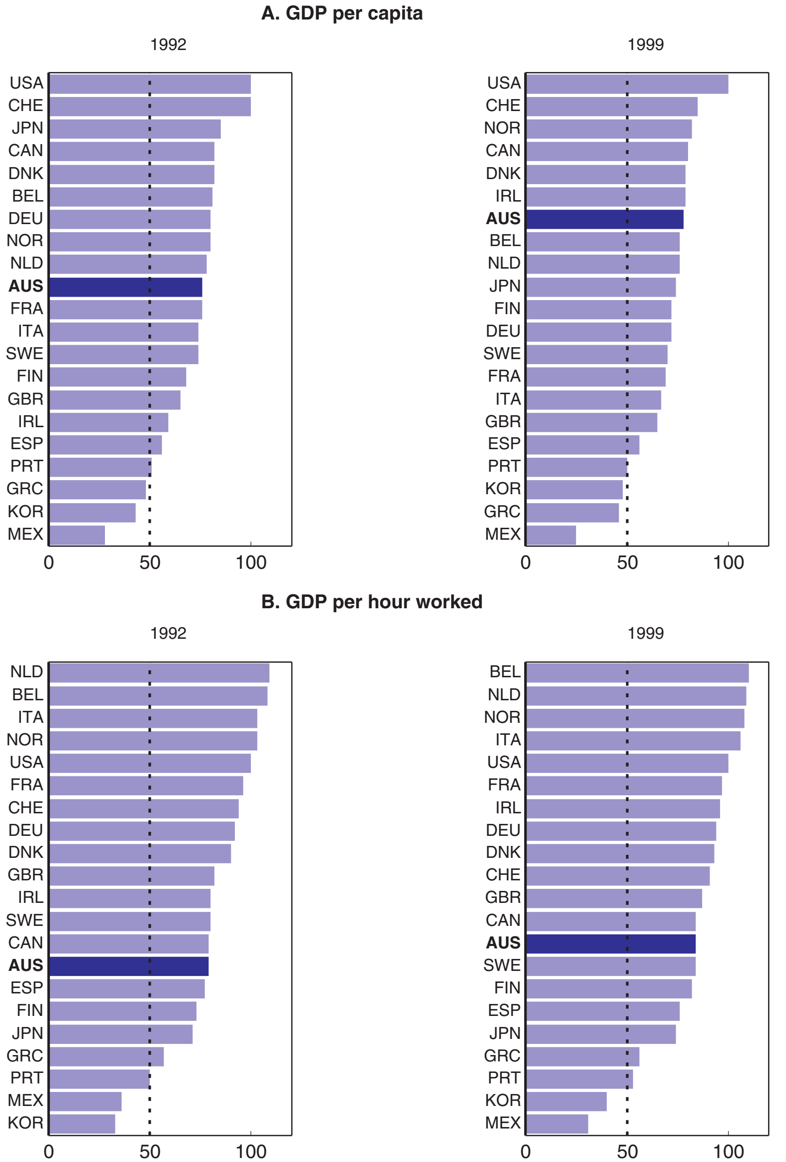
probably reflects the typically long lags between policy action to improve the education system and economic performance. More specifically, it seems that enhanced female retention at school (and increased female labour force participation) in recent years have not yet shown large effects on "quality-adjusted" labour input data because of the relatively low weight of the respective groups in the workforce and because of the time needed for a change in school retention to flow through to changes in the composition of the workforce.

Going forward

The foregoing suggests that Australia's good macroeconomic performance in the past ten years (relative to both other OECD countries, and to its own previous history) owes much to structural reforms that have encouraged producers to minimise costs and to innovate, and to suppliers of labour to be more flexible in working arrangements and compensation. It is very likely that the impact of the major reforms in labour and product markets on MFP growth will be felt for some years to come, as will the benefits of wider use of, and better adaptation to, new technologies. This raises the question of policy directions for the future, apart from dealing with unfinished business, for example as regards taxation or remaining privatisation.

Notwithstanding the recent high growth of productivity, GDP and per capita income, Australia's income and productivity *levels* are still exceeded by a number of OECD countries (Figure 30). Indeed, although Australia's per capita GDP relative to that of the United States improved by 4 percentage points from 1990 to 2001, to

Figure 30. **International comparison of income and productivity levels**
United States = 100



Source: OECD, *Science, Technology and Industry: Scoreboard of indicators* (2001).

78 per cent of the US per capita GDP, this was the same ratio as in 1950. GDP per hour worked moved from 77 per cent in 1990 to 83 per cent of that of the United States in 2001 but remains even further below hourly productivity in some European countries. While comparisons are fraught with measurement problems and reflect in part fundamental differences in endowments and geography of the economies compared, they suggest that there remains substantial scope for the Australian economy to catch up with the highest performers among OECD countries The potential to narrow the gap to richer OECD countries in terms of per capita GDP could be achieved by a continuation of Australia's outstanding productivity performance, assisted by more and better labour inputs. The latter will be influenced both by policies to encourage participation and by improving education and training. The maintenance of higher growth and enhanced integration of labour into the economic growth process would also strengthen the tax base.

A challenge that faces Australia, as other Member countries, is adapting to an ageing society. The purely fiscal implications of public pensions in the Australian case are not particularly preoccupying, because the pay-as-you-go Age Pension element is small relative to average wages, and the demographic structure is less unfavourable (in part because of sustained immigration – see next Chapter). Nevertheless, official estimates of the fiscal impact of ageing, reflecting higher expenditures on health and care services for an older population, as well as on other age-related expenditures and revenues, suggest a significant rise in fiscal pressure relative to GDP on the basis of current trends and parameters. This emerging burden could be lightened by policies that raise productivity and labour force participation. Assuming no adverse impact of such policies on equity or the work/leisure trade-off, these are policies that are desirable even in the absence of age-related fiscal pressures.

The remaining part of this chapter discusses a selected number of issues that are relevant in this context. These are the productivity-enhancing reforms to the industrial relations system, labour market assistance, initiatives to make the education and training system more efficient, competition policy, and financial market reform, and the overhaul of the welfare system to raise participation rates. The chapter also contains a section on the pension system, which complements the discussion the cost of the health care system in Chapter II, as well as a review of policies towards the achievement of globally sustainable economic growth. A synopsis of the recent progress made in structural reforms is given by Table 17.

Remaining problems in industrial relations

The role of awards

The present Australian industrial relations system is characterised by the co-existence of negotiated enterprise agreements and arbitrated awards. This

Table 17. **Implementing structural reform: an overview**

Proposal	Actions taken	Assessment/recommendations
I. Increase the flexibility of wages and employment conditions		
– Make further efforts to arrive at a decentralised industrial *relations* system based on enterprise bargaining.	– Implementation of the *Workplace Relations Act* 1996 (WRA) in early 1997.	– Ease regulatory requirements further so as to encourage comprehensive enterprise agreements(as opposed to "add-ons" to awards).
– Simplify the complex and prescriptive award system.	– The WRA restricts awards to 20 "allowable matters" in order to confine awards to a safety net of minimum wages and core conditions of work.	– Reduce the number of allowable matters further.
– Increase in award wage rates should be modest and focus on the low paid, consistent with the intention that awards operate as a safety net.	– May 2002 "Safety-Net Review" delivered an increase in the federal minimum wage of 4.4 per cent.	– Wage increases should reflect the employment prospects of the low skilled.
– Avoid practice of pattern bargaining.	– *Workplace Relations Amendment* (*Genuine Bargaining*) *Bill* 2002 reinforces the focus of agreements on local circumstances.	– Implement rapidly.
– Contain damage from industrial action.	– *Workplace Relations Amendment* (*Secret Ballots for Protected Action*) *Bill* 2002 requires secret ballots at the workplace to authorise protected industrial action.	– Implement as soon as possible.
– Harmonise federal and State industrial relations systems to reduce compliance costs.	– The Commonwealth Government explores the option of basing industrial relations on the Constitution's corporations power.	– Option should be assessed carefully.
– Reform employment protection legislation, limiting the disincentives to hiring.	– *Workplace Relations Amendment* (*Termination of Employment*) *Act* 2001 reinforces disincentives to speculative and unfounded claims in the context of termination of employment. Two additional Bills of 2002 aim at exempting small businesses and short-term casual workers from unfair dismissal law.	– Consider more general reform of the legislation.

Table 17. **Implementing structural reform: an overview** (*cont.*)

Proposal	Actions taken	Assessment/recommendations
II. Reform income support system		
– Make employment assistance more responsive to client needs and enhance its efficiency by introducing competition into the market.	– The employment services market (*Job Network*) commenced on 1 May 1998, comprising around 200 private and public government providers. The second Employment Services contract runs from February 2000 to June 2003. The new *Active Participation Model* will integrate *Job Network* services with *MutualObligation* activities.	– Encourage more transparency in the market for vacancies to prevent possible hoarding by Job Matching providers. Avoid "parking" of disadvantaged job-seekers in the *Intensive Assistance Programme*. Reduce costliness and complexity of the *Job Network* tender process.
– Reform activity-tested income support to promote more active job search	– The Commonwealth Government introduced its Mutual Obligation initiative which makes benefit eligibility dependent on participation in approved activities.	– Co-ordinate Intensive Assistance with Mutual Obligation and Work for the Dole programmes.
	– Introduction in the 2001-02 Budget of a comprehensive welfare reform package – *Australians Working Together* – which extends the Mutual Obligation requirements to 35-49 years olds; provided for a phased introduction of Participation requirements to qualify for Parenting Payments; and introduced a "Working Credit", which reduces the amount of income counted under the income test.	– Extend the Mutual Obligation principle to all beneficiaries of working age. – Monitor closely and rigorously the fulfilment of participation requirements under the Mutual Obligation principle. – Lower further the high marginal effective tax rates.
	– Measures in the 2002-03 Budget to improve the work capacity of people with disability and to tighten the eligibility requirements for Disability Support Pension.	– Measures were rejected by the Senate.

Table 17. **Implementing structural reform: an overview** (*cont.*)

Proposal	Actions taken	Assessment/recommendations
III. Improve the education and training system		
– Reform the apprenticeship and traineeship systems to facilitate the development of vocational education and training (VET).	– Introduction in 1997 of *The New Apprenticeship Scheme*.	– There has been considerable growth in structural training arrangements.
		– VET is becoming better adapted to client needs.
	– Establishment of *The National Training Framework* in 2001.	– The training market is developing steadily.
– Tailor education and training system closer to the labour market needs.	– Introduction of the *User Choice* initiative in 1998	– Further develop and strengthen pathways from school to work, especially for those young persons most at risk of experiencing difficulty.
	– Development of a new *Framework for Vocational Education in Schools* which spans all years of Education.	– Reduce the incidence of early school leaving.
	– Development of a cohesive *National Transition System* to provide immediate assistance to young people in school to work transition.	
– Proceed with the planned review of the higher education system.	– Release of a consultation paper, in March 2002, on the review of higher education.	– Introduce more flexible funding arrangements for higher education, while providing an access on an equitable basis and prompting high quality of teaching and learning.

Table 17. **Implementing structural reform: an overview** (*cont.*)

Proposal	Actions taken	Assessment/recommendations
IV. Enhance product market competition		
– Implement remaining parts of the National Competition Policy programme.	– The NCC's 2002 Assessment of Governments' Progress in Implementing National Competition Policy on which phased payments to States will depend was released 6 December 2002. – Review of nearly 1 800 pieces of Commonwealth and State legislation is under progress.	– Accelerate full contestability in electricity markets, completion of rural water reform and road transport Reform. Enhance competition in fixed-line telephony and open up postal services market More progress should be made on reforms affecting small businesses.
– Make large cuts in the high tariffs for cars, footwear, clothing and textiles.	– None.	– Recommendation maintained.
V. Reform the health care system to achieve social objectives more efficiently		
– Containing growth in the Pharmaceutical Benefit Scheme.	– Measures were undertaken in FY 2000-01 to improve the management of Pharmaceutical Benefits Scheme medications and the Monitoring of pharmaceutical benefits entitlement. – The 2002-03 Budget announced an increase in the patient co-payments for prescriptions; it also incorporated a package of measures to improve the quality use of the PBS medicines and to ensure that these medicines are prescribed appropriately.	– These measures will help containing costs and ensure the sustainability of the PBS. The released savings will provide the means for continuing access to new and expensive medicines.
– Achieving a better balance in the private/ public mix of financing and delivery of health and aged care	– Introduction of a 30 per cent non-means-tested rebate on the costs of private health insurance membership on 1 January 1999. – Implementation from July 2000 of the "Lifetime Health Cover" scheme enabling health care funds to charge different premiums, depending on the age the at which individuals first buy health insurance.	– This will improve the affordability of private health care and enhance the health options. – The scheme reduces costs over time by encouraging people to joint a health fund earlier in life and maintain their membership.

Table 17. **Implementing structural reform: an overview** (*cont.*)

Proposal	Actions taken	Assessment/recommendations
VI. Reforms to cope with population ageing		
Raise the preservation age for superannuation benefits to that required for access to the age pension (*i.e.* 65).	– The government has legislated a phased increase in the preservation age from 55 in 2015 to 60 by 2025.	– Recommendation maintained.
– Limit the value of owner-occupied housing that is exempt from the means (assets) test for the age pension.	– None.	– Recommendation maintained.
– Simplify the tax treatment of superannuation	– Proposal to amend the tax rules on superannuation benefits.	– Recommendation maintained.
VII. Reform the tax system		
– Replace whole sales tax (WST) by general consumption tax.	– In July 2000, the WST was abolished and a goods and services tax (GST) introduced.	– The introduction of GST and abolition of a number of State indirect taxes will substantially reduce the economic costs of taxation.
– Reduce high effective marginal tax rates and alleviate poverty trap problem.	– The July 2000 tax package reduced marginal income tax rates for most taxpayers.	
– Reduce gap between the top personal marginal income tax rate and the company tax rate.	– Introduction of measures in July 2000 of integrity provisions (the alienation of personal services Income measures).	– These measures prevent tax avoidance by imposing restrictions on the ability of an individual to retain personal services income in an entity and on deductions which can be claimed. Efforts towards this direction should continue.
– Increase the tax-free income level	– None.	– Raises concerns about equity, as well as work and savings incentives.
– Abolish inefficient state indirect taxes.	– Debits tax will be abolished by 1 July 2005, subject to review by the Ministerial Council. In addition, the Ministerial Council will by 2005 review the need for a range of other inefficient State taxes.	– Accelerate the abolition of the debits tax to enhance the efficiency gains from the tax reform.
– Reform the States' narrow-based payroll tax and determine the role of environmental taxes in Achieving ecological objectives.	– None.	– Recommendation maintained.

Source: OECD Secretariat.

offers the workforce a wide choice with respect to their working arrangements and conditions, but it has also slowed the move to decentralised bargaining and may reduce productivity. Comprehensive enterprise agreements that can completely replace all the issues covered by awards are not yet widespread. Latest data for 2001 indicate that only some 8 per cent of all certified enterprise agreements were comprehensive, covering about 14 per cent of the labour force. Most agreements between individual employers and their employees operate in conjunction with an award as a benchmark around which wages and other employment conditions are negotiated. Moreover, the increased incidence of enterprise agreements does not necessarily reflect their significance and the extent to which they have changed work conditions. Many of these agreements only deal with a relatively narrow range of topics. And for nearly a quarter of all employees, wages and work conditions are still determined exclusively by awards. Regulatory flexibility of workplace arrangements could be further enhanced and the potential for productivity gains raised by reducing the number of "allowable award matters" further, and by tightening their definitions and specifications to a less comprehensive set of core conditions of employment. Indeed, the twenty "allowable matters" constitute quite an extensive list,[119] although their reduction meets political resistance. The Australian Government has recently introduced legislation to achieve additional simplification of federal awards. The Workplace Relations Amendment (Award Simplification) Bill 2002, if passed, will more clearly define and specify allowable award matters and incidental matters.

Pattern bargaining

Another impediment to the spread of decentralised bargaining is the practice of industry level pattern bargaining whereby either party seeks common outcomes on an all or nothing basis from agreements across a number of enterprises or workplaces. A typical strategy is the introduction of common expiry dates of agreements. This puts employees and employee organisations at different workplaces in a position to engage in co-ordinated protected industrial action aimed at realising common outcomes at the subsequent round of agreements. Such practice seems most prevalent in the construction[120] and manufacturing industries, two industries with a high incidence of industrial action. The report of the Department of Employment and Workplace Relations (2002) identified a substantial number of agreements for different workplaces that provide for identical outcomes in wages, conditions and expiry dates or a combination of these.[121] As the practice of pattern bargaining inhibits the spread of genuine workplace negotiation with outcomes based on local circumstances and mutual interests, the Commonwealth government proposed a new Bill in February 2002, *the Workplace Relations Amendment (Genuine Bargaining) Bill* 2002, to reinforce the statutory intent of the WRA. The Bill was passed in amended form in November 2002. The new provisions will help the Australian Industrial Relations Commission to suspend or terminate a bargaining period on the ground that the notifying party is not genuinely trying to reach agreement; allow parties to apply for suspension or termination of bargaining periods affecting an employer, without having to identify the specific bargaining periods involved; and allow the Commission to prevent the initiation of a new bargaining period, or to attach conditions to any new bargaining period, where a bargaining period has been withdrawn or suspended, in the same way that the Commission can where a bargaining period has been terminated.

Harmonisation of federal and State industrial relations systems

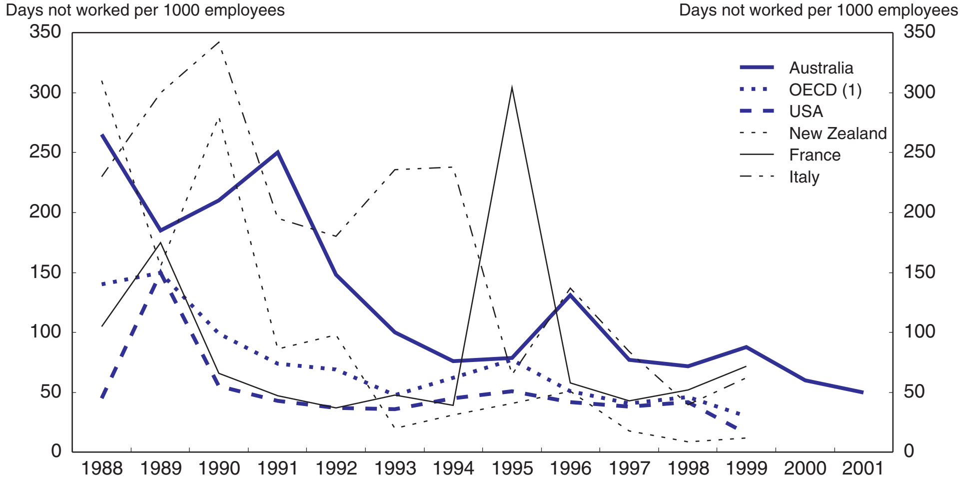
Australia's dual system of federal and State industrial laws and tribunals means that most larger enterprises, and many small ones, have some employees covered by the federal system and some by the relevant state system. It implies significant inefficiencies for most businesses, as it forces employers to deal with two distinct systems, and gives rise to time-consuming jurisdictional disputes. While co-operation between different systems has increased in recent years, unnecessary and artificial conflict still frequently occurs. Hence, substantial efficiency gains could be reaped by moving to a more unified system. As a significant step towards harmonising the various workplace relations systems, the Federal Government has introduced legislation that would expand the coverage of federal unfair dismissal laws from around 50 per cent of all employees to around 85 per cent of all employees by using the full extent of the corporations power of the Constitution. The legislation would also remove access to State unfair dismissal remedies for employees in the federal jurisdiction.

Industrial dispute resolution

The *Workplace Relations Act* 1996 prohibited industrial action (*i.e.* strike and lock out) during the period of an agreement's operation, required notification of proposed industrial action outside the period of the agreement, and prohibited strike pay and strengthened sanctions against unprotected industrial actions.[122] Most importantly, bargaining has to be in relation to an enterprise bargaining agreement, which implies that negotiations for branch or sectoral agreements do not enjoy protection. Further, provisions banning "secondary boycotts" (*i.e.* sympathy or solidarity action by employees not party to an original dispute) have been strengthened.

All this has undoubtedly contributed to the continued reduction in the level of disputes in Australian workplaces. Today, the level of disputes in Australia is only around one sixth of what it was twenty years ago, when Australia was one of the most strike-prone countries in the OECD. Nevertheless, during the 1990s, the number of working days lost also trended downward in most other OECD countries, keeping the Australian figure well above the OECD average in recent years (Figure 31). To minimise the incidence of unnecessary industrial action, the fed-

Figure 31. **Working days lost in labour disputes**



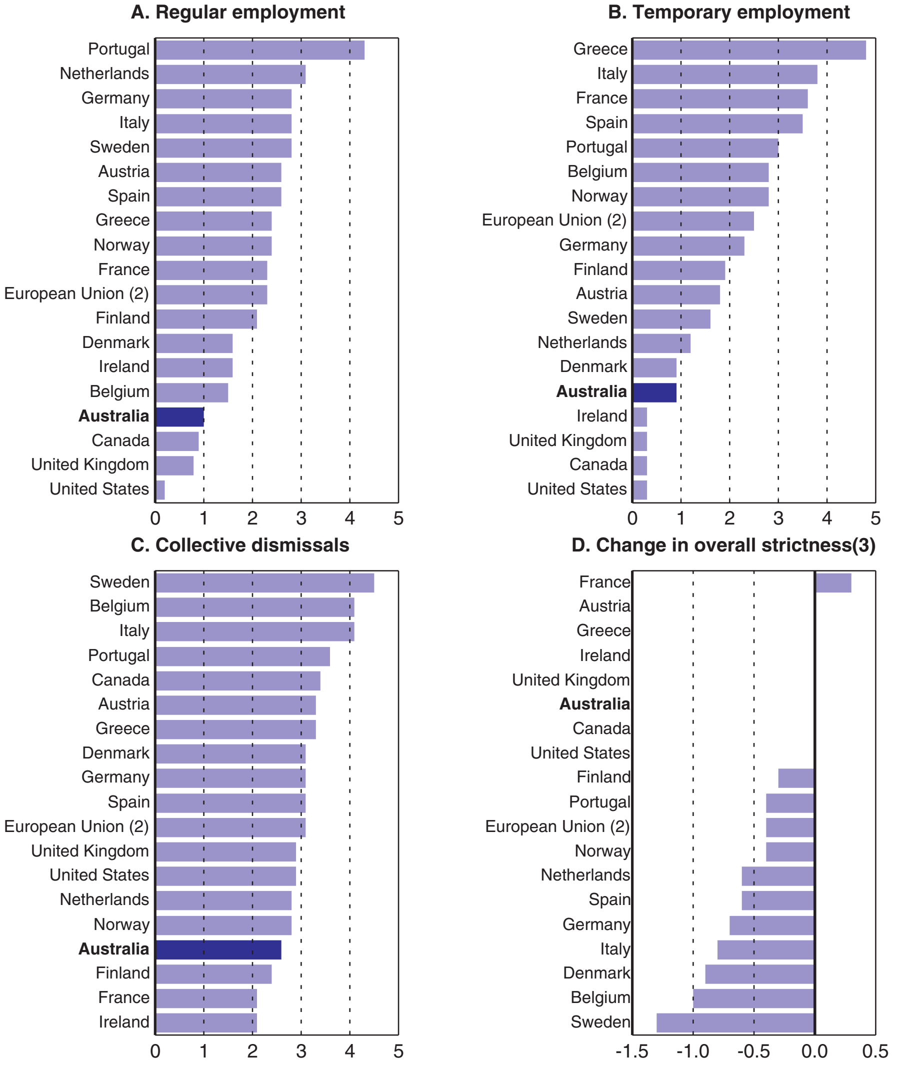
1. Weighted average.
Source: Davies (2001); Australian Bureau of Statistics.

eral government has proposed legislation[123] which would require secret ballots to be held at the workplace level to authorise protected industrial action organised by unions and employees. Another Government proposal[124] would speed up the process whereby employers could obtain orders against parties engaging in unlawful industrial action.

Termination of employment legislation

OECD assessments consistently show that Australia's employment protection legislation (EPL) is one of the least strict in the OECD area,[125] the only countries with more relaxed EPL being the United States, United Kingdom, Canada and Ireland (Figure 32). Australia's strictness of EPL ranks particularly low with regard to procedural requirements in the case of individual dismissal and on the criteria used and the compensation given for unfair dismissal. Employee conduct and economic redundancy (retrenchment) are legitimate grounds for dismissal. There are also relatively low legal requirements for notice periods.[126] In addition, regulations for temporary employment are comparatively light handed. There are no restrictions on the type of work or areas of economic activity where temporary work agencies can become active. Current legislation neither specifies a maximum number of successive contracts or contract renewals. It is likely have played a

Figure 32. **Employment protection legislation**[1]
Late 1990s



1. Indicators of strictness of legislation. Scores can range from 0 to 6 with higher values representing stricter legislation.
2. Weighted average.
3. Average of indicators for regular and temporary contracts since the late 1980s.

Source: OECD, *Employment Outlook*, June 1999.

facilitating role in the adoption of new techniques such as ICT, which often require changes in personnel.

Notwithstanding the comparatively low strictness of overall EPL requirements, debate continues in Australia as to whether current provisions significantly discourage hiring. Particularly for small businesses,[127] employer organisations are of the view – expressed in hearings before parliamentary committees – that unfair dismissal laws are still holding back job creation. Although there are substantial impediments to using empirical data for analysing the employment effects of unfair dismissal legislation, this view finds some support in business surveys.[128] A recent study by D. Harding (2002), based on the results from telephone interviews of 1802 small and medium-sized enterprises, presents estimates of the impact of unfair dismissal laws on this part of the business sector and the total economy. The study gives a range of the estimated costs the legislation imposes on the national economy, of which the lower bound is A$ 1.3 billion (0.2 per cent of GDP). In addition, the study found that unfair dismissal laws contributed to the loss of about 77 000 jobs from businesses which used to employ staff and now no longer employ anyone. A major conclusion from Harding's analysis is that the negative employment effect has shown up in particular in higher unemployment of low skilled workers in the low-wage segment, a group among which the young are over-represented. Hence, the negative employment effect from the legislation has the potential to last over a person's lifetime.

To make EPL requirements more employment friendly, federal legislation has been amended further by the *Workplace Relations Amendment (Termination of Employment) Act* 2001, which came into effect in August 2001. It contains a range of provisions including some designed to reinforce disincentives to speculative and unfounded claims in the context of termination of employment. Among them are a requirement that new employees have to be employed for three months before they can claim unfair dismissal compensation, and this can be raised (in certain circumstances) or lowered by written agreement in advance of employment. Moreover, the new law also contains a requirement that the Australian Industrial Relations Commission (AIRC) must take into account the different sizes of businesses when assessing whether their dismissal procedures were reasonable. All this should help to contain the costs of adjusting the workforce and act against disincentives to hiring workers, thereby reducing the undesirable side-effects of employment protection legislation.

Since the passage of the *Workplace Relations Amendment (Termination of Employment) Act* 2001, the Government has introduced into Parliament three additional Bills, which aim at further amending the federal legislation on termination of employment. The first of these Bills (which has been reintroduced to the Parliament after the Government found amendments made to the Bill by the Senate to be unacceptable) would exempt small businesses (in the ABS definition) from the unfair dismissal provisions of the 1996 Act. The second Bill would restore an exemption from the unfair dismissal provisions of the Act for short-term casual employees following a Federal Court challenge of the regulations providing the exemption. In addition, it would move provisions imposing a filing fee for termination of employment applications from the Workplace Relations Regulation into the WRA. The third Bill would extend the operation of the unfair dismissal provisions of the WRA by making greater use of the corporations power of the Constitution. As a result, federal coverage would increase from around 50 per cent of all employees to around 85 per cent of all employees. In addition, employees in the federal unfair dismissal jurisdiction would be prevented from accessing remedies under comparable State unfair dismissal schemes. The Bill also contains a range of other amendments to the federal unfair dismissal laws, including specific initiatives aimed at improving the operation of the laws for small businesses.

Assessment

Altogether, the reform of Australia's complex industrial relations system has induced a strong uptake of collective agreements at the enterprise level, moving away from the formerly centralised, rigid and complex system. The new system enables employers to trade off wage increases for changes in work practices, and is thus an important factor for reducing labour inefficiencies and increasing the flexibility of work conditions. In addition, less adversarial labour relations are likely to have encouraged innovation, facilitated greater acceptance of new technology and promoted the development of worker skills.[129] Indeed, as the OECD Growth Project[130] concludes, to enhance benefits from new technologies and to realise the potential of human capital, firms are often required to change work organisation and wage-setting schemes, with greater emphasis on performance-related pay. It appears that countries that have a decentralised bargaining system and more relaxed employment protection legislation are better equipped to innovate in industries characterised by multiple and rapidly-evolving technologies. All this supports the view that industrial relations reform has contributed to the observed pick-up in productivity growth in Australia over the past ten years or so.

A number of problems remain, however. While collective enterprise agreements have risen in importance, the growing practice of pattern bargaining goes against the intention of the reforms. And so far, the number of individual workplace agreements has remained quite low, probably reflecting their high transactions cost. The Government is seeking to simplify the procedures for making individual and collective agreements through the Workplace Relations Amendment (Simplifying Agreement-making) Bill 2002, which is currently before the Parliament. Moreover, the award system still plays an important role in setting minimum wages, which – at around half of average weekly earnings – are higher than in most other OECD countries with minimum wage arrangements. And even though simplified awards impose fewer constraints on the operation of enterprises than before, the rather extensive coverage of the twenty "allowable matters" still implies a substantial degree of complexity. Hence, regulatory flexibility of workplaces could be enhanced further if the number of employment conditions determined by awards were reduced by more and their specifications tightened further to a less comprehensive set of core employment conditions. This would allow the individual situation of enterprises to be better taken into account when negotiating agreements. The overall reach of industrial relations reform would be enhanced by the harmonisation of federal and State legislation, not only to reduce regulatory costs for businesses and governments, but also to avoid reforms of the federal system being rolled back at the State level. There also seems to be scope for reducing the disincentives on firms, especially smaller businesses, to hire workers arising from unfair dismissal legislation. However, any changes here should strike an appropriate balance between the benefits and costs of employment protection legislation.

Labour market assistance

Efficient allocation of labour resources requires that the unemployed and other job-seekers find new jobs best responding to their competencies within a reasonable time. A fine balance has to be struck between pressuring job-seekers to take the first available job, and having them wait so long that their human capital decays. In the past, the efficient provision of employment assistance was hampered by the inflexibility of services offered, lack of choice and diversity, the absence of competition, and unclear objectives and outcomes. The new approach as from 1998 assumes that a competitive market for employment services, with the public sector a mere purchaser of services, would not only provide a number of benefits to job seekers and employers but also allow a substantial reduction in spending. The rationale underlying the new system is that that fees paid to service providers act as strong incentives for them to perform and that competition encourages a high level of service quality. To ensure that highly disadvantaged job-seekers benefit from the assistance provided by the new system, a differential fee structure applies, with the highest fees being paid for those who are most at risk and hardest to place in a job and being paid in full only after a job-seeker has been off allowances for longer than six months. Service providers are not allowed to refuse clients, which limits their ability to "cream" job-seekers. These arrangements made Australia one of the first OECD countries to introduce market-type mechanisms into its employment service framework.

The new framework implied the almost complete outsourcing of the public employment service[131] to the newly-created *Job Network*, a managed market for the provision of subsidised employment services to the unemployed. This quasi-market for employment assistance services tries to mimic features of genuine markets by providing scope for competition, variable prices, some degree of choice for job seekers, flexibility in the way services are delivered, and rewards for good providers. The *Job Network* is complemented by other employment services, including Work for the Dole[132] and the Indigenous Employment Programme, the Apprenticeship and Traineeship System, and employment services for job seekers with disabilities. The main components of the new labour-market assistance system are outlined in Box 3.

There have been a number of critical assessments of the new *Job Network*.[133] In general, they conclude that the *Job Network*'s purchaser-provider model, with its focus on outcomes, competition and choice, is a suitable policy framework for the delivery of active labour market programmes. Competition between providers and the use of outcome payments indeed have created incentives for improved efficiency and better outcomes. Compared with labour market assistance provided under the *Working Nation* programme, the new system has achieved a substantial reduction in the unit costs of employment assistance for unemployed job seekers. Surveys also indicate a higher level of satisfaction of job seekers and employers compared with previous public employment services. Nevertheless, a recent independent review by the Productivity Commission (2002a) (see Box 3), based on a variety of assessment methods, concludes that so far, *Job Network* programmes are likely to have had only modest positive effects on the job seekers' chances of gaining employment. This is in line with other assessments of the new system, including the findings of the Department of Employment and Workplace Relations (DEWR, 2002a), and with evaluations of similar labour market programmes abroad and suggests that most unemployment is structural and cyclical, rather than frictional. Outcomes are, however, likely to improve over time as service providers are set to learn what works best, and poor service providers will lose their contracts.

In its response[134] to the Productivity Commission's *Review*, the Government supported the overall thrust of the Commission's recommendations, particularly the endorsement of the purchaser-provider model, which confirms that substantial private and community sector involvement in the delivery of employment services is feasible. The Government pointed out that the implementation of the so-called *Active Participation Model* – announced in the 2002-2003 Budget – will address some of the problems highlighted in the *Review*. Under this new model, job seekers would no longer be referred to inappropriate programmes, but would receive customised assistance within the *Intensive Support* programme after twelve months of unemployment. Many job seekers will receive immediate access to customised assistance within the Intensive Support programme upon being identified as having significant barriers to employment. The new model is designed to offer simpler and faster access to services, and improved linkages between the *Job Network* and other services. However, it will be introduced only from 1st July 2003 in association with the Third Employment Services Contract.

Box 3. The Job Network System – main features and an assessment

The main pillars of the new labour market assistance system are Centrelink and Job Network:

– *Centrelink* is the gateway to Job Network and undertakes the registration, assessment and referral of job-seekers to a Job Network member. It provides job-seekers with information about available employment services. In addition, it offers a uniform national service for registering job-seekers, administering unemployment benefits, assessing job-seekers' eligibility for employment assistance, administering the activity test, and enforcing compliance with conditions of income support. It classifies job-seekers, using the Job Seeker Classification Instrument (JSCI) to identify the relative difficulty job-seekers have in finding employment because of their personal circumstances and labour market skills. Based on reference to their JSCI score, Centrelink refers job-seekers with scores within a particular bandwidth to Job Network members providing Intensive Assistance.

– *Job Network*, the Commonwealth Government's primary employment service, is a national network of around 200 private, community and government organisations contracted by the Government to deliver employment services to assist unemployed people into jobs.This new network replaced the publicly operated Commonwealth Employment Service and a range of labour market programmes that delivered short-term training, wage subsidies and work experience. Job Network is a contestable employment placement market, with competition between contracted service providers for the provision of placement and case management services. Job Network contracts are awarded through a competitive tender process. The first contract ran from May 1998 until February 2000 and the second contract runs from February 2000 until June 2003 and the third contract will commence in July 2003 and run until June 2006. Job Network members who have won contracts under a tender process compete to attract job-seekers to their service. High levels of outcomes achieved may increase the probability of being awarded additional contracts in the next tender round. Under the first two employment contracts, the Job Network comprised three key services. Job Network Members could provide one or more of these services.

  - *Job Matching*, which is the gathering of available vacancies and assisting eligible job-seekers into jobs through the provision of labour exchange services;
  - *Job Search Training*, which is assisting job-seekers with a moderate degree of labour market disadvantage in obtaining employment through training in job search skills, interview techniques, motivation and confidence-building; and
  - *Intensive Assistance*, which implies the provision of individually tailored assistance to obtain employment for the most disadvantaged job-seekers, as determined through the JSCI.

Box 3. **The Job Network System – main features and an assessment** (*cont.*)

The Productivity Commission's *Review of the Job Network* (2002a) identified a number of unsatisfactory aspects of it. They are:

– Many disadvantaged job seekers receive little assistance while being "parked" in the *Intensive Assistance Programme*. Job seekers can be required to participate in this programme to retain eligibility for income support. The "parking" problem arises for those job seekers who are less responsive to the interventions of the service provider and thus are unlikely to generate income to the provider. There is also the problem of limited options for re-referring disadvantaged job seekers to other, more appropriate programmes, such as Work for the Dole. Hence, better targeting of the needs of disadvantaged job seekers, changes to the payment systems to providers, and greater options for re-referring job seekers to other programmes are required.

– Many job seekers do not choose their *Job Network* provider. Hence, better information on providers needs to be available to job seekers to inform their choice.

– Criticism has also been expressed with regard to the *Job Network* tender process, which is regarded as costly, complex and not ensuring an optimal pricing of services. The Productivity Commission proposes a licensing and accreditation system, with providers having free entry into *Job Network*. Providers would also be subject to ongoing quality assessment.

– There is also the problem that service providers are given a fixed quota of *Job Search Training* and *Intensive Assistance* places at the beginning of each contract period, which discriminates against the better agencies. A solution could be to move progressively to unregulated case load sizes, accompanied by the removal of the random allocation in the auto-referral system to favour the more successful providers.

– The Department of Employment and Workplace Relations seems to impose an increasing compliance burden on service providers in response to abuse of the system,[1] and this is believed to undermine the flexibility of *Job Network*. Instead, a risk management approach to contract monitoring and compliance is proposed.

– Subsidies for some redundant or poorly targeted *Job Network* programmes such as the Harvest Trail and the Self Employment Development programme[2] should be removed to allow *Job Network* to focus on its core function of getting jobs for the most disadvantaged job seekers.

1. Examples of abuse are the "manufacturing" of jobs or the recycling of a succession of job seekers through the same job to obtain outcome payments.
2. According to the Productivity Commission, the Self Employment Development Programme should be abolished as its outcomes are very poor, a recommendation which the Government supports in principle. The Project Contracting (Harvest Labour Services), a rural industry assistance programme, is proposed no longer to be subsidised, as it has no strong rationale in terms of assisting disadvantaged job seekers. The Government, however, considers that this programme has a role in supporting the operation of this segment of the market.

Source: Department of Employment and Workplace Relations and Productivity Commission.

In sum, the new labour market assistance system remains "work in progress", which needs to be fine-tuned over time in the light of experience made with its different programme components. Various evaluations have explored ways of raising the effectiveness of the *Job Network*, especially the arrangements for those jobs seekers who are at risk of prolonged unemployment and welfare dependence. The results suggest that labour market assistance policies and Welfare Reform need to be more closely integrated. The new *Active Participation Model* will be a step in this direction as it will integrate *Job Network* services with Mutual Obligation activities. A challenge that the new employment assistance services have not faced yet is how they will perform during a cyclical downturn. Experience to date suggests that even a sophisticated and reasonably efficient system of labour market services can only be expected to reduce unemployment rates slightly, and to have a small positive impact on *net* employment, except insofar as it results in a lasting reduction in long-term unemployment. This strengthens the need for more labour market flexibility, an issue which can be better addressed by other policies, such as the reform of the industrial relations arrangements and of the training and education system.

Welfare reform: policies to raise participation

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 redistributive relative to most other OECD countries (Box 4). In 1999, total public social security expenditure in Australia was around 17 per cent of GDP, well below the corresponding averages for the EU and OECD areas. A similar conclusion is derived when looking at the gross public cash benefits, which exclude health and social services (Figure 33). Despite the relatively low level of expenditure, OECD estimates suggest that the degree of net redistribution to the poorest 30 per cent is significantly higher than in many other industrialised countries. Moreover, the lowest three deciles of the population by household income in Australia receive 58 per cent of social security transfer payments, the highest share among the 13 countries in the sample (Burniaux *et al.*, 1998). While the comprehensive targeting of the social security system in Australia is strong in cost effectiveness and redistribution, it may also significantly reduce the incentives for work because of the relatively high marginal effective tax rates (METRs) it entails. The high METRs arise because of the interaction of the transfer and tax systems and, more specifically, from the combined effect of the withdrawal rates in the transfer system and the marginal income tax rates in the tax system. At the extreme, the tax and social security income tests interaction may create "poverty traps", where the individuals receive little or no financial benefits from extra earnings because of the loss of means-tested payments.[135]

Box 4. The main features of the Australian Income Support System*

Australia has a national income support system financed through general government revenue. The primary aim of the system is to provide protection against poverty, rather than income maintenance as is the case in most OECD countries. There are non earnings-related features in the social protection system. Benefits are paid at a flat rate and are available on an indefinite basis, subject to means-testing against current income (including unearned income) and assets. Maximum payment rates vary according to category of benefit, family situation and age, with almost all payments being adjusted in line with movements in the CPI. Activity-testing is relatively weak for many of those receiving income support benefits, apart from those on unemployment benefits and students.

There are three broad categories of income support payments: pensions, which include disability benefits, as well as old-age pensions; allowances, designed originally to cover short-term needs (sickness and unemployment), and currently also some longer-term situations (*e.g.* the unemployed aged over 60, widows); and Special Benefit. Overall, the social security system provides: *i*) non-activity tested entitlements for various groups to subsist outside the labour force (most on pensions, although some receive an allowance); *ii*) allowances for unemployment and students, subject to activity-testing; and *iii*) a safety net (Special Benefit) for those in need who do not qualify for other income support benefits.

Means-testing ensures that assistance is targeted towards those in most need and that the welfare system remains sustainable and affordable to taxpayers. The means tests for assistance benefits in Australia are relatively generous by international comparison, probably due to the lack of insurance benefits where such a test would not apply. Income tests, which are applied on a fortnightly basis, usually include:

– *a free area* – that is, the amount of private income a person can receive from earnings or other sources without any reduction in the rate of social security payment received;

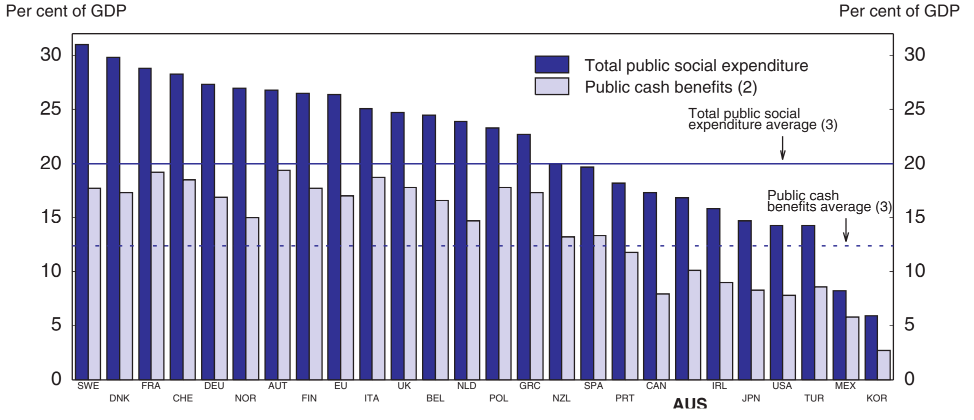
– one or more *taper* (*withdrawal*) *rates* – that is, the rate at which income support payments are withdrawn for each additional dollar of private income earned above the free area;

– A *cut-out point* – this is, the amount of private income at which a person ceases to receive any welfare support.

Given their longer-term duration, pensions are more generous, in terms of basic payment level and considerably more generous in terms of income tests. A similar principle applies to the asset tests. Pensions are also adjusted in line with growth in average wages. In general, pensions have tapered asset tests, whereas allowances have a "sudden death" cut-out point, above which no income support payment is available.

* The Box draws on the McClure Interim Report (RGWR, 2000b). For an overview of the system see also Whiteford and Angenent (2001); IMF (2001); and OECD (2001), *Innovations in Labour Market Policies*.

Figure 33. **Public social expenditure: an international comparison**[1]
As a percentage of GDP



1. At the latest available year.
2. Public cash benefits are defined as total public social expenditure minus health and social services.
3. Averages are calculated using all OECD countries.

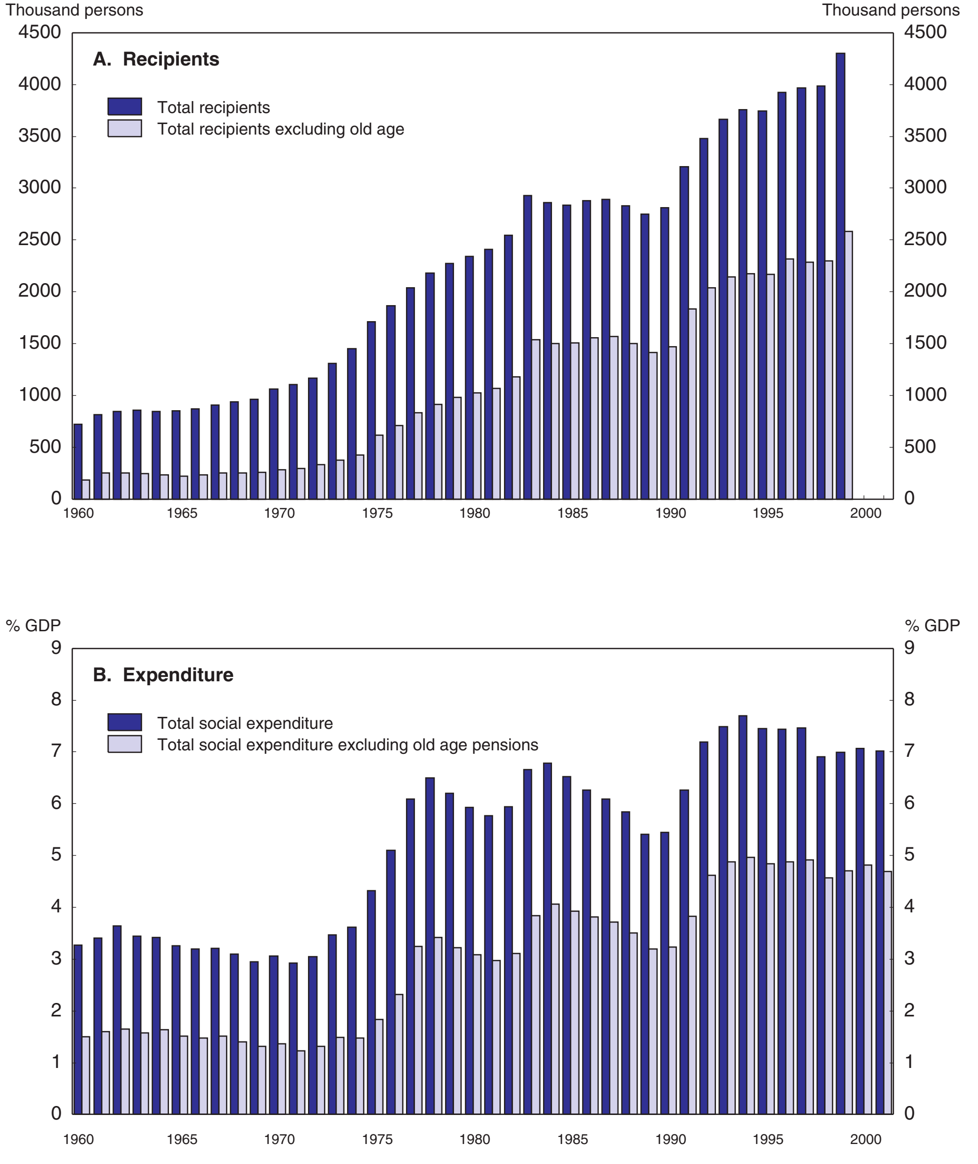
Source: OECD, Social Expenditure Database 2001.

The McClure Report recommendations

In September 1999 the government announced its intention to review the welfare system and appointed a Reference Group – chaired by Patrick McClure, Chief Executive of Mission Australia – to advise on options for changing the income support arrangements and the provision of related services (including employment, education and training) with the broad objective of preventing and reducing welfare dependency. The terms of references focused particularly on the incentive effects of the design of social security payments for the workforce-age population, a broader application of the Mutual Obligation principle, and international best practices. The Group issued the Final Report in July 2000 (RGWR, 2000a).[136]

The setting up of the McClure Reference group, and subsequent reforms, were motivated, to a large extent, by concerns about the increasing level of welfare dependency since the 1960s and the socio-economic costs associated with such a development, including possible adverse inter-generational effects[137] (Figure 34). Disturbingly, welfare dependency persisted in the 1990s in the face of strong economic growth and falling unemployment. A particular concern has been the growing reliance on income support rather than labour income in the working age group, with one in seven such individuals receiving at least 90 per cent of his/

Figure 34. **Indicators of welfare use and spending**



Source: Commonwealth Treasury of Australia.

her income in the form of government transfers in 1997-98. The social groups most concerned in recent years have been lone parents, people over the age of 55 and single people without children. The increased inequality in the distribution of employment since the early 1980s has led to a growing polarisation of households into those that are "job rich" and those that are "job poor": as well as more two-income families, there are now more families with no labour income, matching the decline in the number of families with one earner. The above trends have been underpinned by economic and social changes, as well as changes in government policy. The main factors include the rise in unemployment, especially long-term unemployment; the increasing importance of part-time jobs and casualisation; female employment; skill-biased technical progress; sustained increases in the rate of lone parenthood; a decline in fertility rates; and the ageing of the population. Finally, policy changes have involved extending the coverage and types of assistance, and have significantly increased the real level of benefit for most of the covered groups, thus providing incentives to move on to income support and, because of the way they are fashioned, reducing incentives to move off it.

The McClure report noted that the existing income support system was outdated, as it was not designed to deal with the socio-economic and demographic changes of recent times. As such, the system may be failing on many counts those individuals it was intended to assist. Overall, the Reference Group identified four main shortcomings of the welfare system that underpin the need for a comprehensive reform: *i*) fragmented service delivery arrangements not adequately focussed on participation goals; *ii*) an overly complex and inflexible array of income support payments; *iii*) inadequate incentives for some forms of participation and inadequate awards for some forms of work; and *iv*) insufficient recognition of the many forms in which people make a contribution, including social participation. The costs of participation, including child care and transportation costs, have also been identified by the Reference Group as a barrier to social and economic participation.

Some steps towards lowering METRs, and thereby encouraging participation, were made with the introduction of A *New Tax System* (ANTS) in July 2000[138] which, in addition to reducing marginal tax rates, consolidated and simplified family-related payments, and eased income tests for pensions and family assistance (OECD, 2001a). It was recognised, however, that more remains to be done, especially when means tests for 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.[139] Another area of concern at that time related to the treatment of people who have access to temporary jobs (especially part-time and casual employment) or work intermittently throughout the year, as income tests applied to earnings obtained at a certain point in time. Benefits could be withdrawn, at times, for some people whose income is low over the year as a whole, but who receive earnings from intermittent work (Dawkins, 2001).

The Report recommended the establishment of a "Participation Support System" based on five "mutually reinforcing" principles: *i*) individualised service delivery, described in terms of a "central gateway and assessment process"; *ii*) a simpler support structure; *iii*) enhanced incentives and financial assistance to encourage and support participation; *iv*) a broader application of the mutual obligation concept; and *v*) social partnerships to build community capacity to increase participation. As well as recommending the implementation of a new Participation Support Scheme in the medium-to-long term, the Report proposed some "initial-step" measures to ensure that implementation is guided by solid information and analysis.

The government's official response[140] welcomed the McClure Report, emphasising that the welfare reform was not intended to be a cost-cutting exercise; rather, it was seen as a "structural change", aiming at transforming the traditionally passive and rather rigid social security system into to a more actively-managed social safety net that would encourage social and economic participation. The full implementation of welfare reform will require a substantial up-front investment of budget funds and will take several years to complete. The expected return from such investment is higher output growth and savings on social security expenditure over the longer term.

Towards an actively-managed social safety net

As a first step towards overhauling the welfare system, the government introduced in the 2001-02 Budget a comprehensive package of reforms over the years 2001-02 to 2004-05. The package – *Australians Working Together* (AWT) – provided a better balance between incentives to work, obligations to the community, and government assistance, in line with the recommendations of the McClure Report. AWT provided new funding of around A$ 324 million over four years on assisting people to find jobs, through the expansion and improvement of employment services and standardised mutual obligation requirements. Additional funding was also provided for the establishment of the Working Credit, the introduction of training credits[141] for job seekers undertaking Work for the Dole or equivalent Community Work activities and other targeted initiatives for parents, mature aged people, indigenous Australians and people with disabilities.[142]

A key objective of the AWT package is to provide people with the appropriate assistance and incentives to stay involved with their communities and regain their financial independence. Towards this end, Mutual Obligation requirements for people receiving unemployment benefits have been extended to individuals aged 35-49 years and standardised, in accordance with the recommendations of the McClure Report. From July 2002, the Mutual Obligation principle applies to job seekers between 18 and 49 years after 6 months on unemployment benefits, although 40 to 49 year olds have less stringent requirements.[143] The AWT further introduced participation requirements for parents with school-age children receiving Parenting Payment to help prepare them to return to work as their children grow up. Specifically, under the new arrangements, parenting payment recipients (whose youngest child is aged between 6 and 12) will be required to attend an annual interview with a Personal Adviser. Also, parents whose youngest child is aged between 13 and 15 will be required to do the equivalent of one day a week of community work, part-time paid work, study, or training if they are receiving parenting payment. The rigorous enforceability of activity requirements under the Mutual Obligation framework is of crucial importance for achieving the intended impact of such a framework, namely providing individuals with the right incentives to undertake employment.

As a further step towards fostering labour force participation, the government introduced in the 2001-02 Budget the Working Credit initiative[144] aiming to deal with the problem of high METRs. The new incentive encourages greater take-up of full-time, part-time or irregular casual work by allowing welfare beneficiaries to keep more of the income support payments when they start work. Through Working Credits, income-support recipients are able to accumulate credits (up to a ceiling A$ 1 000) for earned income in periods during which they have little or no earnings, which they can then use to reduce the impact of the income test on income support payments when they get a paid job or higher earnings.[145] Further reform efforts are desirable to assist welfare beneficiaries to work and to ensure that the income-support scheme, including its METR aspects, is not having an adverse effect on the labour market attachment. Measures in the 2001-02 Budget to expand childcare places and encourage community and business engagement in identifying and generating employment opportunities for disadvantaged groups (including people with disabilities, older people, indigenous Australians and parents returning to work) are important complementary initiatives in this regard.

Recent policy actions

Building on previous initiatives, including the Job Network and Australian Working Together programme, the 2002-03 Budget introduced the next phase of welfare reform, focusing upon the provision of more effective employment assistance to job seekers and the improvement of the work capacity of people claiming or receiving Disability Support Pension (DSP). Under the *Active Participation Model*, from July 2003,[146] job seekers will be supported by a single Job Network member throughout the period of unemployment and will receive a Service Guarantee and increased access to job vacancies and job matching services.[147] New Job Seeker Accounts, which may be used for expenses, such as training, work experience, transport and other, will help them find jobs. These arrangements also include support measures for long-term unemployed job seekers, who will receive customised assistance within Intensive Support after 12 months of unemployment, or earlier, if they are assessed as being disadvantaged. The high degree of individualised assistance embodied in the new provisions is expected to improve the targeting and matching ability of employment services and support more active job search activity, facilitating the transition back to work. The government will also provide for additional Work for the Dole places to enhance participation opportunities for job seekers.

In addition to providing more effective employment services, as part of the welfare reforms, the 2002-03 Budget has increased the support and tightened eligibility requirements for people claiming or receiving the Disability Support Pension (DSP). DSP recipients have more than doubled since 1990, with one in nine Australians aged 50 to 64 now receiving the DSP. The total number of DSP recipients now exceeds the number of unemployment benefits recipients. To assist people with disabilities to develop and improve their work capacity, up to 73 000 new places in employment assistance, vocational education and training and rehabilitation services will be created over three years, building upon previous initiatives announced as part of the AWT package. The new measures also provided for a tightening of the eligibility criteria for the DSP aiming to encourage labour market engagement, or active participation in society, of people with substantial work capacity. Specifically, they envisaged that the DSP will be payable to people with a work capacity of less than 15 hours per week, rather than 30 hours per week as is currently the case. However, the proposed phased implementation of the changes to the DSP faced strong opposition.[148] The revised Disability Reform Bill, introduced to Parliament on 27 June 2002 attempted to address these concerns by putting in place new eligibility rules that are applicable only to people who claim DSP from July 2003.[149] However, the revised bill was defeated in the Senate in November 2002. This is unfortunate as the restriction of DSP eligibility to people with limited work capacity envisaged by the bill was a positive step towards reducing the extensive use of this programme, with an estimated net saving of A$ 163 million over four years.[150] However, the government appears committed to welfare reform and improving work opportunities for people with a disability.[151]

Assessment

All in all, the re-orientation of the Australia's support system in the context of the welfare reform under implementation is a policy initiative in the right direction as it encourages individuals to seek, and keep, jobs. The extension of Mutual Obligation to all beneficiaries of working age would be advisable for the realisation of such objectives. Steps should continue to be taken to develop and improve the work capacity of people with disabilities. Close monitoring and strict enforceability of activity requirements under the Mutual Obligation framework and of the tighter eligibility requirements for DSP are important for achieving the intended impact of the welfare reform on participation, while helping to contain the budgetary costs arising from implementation of the new measures. In addition, further steps are needed to reduce the high METRs embedded in the system so as to improve the incentives to work and increase self-reliance, thereby minimising social exclusion and preventing welfare dependency.

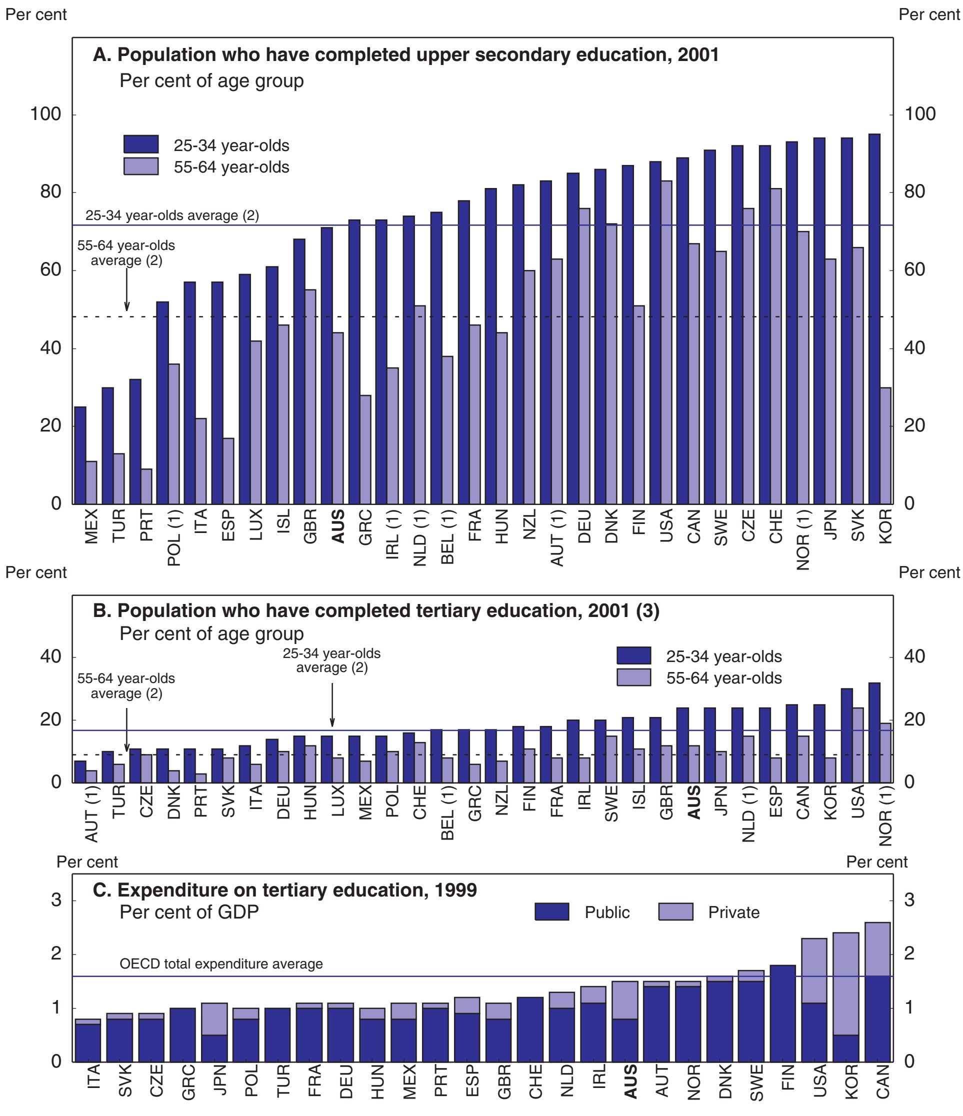
Education and training[152]

Updating labour-force skills and competencies is needed to achieve higher productivity levels. Over the past two and a half decades Australia has made significant progress in this direction, as shown by the difference in the educational attainment between younger and older groups, serving as an indirect proxy of the evolution of the stock of human capital. In 2001, around 70 per cent of the population aged 25 to 34 have attained at least upper secondary education, compared with only 44 per cent of 55 to 64 year-olds. The difference is even more striking in the case of those with tertiary education, where attainment by the younger population group is twice that of the older population group (Figure 35). A recent OECD survey on schooling world-wide shows that the average performance on "combined reading literacy" of 15 year-old Australian students is significantly above the OECD average.[153] However, there is still room for improvement in view of the wide disparities in student performance,[154] attributable, in larger part, to within-schools differences. International comparisons of school-to-work transition outcomes for young people also suggest that, while the employment rates for young adults are above the OECD average, and a relatively high proportion of young adults obtain tertiary qualifications, teenage unemployment and early school leaving rates in Australia exceed the area-wide average. Moreover, the employment disadvantage of poorly qualified school leavers, compared to their better educated counterparts, is somewhat above the OECD average (Figure 36).[155] Increasing skill demands in Australia and other OECD countries have made qualifications at the upper secondary level of education (or an apprenticeship qualification) a necessary condition for the employability of young people (OECD 2002, *Education at a Glance*).

Further improving the school to work transition and the quality of education outcomes

Following up on previous structural reforms in the vocational education and training (VET) system, the government has introduced since the mid-1990s a range of initiatives aiming at increasing the labour-market responsiveness and flexibility of the system and enhancing its national consistency. The reforms have also been designed to expand training opportunities into new industry and occupational areas, increase the number of publicly-funded training places, and provide quality educational pathways and closer links between schools, VET and

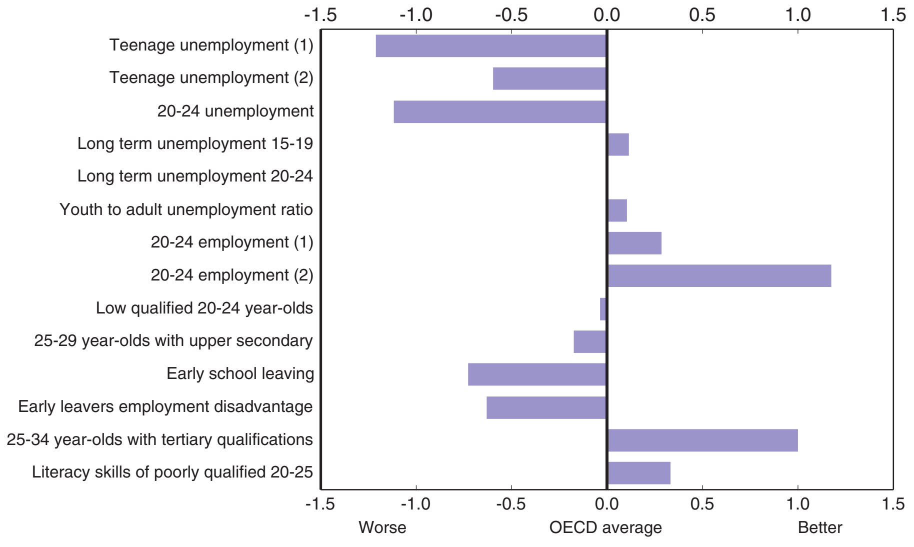
Figure 35. **Education indicators in comparison**
Per cent



1. Data refer to 2000.
2. Unweighted average.
3. Tertiary education is defined as tertiary type A and advanced research programmes.

Source: OECD, *Education at a Glance* (2002).

Figure 36. **Transition indicators**[1]



1. For each indicator country values have been converted to a common mean (one) and a common standard deviation (zero). The sign of the resulting standard scores has been adjusted so that negative values indicate outcomes that are worse than the OECD average and positive values indicate outcomes that are better than the OECD average.

Key:
Teenage unemployment (1): 15-19 year-old unemployed non-students as a percentage of all 15-19 year-olds, 2001.
Teenage unemployment (2): Total unemployed 15-19 as a percentage of all 15-19 year-olds, 2000.
20-24 unemployment: 20-24 unemployment to population ratio, 2000.
Long term unemployment 15-19: Per cent of unemployed 15-19 year-olds unemployed for six months or more, 2000.
Long term unemployment 20-24: Per cent of unemployed 20-24 year-olds unemployed for six months or more, 2000.
Youth to adult unemployment ratio: Ratio of unemployment rate among 15-24 year-olds to unemployment rate among 25-54 year-olds, 2000.
20-24 employment (1): Per cent of 20-24 year-old non-students employed, 2001.
20-24 employment (2): Total employed 20-24 year-olds as a percentage of all 20-24 year-olds, 2000.
Low qualified 20-24 year-olds: Per cent of 20-24 year-olds who have completed no more than lower secondary education, 2001.
25-34 year-olds with upper secondary: Per cent of 25-34 year-olds with at least upper secondary education, 2001.
Early school leaving: Per cent not in education one year after the end of compulsory education, 2000.
Early leavers employment disadvantage: Share of total 20-24 year-old employment represented by those with no more than lower secondary education divided by the share of total 20-24 year-old unemployment represented by those with no more than lower secondary education, 2000.
25-34 year-olds with tertiary qualifications: Per cent of 25-34 year-olds with tertiary education (ISCED-97 type A or advanced research programme), 2001.
Literacy skills of poorly qualified 20-25: Mean document literacy score of those with no more than lower secondary education, age 20-5, IALS data collected 1992-98.
Source: OECD.

industry.[156] Fundamental to these reforms was the notion of much greater flexibility in the pathways available to students during their transition from school to work and further education and training. Two important changes have been: the introduction, in 1998, of the New Apprenticeships Programme,[157] and the move to a policy of User Choice, allowing employers and apprentices to select their registered training organisation (whether public or private) and to negotiate key aspects of their training (including content, timing, location and mode of delivery). The number of New Apprentices in training has more than doubled since 1995 (currently more than 365 000 persons), giving Australia's training system the fourth largest coverage of the workforce in the world, behind Switzerland, Germany and Austria, although average duration of training, and completion rates are significantly lower in Australia than in the European examples.[158] The range of occupations offering New Apprenticeships has also broadened to more than 500 occupations across a diverse range of industries (the one-year traineeships introduced in 1985 already involved a considerably wider occupational base than traditional apprenticeships). By definition, this broadening base has resulted in a proportional decline in the traditional trades and related occupations, although such occupations are still well represented.[159] Employment outcomes for those who completed a New Apprenticeship are good: in 2000, some 93 per cent of all New Apprentices had unsubsidised employment three months after completing their training contract. In addition, over 90 per cent of New Apprentices who successfully completed off-the-job training in 1999 were retained in employment or had found a new job by May 2000. Nevertheless, the rate of non-completion of the relatively shorter-duration traineeship is high, often reflecting the dissatisfaction of the trainee with wages, training contents or workplace relations[160] (NCVER 2001a, b). Concern has been expressed that employers' freedom in specifying training modules to meet their needs is leading to narrow or non-portable qualifications, and that incentive payments are sometimes delivered for poor quality on-the-job training. The employment rates of completers, although high, may not surpass those of non-trainees with similar job-tenures.[161] To ensure the quality and the industry-relevance of the training provided under New Apprenticeships, the government has introduced a number of mechanisms including, for example, legally binding training contracts.[162] Moreover, to encourage development of a high level of skills,[163] the government provides a "progression incentive" for New Apprentices moving to a higher level of Certificate.[164] Overall the quality of the vocational education and training system needs to be closely monitored to assess the extent it benefits young people by providing them with the necessary skills to underpin their future learning and employment.

Further reforms in the vocational education and training system have supported the development of initiatives in schools which provide students with a wide range of 'pathways' from school to work and/or further education and training, reducing the risk of unemployment among young people. These include the increase in the number of VET programmes in schools, opportunities for students to undertake (full or part-time) school-based New Apprenticeships and measures fostering closer linkages between schools, industry, and the community. An important initiative in this area has been the introduction of VET in Schools which permits senior secondary students to study VET programmes at school, resulting in both a senior certificate and national vocational qualifications.[165] The implementation, since 2001, of *The New Framework for Vocational Education in Schools*, spanning both primary and secondary education, represents an additional step towards the better integration of VET with the broader education sectors and the achievement of more successful transition outcomes for youths. By offering the potential for building partnerships, the integrated approach is seen as expanding the range of vocational education opportunities (including the key related areas of career and enterprise education) and encouraging a higher proportion of young people to stay in education.

Recent government efforts aim at putting in place a cohesive National Transition System, in line with the recommendations of the 2001 Report from the Prime Minister's *Youth Pathways Action Plan Taskforce*. As a direct response to the Report, the 2001-02 Budget featured a comprehensive package of measures which provide immediate assistance to young people in transition from school to further education or work, while enabling the government to pilot a number of recommendations made by the Taskforce. These measures include the expansion of the Enterprise Career Education Foundation (ECEF)[166] into remote areas, increased mentoring opportunities for young people through the development of the Mentor Marketplace, community pilots for better combining services to young people at a local level, and pilots for transition advisers to help young people into independence. The measures also reinforce initiatives already under way with the provision of further funding for the Jobs Pathway, and increases in the Job Placement, Employment and Training Programme to assist young people at risk of homelessness and other disadvantaged youths.[167]

A key issue in the policy agenda is to reform and innovate the infrastructure, funding and quality of education and training, through the implementation of the Education and Training Action Plan for Information Economy, aiming to enhance the capacity of the education sector to utilise new technologies, as well as the strengthening of teacher quality. Measures in the 2002-03 Budget include the provision of further funding for the continuation of the Quality Teacher Programme, to assist the professional development and the renewal of teacher skills in priority areas (such as literacy, science and information technology).

The government has further initiated a major project to improve the quality of indigenous education, aiming to stimulate changes in teaching practices at the school level and to accelerate the achievement of education equality for indigenous students. A policy priority is to ensure that mainstream programmes are more accountable and inclusive of indigenous issues. In countries like Australia, where the findings from the PISA assessment suggest that there is considerable variation in student performance on the 'combined reading literacy' scale within schools, the obvious area of improvement is to concentrate more effort lower down the ability range within schools, rather than target particular schools (OECD 2001c). The relatively strong relationship between socio-economic background and reading literacy, on the basis of the PISA findings, reinforces the need for individual schools in Australia to provide for more diversity of students.[168] Further effort is also needed to make school a more attractive place for youths in order to discourage early drop-outs. As discussed in the previous OECD *Survey*, a move towards a more diversified curriculum within the upper secondary school, able to satisfy a wider range of adolescents' developing vocational aspirations and interests, is an important initiative in this regard. Smaller class sizes would permit better careers advice to support the transition pathways of all young people, while larger high schools would also allow for the provision of more specialised advice, guidance and support services. The adequacy of advice and guidance service has recently been identified as a priority in the government's policy agenda. One form of support that needs further strengthening in Australia is that of re-entry programmes for those early school leavers who wish to return to learning (Sweet, 2001).

Higher education sector

The government launched a Higher Education Review in March 2002 with the release of the discussion paper *Higher Education at the Crossroads*. The paper was intended to stimulate debate about the future challenges facing Australian universities and relevant policy options. In addition to funding arrangements for universities, the consultation process canvassed issues related to: diversity, specialisation and regional engagement; governance and university administration (including bureaucratic inefficiencies); workplace relations in universities; student access and equitable opportunities; quality of teaching and learning; and university efficiency. The development of more "flexible, accessible, and equitable" financing arrangements for higher education is seen as important for ensuring the long-term prosperity of the sector. Total expenditure on tertiary education, as a proportion of GDP, declined to 1.5 per cent in 1999, compared with 1.7 per cent in 1995, although it remains close to the OECD average (Figure 35). Recent research by OECD highlights the benefits from investing on higher education. Specifically, in all 10 countries studied, the private internal rate of return[169] to investment in tertiary education was found to be higher than real interest rates, and often significantly so, suggesting that additional education contributes to the accumulation of wealth. Social rates of return were also found to be well above the risk-free real interest rates, although they tend to be lower than the private returns due to the significant social costs of education.[170] This suggests that students benefiting from tertiary education should contribute to its cost, and this is already the case in an increasing number of OECD countries. The Australian system of not levying tuition costs up-front, and the fact that the Higher Education Contribution Scheme (HECS) repayments are income-contingent do not discourage low-income groups from participating in higher education, although such groups continue to be under-represented.

Assessment

Overall, educational policies, especially recent proposals, are in the right direction for improving the transition outcomes from school to working life and further education for young people. They should thus raise both the allocative efficiency of the labour market, and individual competencies. Efforts towards broadening the secondary school curriculum to meet a wider range of student aspirations and abilities should be continued. A further strengthening of the links between VET and higher education is advisable not only in terms of enhancing the educational pathways for young people, but also to improve the efficient allocation of resources in the two sectors. The proposal for the development of more "flexible, accessible, and equitable" financing arrangements for higher education is a positive step towards further improving the human capital stock and fostering a knowledge-based economy.

National Competition Policy

The reform framework

Australia's nine governments introduced the National Competition Policy (NCP) in 1995, following the recommendations of the Independent Committee of Inquiry[171] in 1993 to apply the *Trade Practices Act* 1974 – Australia's main competitive policy statute – to virtually all areas of the economy. This extended the reach of the *Trade Practices Act's* prohibitions of anti-competitive conduct to all government businesses and unincorporated enterprises engaged in intrastate commerce. A nationally co-ordinated approach to competition policy was chosen to establish a level playing field for all businesses in Australia.[172] The Council of Australian Governments is in charge of the national co-ordination of the NCP reform objectives and assessment benchmarks.

While the States and Territories are responsible for major elements of the NCP, the Commonwealth Government reaps most of the pecuniary benefit *via* increased tax revenues from greater economic activity. Hence, the Commonwealth provides competition payments to the State and Territory governments to redistribute the gains. To receive full competition payments, States and Territories must achieve satisfactory progress in terms of the agreed reform agenda. The National Competition Council[173] (NCC), which was established by the *Competition Policy Reform Act*[174] 1995, assesses whether jurisdictions have met their obligations to implement the National Competition Policy and related reforms in gas, electricity, water and road transport. Governments are entitled to choose not to implement all elements of the National Competition Policy, but in doing so may not receive full competition payments.

Apart from lifting the exemption of State and Territory government businesses and unincorporated businesses from the *Trade Practices Act*, the intergovernmental National Competition Policy agreements[175] have enhanced competition by:

- establishing a legal regime (*National Access Regime*) in the *Trade Practices Act* that enables competing businesses to use nationally *essential* infrastructure services,[176] *i.e.* services that are generally provided by natural monopoly networks;
- setting in motion the reviews of all laws that unjustifiably restrict competition and reform them if certain conditions are met (*Legislation Review*);
- introducing *competitive neutrality* (Box 5) principles to significant government business activities to ensure that such businesses do not have unfair advantages when competing with privately-owned businesses;

Box 5. **Competitive neutrality requirements for Government businesses**

The *competitive neutrality principle* specifies that government businesses activities which operate within a competitive market framework should not enjoy any net competitive advantage merely as a result of public sector ownership. This involves subjecting government businesses activities to the following competitive neutrality requirements:

- *Taxation neutrality* ensuring that the government business activity is not advantaged by taxation exemptions not available to other competitors.
- *Debt neutrality* subjecting the government business activity to similar borrowing costs as that of its competitors (by means of a borrowing charge to offset the borrowing costs advantages arising from explicit or implicit government guarantees on borrowing; or if borrowing from the Budget, requiring the Government business to pay rates of interest commensurate with prevailing financial market rates).
- *Rate of return requirements* requiring the government business activity to earn commercial rates of return and pay commercial dividends to the Budget.
- *Regulatory neutrality* requiring that the government business activity is not advantaged by operating in a different regulatory environment to that of its counterpart private sector businesses. And
- *Full cost pricing principles* ensuring that the prices charged by the government business reflect full cost allocation for its business activities.

Source: Commonwealth Government of Australia.

– establishing principles for reforming government monopolies and prices oversight of government businesses; and by
– implementing previously agreed "related" specific reforms in important infrastructure areas, including electricity, gas, water and road transport.

Legislation review

The legislation review and reform programme is an important element of the NCP, guided by the principle that legislation should not restrict competition unless it can be demonstrated that the benefits of the restriction to the community as a whole outweigh the costs, and that the objectives of the legislation can only be achieved by restricting competition. New legislation that restricts competition must also meet these principles. About 1 800 pieces of legislation have been identified to be reviewed over seven years, with the deadline set by the Council of Australian Governments for completion and implementation of reform at 30 June 2002. However, no government was in a position to complete its programme in time, in part because of the large scope of the task, but also reflecting opposition from the groups that benefit from protection. Nevertheless, a large number of laws regulating significant areas of economic activity have been reviewed and many restrictions which were found not to provide a benefit to society have been removed or were amended. Much of the review work currently under way is expected to be completed by the next NCP progress assessment in June 2003. Unfinished business includes the implementation of specific water and energy reform commitments and the reform of the remaining statutory agricultural marketing arrangements, retail trading arrangements (including trading hours and liquor licensing arrangements), taxi licensing,[177] the regulation of the professions[178] and mandatory insurance arrangements (*e.g.* workers compensation and third party motor vehicle insurance).

Over the past year, an Independent Committee of Inquiry ("Dawson Inquiry") undertook a review of the competition and authorisation provisions contained in the *Trade Practices Act* 1974 (TPA), and their administration by the Australian Competition and Consumer Commission. The Committee is considering whether the TPA provides sufficient recognition of ongoing globalisation and its impact on the ability of Australian companies to compete globally. It is also considering whether the TPA is sufficiently flexible to respond to the transitional needs of industries undergoing or affected by structural and/or regulatory change, and those in rural and regional Australia, and whether the TPA provides an appropriate balance of power between small and large businesses. The Committee was scheduled to report to the Government by the end of January 2003.

Infrastructure industry reforms

Much progress has been made in reforming infrastructure service industries. A key feature of these reforms has been putting into effect the rules established by the NCP for third party access to "essential" infrastructure services provided by facilities of national significance. The national access regime gives economic entities the legal right to negotiate for the use of "essential" services provided by infrastructure operated by other businesses. It seeks to ensure that businesses are offered reasonable terms and conditions of access. In the event that the parties are unable to reach a commercial agreement, the regime provides recourse to compulsory and binding arbitration. Since its introduction in 1995, the *National Access Regime* has proved to be an innovative, but often controversial piece of regulation, affecting infrastructure assets of a value of well over A$ 50 billion. The *Regime* has been reviewed by the Productivity Commission (2001b) with the conclusion that that retention of the access regime is warranted but that some significant changes to its current arrangements are required. The proposed amendments seek to facilitate efficient investment in essential infrastructure and to ensure that the access regime is better targeted and more workable. The Government's response to the review will be finalised after consultations with jurisdictions.[179]

Electricity

Considerable progress has been made in developing a competitive and efficient electricity industry, which is one of the key objectives of the NCP. The structural reforms of electricity utilities are complete in New South Wales, Victoria, Queensland, South Australia and the ACT, which are now part of a national electricity market, linked by an interconnected electricity grid. Tasmania is expected to join in 2004, on completion of an interconnection with Victoria *via* an undersea power cable. Western Australia and the Northern Territory are not part of the national market because of their geographical location. The interconnection of jurisdictions' grids has led to increased cross-border trading, which has allowed jurisdictions to better manage peaks in demand by drawing electricity from interstate generators when demand exceeds their own supply capacity.

In 2000, the market for large retail customers – consuming more than 200 megawatt hours per year – became contestable within the national electricity market. Full retail contestability was achieved for all consumers in New South Wales, Victoria and South Australia. The ACT is expected to follow in March 2003. So far, Queensland has decided against full retail contestability but will review its decision in 2004.

There have been substantial improvements in the performance of the electricity industry participating in the national electricity market. The Australian Bureau of Agricultural and Resource Economics (ABARE) estimated that three years after the commencement of the national electricity market, the benefits from electricity reform were equivalent to an increase in Australia's real GDP by A$ 1½ billion (2001 prices). ABARE predicts that electricity reform alone will raise Australia's real GDP in 2010 by ¼ per cent above what it would have been without reform.[180] The New South Wales 2001 NCP Annual Report cited Treasury estimates that electricity customers in the State[181] saved over A$ 1.6 billion (in 2001 prices) between the commencement of reform in May 1995 and December 2000. The benefits of competition reform have been passed on to consumers in the form of lower electricity prices, although nation-wide retail contestability is not achieved yet, so that households can benefit only from competition in electricity generation and retailing activities. Even so, households benefit from internationally low electricity prices (Figure 37).[182] During the ten years ending in 2000-01, electricity prices for households fell in real terms in all capital cities except Hobart, Canberra and Adelaide, with falls ranging from 1 per cent in Melbourne to 7 per cent in Brisbane.[183] As a proportion of total household expenditure, the savings were most significant for those households in the lowest income bracket. Total savings made by all households across all capital cities in financial year 2000-01 amounted to about A$ 70 million. Among other benefits from reform have been higher reliability of supply and system security.

Gas

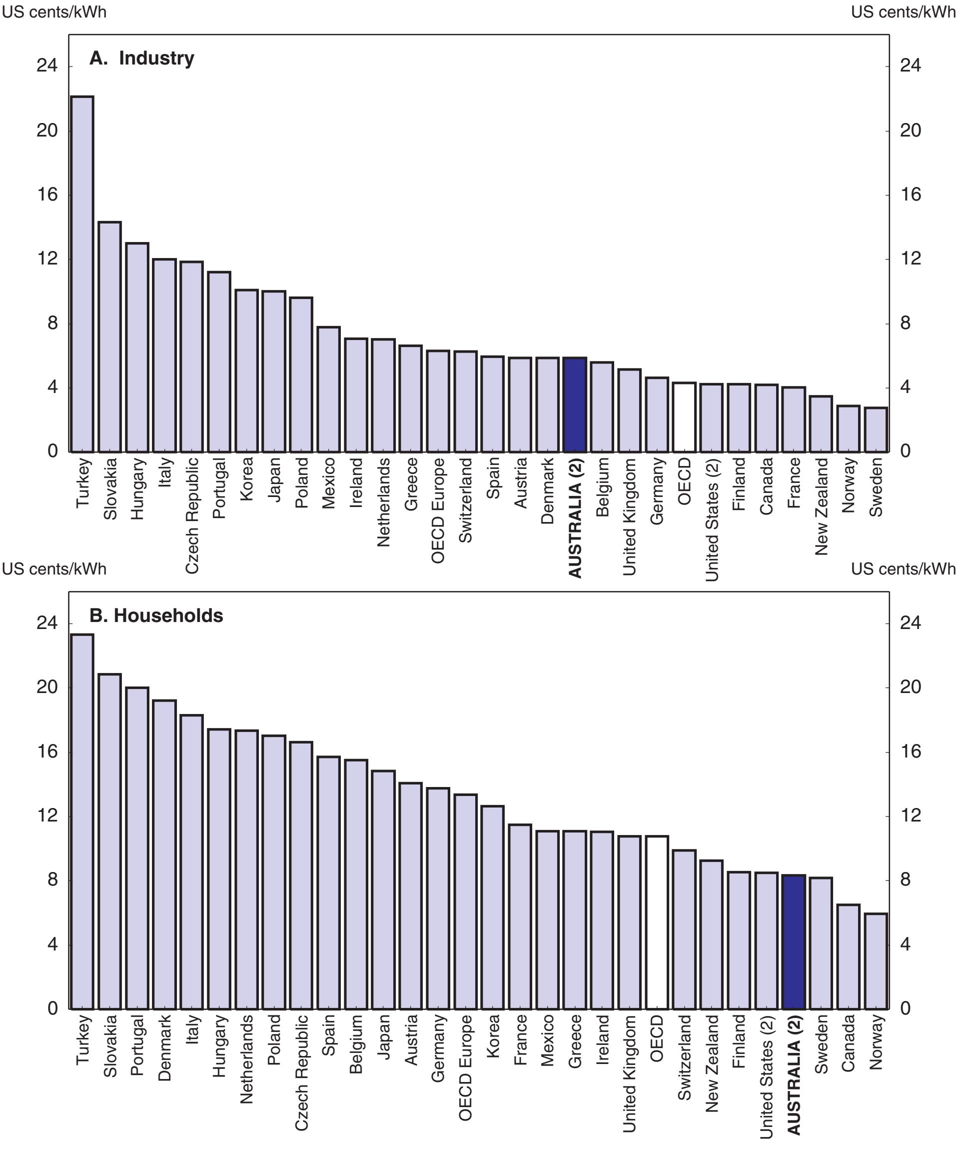
The NCP reform programme for the gas sector has been largely implemented in most jurisdictions. All governments have met their obligations to separate transmission, production and retail sectors of the gas sector and to introduce third party access regulation for natural gas pipelines. But while larger customers already enjoy choice of supplier, retail contestability is not fully achieved in the gas market, especially for smaller customers. However, regulatory barriers to full retail contestability have been removed in five jurisdictions, with three of them introducing systems to support consumer choice.

The implementation of the National Third Party Access Code for Natural Gas Pipelines (National Gas Code) and increased competition in gas exploration have encouraged gas production and pipeline development. Since 1995 more than A$ 1 billion per annum has been invested in gas exploration, transmission and distribution. It is estimated[184] that the pipeline infrastructure has nearly doubled between 1989 and 2001, to over 17 000 kilometres.

Water

Australia's inappropriate water management over many years has created severe environmental problems.[185] The main reform challenge is dealing with the environmental impacts of water use while ensuring effective property rights in water, and meeting the competing demands of irrigators, urban users and stressed rivers. The NCP water reform programme, which is scheduled to be largely completed by 2005, involves the adoption of urban and rural water charges that reflect cost recovery, the establishment of a system for determining and trading water entitlements and the provision of water allocation to the environment.

Figure 37. **Electricity prices in industry and households**[1]
Using PPPs



1. In 2001 or latest year available.
2. Price excluding tax for Australia and the United States.
Source: IEA, Energy prices and taxes (2002).

Of this programme, the *urban* water reforms are now almost complete. They include consumption-based pricing of urban water to discourage wasteful use and full cost recovery by water service providers to help 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. The *rural* water reforms relate primarily to arrangements for using water for irrigated agriculture, (more than 70 per cent of water use in Australia is in irrigation). Excessive allocations to irrigation over most of the past century have caused extensive damage to river systems and groundwater resources, while salinity associated with rising water-tables is rendering infertile large tracts of productive land. Rural pricing reform has seen all governments establish reform paths to institute efficient water pricing, ensure adequate water allocations to the environment, and to provide clear water property rights, separate from land title. Irrigators are charged for water use on a volumetric basis, where possible, and cross subsidies are being eliminated or being made more transparent. However, water trading arrangements, based on a system of property rights separate from land title, are not fully implemented.

Road transport

The NCP road transport reform programme focuses on effective and nationally consistent regulation, in order to transform the road transport industry into a truly national industry with minimal impediments to interstate operations. The programme is specified in a package of 31 initiatives covering six areas (registration charges for heavy vehicles, transport of dangerous goods, vehicle operations, heavy vehicle registrations, driver licensing, and compliance and enforcement). Governments did not endorse any road transport reforms for assessment by the NCC in 2002. They also have not listed for NCP assessment some of the reforms from the original road transport package (notably, the speeding policy of heavy vehicles and the higher mass limits), although some governments have implemented these either in whole or in part. However, reforms that were not implemented and operational at the time of the 2001 NCP assessment are now substantially complete, and – at the time of writing in late 2002 – most outstanding reforms are expected to be in place by early 2003. Road reform is now being pursued outside the NCP framework through a co-operative intergovernmental process. As part of this process, transport Ministers from each jurisdiction agreed in 2002 to establish a National Transport Commission to deal with road, rail and intermodal regulatory reform.

Rail transport

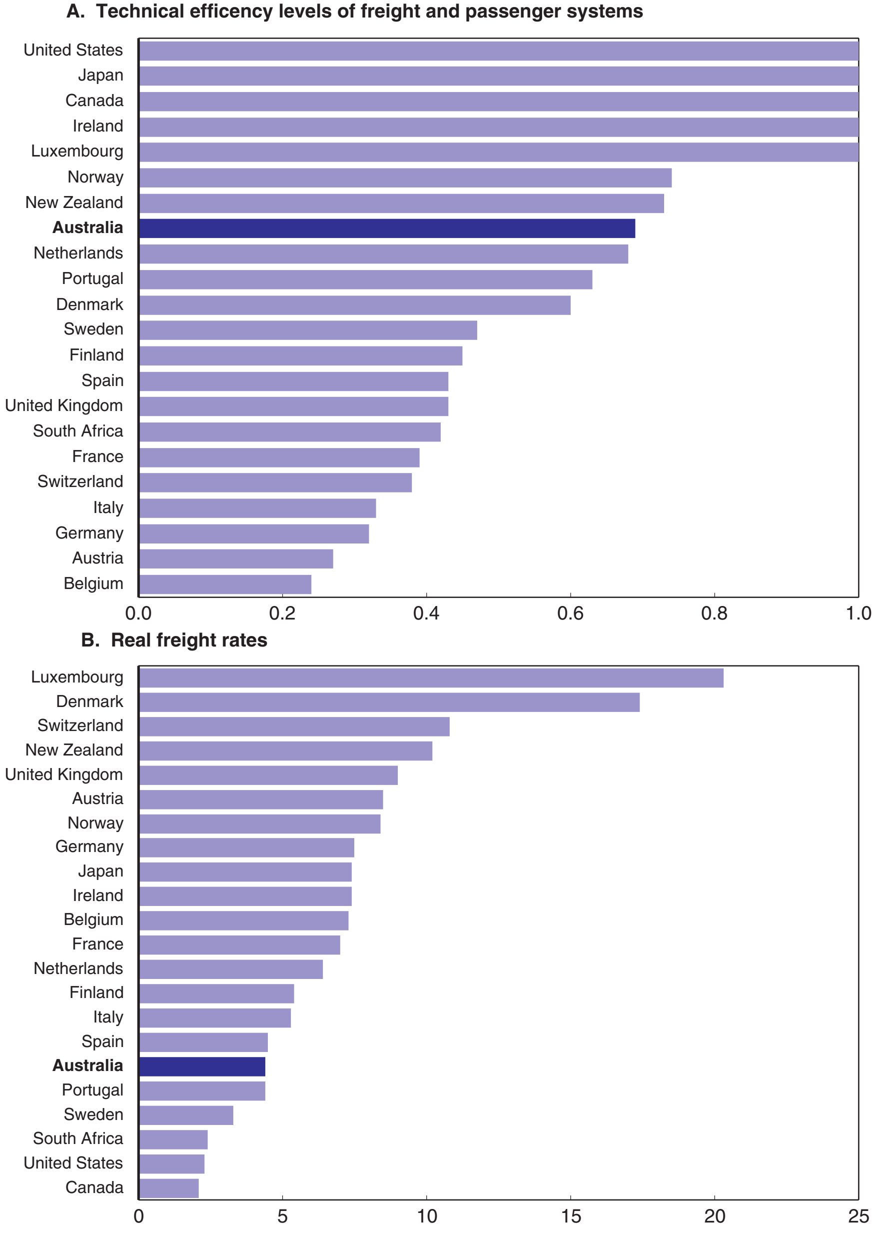
The National Competition Policy agreements do not include specific arrangements for rail reform. However, rail services are subject to all of the general provisions of the Competition Principles Agreement, which has generated significant reform in the rail sector. State access regimes are facilitating competition in rail haulage operations, especially in bulk haulage operations. For example, New South Wales coal mining operations have benefited from large reductions in haulage costs, helping to ensure the viability of these operations, and similar benefits are expected for users of bulk haulage services in other States.

As all government rail track and freight businesses are significant businesses, they are subject to competitive neutrality obligations. These have been addressed by corporatising rail businesses and in some cases, privatisation. Accordingly, the Commonwealth has sold its interests in the Australian Railways Commission, and restructured and sold train operations and track businesses of Australian National over the period 1993-2002. Importantly, this reform process included the establishment of the Australian Rail Track Corporation (ARTC), which has provided operators with better service over much of the interstate track. Subsequently, efficiency on the East-West corridor has increased. Nevertheless, the continuing involvement of the states in the railway sector, the lack of nationally uniform operational requirements on the interstate rail network and the lack of attention to resolving interstate access questions involving New South Wales track (which has delayed ARTC investment on the North-South corridor in that State) are issues that need to be addressed to keep the sector viable in the longer term. Indeed, although estimates by the Productivity Commission (1999d) suggest a sharp increase (about 8 per cent per year) in the productivity of the Australian freight and passenger rail system since the late 1980s, the technical efficiency[186] of the rail system is estimated to be substantially lower than in a number of other countries[187] (Figure 38). Nevertheless, Australian freight rates are quite low by international comparison, which suggests that railway profitability is lower than elsewhere.

Air transport

The structure of Australia's aviation market changed substantially when Ansett, Australia's second biggest airline, collapsed in September 2001. The demise of the airline, which held 39 per cent of the domestic air travel market, allowed Qantas to raise its domestic market share market from 55 per cent to more than 80 per cent shortly after Ansett's failure, while at the same time reducing the availability of discount fares. Since then, new entrant Virgin Blue, now Australia's only other trunk route competitor, expanded its share in the domestic air travel market to some 23 per cent. There is a risk, however, that Qantas might use its dominant position to undercut the prices of its only competitor to deter or prevent Virgin Blue from engaging in competitive conduct in the market, including the expansion of its network. First indications of this to happen have induced the Australian Competition and Consumer Commission (ACCC) to embark in 2002 on an

Figure 38. **Railway system performance: an international comparison**



Source: Productivity Commission.

investigation into some of the dominant firm's practices, to assess if they imply an abuse of market power.

The geographical and demographical features of Australia favour air transport, as the population is concentrated in a few major cities that are at some distance from each other (Sydney is as far from Melbourne as Paris is from Milan, Brisbane is about as far from Perth as Washington is from Los Angeles), while high per capita incomes also favour this mode of transportation. However, the relatively low overall population limits the size of the airline market and its ability to support many competitors. Nevertheless, the current structure of the market for domestic air travel could result in both higher fares and lower service. Although there is no easy solution to this problem, competition could be enhanced by lifting constraints on foreign airlines serving Australia to carry freight and (international and national) passengers within the country. Ideally, liberalisation would be achieved on a reciprocal basis with other countries, but if this were not feasible, a unilateral move to enhance competition in domestic aviation should be considered.

Telecommunications

The telecommunications market was fully liberalised in 1997 and regulation separated from the commercial activities of the incumbent telecommunications operator Telstra, in line with the requirements of the NCP. However, the local fixed network was not separated from the company's competitive elements, but anti-competitive conduct was prohibited and third party access has been submitted to a telecommunications-specific access regime.[188] The latter was amended in September 2001 by the introduction of a series of measures which aim at improving the dispute resolution mechanism under the current access regime to facilitate the commercial settlement of disputes. In response to the Productivity Commission's Inquiry Report on Telecommunications Competition Regulation (2001a), the Government also introduced legislation, passed by the Parliament in December 2002, which will *inter alia* facilitate timely access to basic telecommunications by requiring the Australian Competition and Consumer Commission to publish benchmark terms and conditions; enhance the timeliness of dispute resolution; facilitate investment in new telecommunications infrastructure; and encourage a more transparent regulatory market by requiring accounting separation of Telstra's wholesale and retail operations.

Assessment

Australia is now in its seventh year of the National Competition Policy, the most ambitious and comprehensive programme of economic reform in the country's history, and an ambitious programme by Member country standards in general. Much has been achieved but there is still unfinished business so that the reform timetable has had to be extended. Thus, the deadline for completing the legislative review and reform programme has been set back; the national electricity market reforms, although significantly progressed, will not be implemented to the level of household choice of electricity supplier for several years; and rural water reform will not be completed until at least 2005, probably much later. Moreover, there remain *inter alia*[189] the tasks of enhancing competition in fixed-line telecommunications and of opening the postal services market to competition.[190]

Nevertheless, what has been accomplished in about seven years of the NCP is likely to have had a substantial contribution to the improvement in multifactor productivity and economic growth in recent years. Indeed, the Productivity Commission estimates[191] that as a result of competition policy (and other microeconomic reforms), Australia's GDP is now about 2½ per cent higher than it would otherwise have been,[192] and Australian households' annual incomes on average around A$ 7 000 higher. The Productivity Commission's (1999a) modelling of the regional effects of NCP reforms also suggests that, although initially metropolitan areas had benefited more than rural and regional areas from reform, all except one of 57 regions will gain in the long run from reform in terms of output, while all of 57 regions are predicted to gain in terms of average income per person employed. While the estimates show that 14 regions (accounting for about 6 per cent of total employment) are likely to suffer from short-term job losses from the NCP, five of these regions may recoup these in the medium run.

Given its temporary negative side effects in terms of lost incomes and employment, the reform of legislation restricting competition is often contentious, generating opposition from the groups that benefited from protection. Combined with broader concerns about the speed of economic and social change, this opposition may create a political environment that may impede economic reform. Hence, strong government leadership is required in explaining the need for change, and the removal of restrictions which have been shown not to be in the general public interest. Governments may also assist reform by helping the community financially to adjust to the new environment.

Financial system reform

Based on the view that the stability, integrity and efficiency of the financial system are critical to the performance of the entire economy,[193] labour and product market reforms were complemented by an extensive examination of regulations applying to the financial services industry. This culminated in a comprehensive reform of the financial system[194] which focuses on prudential supervision, depositor protection and the promotion of competition among financial service providers. The "Wallis reform" programme thus responds to ongoing developments in the financial sector, including the blurring of the boundaries between financial instruments and institutions, increasing competition from non-financial institutions and from abroad, and the substitution of financial market transactions for direct financial intermediation. The reform came into effect in two steps on 1 July 1998 and 1 July 1999 and replaced the previous institution-based regulators by three objectives-based agencies whose responsibilities extend across the entire financial system:

- a single prudential regulator, the *Australian Prudential Regulation Authority* (APRA), which is responsible for prudential regulation of authorised deposit-taking institutions, general insurance, life insurance (including friendly societies) and superannuation;
- a single regulator for conduct and disclosure, the Australian Securities and Investments Commission((ASIC), which is responsible for maintaining market integrity, consumer protection, and the supervision of companies; and
- the Reserve Bank of *Australia* (RBA) remains responsible for the overall stability of the financial system, monetary policy and the payments system.

A further stage in financial system reform was the commencement of the *Financial Services Reform Act* 2001 on 11 March 2002. The new *Act* introduced reforms designed to provide for a single, harmonised licensing regime for financial service providers and product issuers, as well as a consistent and comparable financial product disclosure regime, and uniform arrangements for the regulation of financial markets. The regulatory regime established by the *Act* is administered by ASIC. The reform also aims at a consistent framework of consumer protection across the financial services industry, a better understanding and comparability of different financial products by consumers and better access of consumers to efficient complaints-handling procedures for resolving disputes with financial service providers. In addition, the reform seeks to cut compliance costs for financial service providers and to remove regulatory barriers to the introduction of technological innovations. It thus should also provide a boost to e-commerce by facilitating the electronic delivery of a range of financial services and products.

Given the move to more diversified and complex financial institutions and improvements in international best-practice regulation in recent years, there was also a need to reform the prudential regime for general insurance. Hence, the Government introduced significant and wide-ranging reforms to legislation governing the prudential regulation of the general insurance sector. The *General Insurance Reform Act* 2001, which amended the *Insurance Act* 1973, came into effect on 1 July 2002, with changes in capital requirements to be phased in on 1 July 2004. The most important element of reform is a substantial increase in the level of regulatory capital that must be held by insurers. Insurers will be required to hold capital commensurate with the risk profile of the insurance business being underwritten. Accordingly, the capital requirements for "long-tail"[195] insurance, such as public liability and professional indemnity insurance, have been increased. Entry-level capital requirements have been increased from A$ 2 million to A$ 5 million. The changes also impose compulsory risk management systems, which include pricing and underwriting control mechanisms. Other reform elements are expanded obligations on auditors and actuaries to report to the prudential regulator, strengthened enforcement powers, the extension of authorisation requirements to non-operating holding companies, and new powers for the regulator (APRA) to make, vary and revoke prudential standards. It is expected that the reforms will enable the risks in each institution to be addressed more effectively, the supervisory framework to better take into account the individual circumstances of each firm, and the prudential regime to accommodate market developments over time more easily.

The Government has also issued in September 2002 a discussion paper[196] on the issue of compensation for losses suffered by consumers of financial services as a consequence of the misconduct of a financial services licensee or its representatives in the course of service provision, as opposed to losses because of poor returns, or the collapse of the issuer of a financial product. The objective is to ensure an efficient compensation regime, which provides appropriate protection for investors, but does not impose an unjustified burden on service providers.

Complementing the financial system inquiry, the Government established the *Corporate Law Economic Reform Program* (CLERP)[197] to review existing policy in key areas of business regulation. The purpose of the programme is to improve the efficiency of corporate regulation and to reduce regulatory burdens on business, while maintaining investor protection and market integrity. Under this programme, the Government released a number of policy papers containing detailed proposals followed by the release of draft legislative provisions as a means of an intensive consultation process.

The Government released the ninth stage of CLERP in September 2002 which makes proposals to strengthen the regulatory framework in the areas of corporate accountability, the transparency of financial and other information, and the protection of shareholder rights. The 41 proposals aim to promote a disclosure framework that provides the structures and incentives conducive to a fully informed market; it also seeks to assist in defining world's best practice. In particular, it is proposed to punish corporate misbehaviour where it occurs without hampering innovation and wealth creation. *Inter alia*, the proposals would:

– expand the role of the *Financial Reporting Council* to include public oversight of audit independence and audit standard setting in Australia (auditing standards will have the force of law on the same basis as accounting standards issued by the Australian Accounting Standards Board);
– make audit committees mandatory for Australia's top 500 listed companies and make audit partner rotation compulsory after 5 years;

– require disclosure in annual reports of fees for all categories of non-audit services provided by an audit firm and require audit committees to certify that the provision of certain non-audit services did not compromise audit independence;
– increase the maximum civil penalty for contraventions of continuous disclosure provisions of the Corporation Act by bodies corporate from A$ 200 000 to A$ 1 million and revise civil and criminal penalties applying to financial reporting offences; and
– empower ASIC to issue infringement notices in response to minor contraventions of the continuous disclosure regime;
– draft legislation is expected to be released for consultation in early 2003.

The Government's main financial sector policy is to ensure an appropriate balance between safety and efficiency. It has stressed that the reform of the prudential and financial reporting framework cannot be aimed at preventing the failure of an institution but rather to ensure that systems for identifying, measuring and managing the various risks in businesses are in place which reduce the risk of failure to an acceptable level. Indeed, Australia was not spared from major financial sector failures in recent year. A prominent case was the liquidation of the HIH insurance company on 15 March 2001, with an estimated deficiency of over A$ 5 billion, representing one of the biggest collapses in Australian corporate history. In the wake of the event, APRA was subjected to sharp criticism, which questioned its investigative powers, the skills of its staff and its actuarial and reinsurance experience. In consequence, the Government established a Royal Commission to investigate the causes of the failure of the HIH group, which will report in April 2003. The issue of whether to provide a guarantee to consumers against the failure of prudentially regulated institutions has been raised in submissions to the Royal Commission.

Sustainable development in Australia

There is growing concern that long-run sustainable development may be compromised unless measures are taken to achieve balance between economic, environmental, and social outcomes both domestically and on a global basis.[198] This section looks at three specific issues of sustainable development that are of particular importance for Australia. In each case, indicators are presented to measure progress and the evolution of potential problems, and an assessment is made of government policies in that area. The issues covered relate to policies in the realms of ensuring *sustainable retirement income*, *helping to increase incomes in developing countries* and *managing natural resources*. The section also considers whether institutional arrangements are in place to integrate policy-making across the different elements of environmental sustainable development (see Box 6).

Box 6. Integration of policies across different environmental sustainable development areas

Under the Australian constitution, the responsibility for natural resource management and planning rests with the governments of the States and Territories. Consequently, state governments have the responsibility for the major part of environmental legislation, with areas of responsibility defined in two inter-governmental agreements (for more detail see OECD (1999d). The role of national government has grown with the Environmental Protection and Biodiversity Act in 1999 giving the Commonwealth powers in a limited number of nationally significant areas where it can institute an environmental assessment and approval process but does not mandate the use of cost-benefit analysis. Nonetheless, the government strategy for ecologically sustainable development adopts a market-based approach, favouring the incorporation of externalities and risk factors into prices. Cost-benefit analysis is one of the factors taken into account in policy making. However, its role is limited both because the time frame for policy development is often shorter than that needed for cost-benefit analysis and because of the difficulty of quantifying many of the benefits linked to threatened animal and plant species which has been studied most in the assessment process. The much-enhanced environmental monitoring activity is leading to better informed judgements about environmental impacts at the national level.

Providing a sustainable income for the elderly

Main issues

With a low level of public provision of retirement income at present, the principal means for moving towards a higher level of retirement income for individuals in the future is based on a system of mandatory saving for retirement and taxation concessions for savings. These instruments are likely to increasingly interact with a further policy lever, the means-testing of state benefits, in a way that may have adverse effects on the economic pillar of sustainable development through decreasing incentives to save and increasing incentives to early retirement. The main issue is how to balance these adverse impacts with the need to minimise fiscal costs and at the same time ensure income adequacy for the elderly.

Performance

The relative income level of elderly people in Australia has been amongst the lowest in the OECD area. In the mid-1990s, the median disposable income of the elderly relative to the median for all households was some 16 percentage points below the simple average of that ratio in other OECD countries (Table 18). At the same time, the proportion of the elderly with a disposable

Table 18. **Performance indicators: sustainable retirement income**

	Projected increases in old age pension spending	Low income rate of the elderly[1]	Relative disposable income of the elderly[1]	Private pension funds 1999	Age of withdrawal, 1994-1999		Participation rate, 2001, per cent		
							Aged over 65	Aged 55-64	
	Change in per cent of GDP	Per cent of the elderly with income less than 50 per cent of median disposable income	Per cent of the disposable income of all individuals	Per cent of GDP	Male	Female		Male	Female
Australia	1.6	16.1	67.6	63.8	59.7	61.3	6.0	60.0	36.9
Austria	2.2	14.9	86.6	3.6			2.8[1]	42.1[1]	17.5[1]
Belgium	3.3	13.8	77.9	6.1			1.3	36.6	15.7
Canada	5.8	2.5	97.4	45.7	62.6	61.1	6.0	61.3	41.7
Czech Republic	6.8			3.8			4.0	55.0	24.5
Denmark	2.7	9.2	73.0	24.4	62.4	61.5	4.6	65.5	51.8
Finland	4.8	7.5	79.0	10.7	59.8	60.0	3.7	51.2	49.5
France	3.9	10.7	89.7	6.3	59.3	59.8	1.2	43.8	34.1
Germany	5.0	10.4	85.6	3.2	60.5	60.8	3.0	50.6	32.4
Greece		29.2	76.8	4.6	61.7	62.2	5.0	57.0	23.6
Hungary	1.2	6.0	85.2	2.2			3.1	36.3	15.4
Iceland				86.0			19.9	92.8	81.7
Ireland		16.7	74.6	57.8			7.9	66.1	29.5
Italy	–0.3	15.3	84.1	3.0	59.3	58.4	3.4	57.8	26.6
Japan	0.6			18.7	69.1	66.0	21.8	83.4	49.2
Korea	8.0			3.2	67.1	67.5	29.6	71.3	47.9
Luxembourg		6.7[2]		..			0.0	38.1	14.3
Mexico		32.9	85.3	2.4			30.5	80.5	27.6
Netherlands	4.8	1.9	86.3	119.3	61.6	60.1	3.1	52.0	26.9
New Zealand	5.7			..			8.6	74.6	51.7
Norway	8.0	19.1	74.1	7.4	64.2	64.7	13.2	73.6	63.2
Poland	–2.5	8.4[2]		..			7.5	41.5	24.1
Portugal				11.4	65.3	66.5	19.0	63.7	41.9
Slovak Republic							1.1	43.0	11.2
Spain	8.0	11.3[2]		2.3	61.1	61.1	1.6	61.4	23.6
Sweden	1.6	3.0	89.2	..	63.3	61.8	9.4	73.5	67.4
Switzerland		8.4[2]		97.3[3]			11.4	82.4	56.1
Turkey		23.1	92.7	..			18.1	50.8	18.4
United Kingdom	–0.7	11.6	77.8	84.1	62.0	61.2	4.8	64.4	44.6
United States	1.8	20.3	91.7	74.4	65.1	64.2	13.1	68.1	53.0

1. Förster and Pellizzari (2000).
2. Smeeding (2002).
3. 1998.

Source: Förster and Pellizzari (2000); Jesuit and Smeeding (2002), *Luxembourg Income Study*; OECD *Labour Force Statistics*, Scherer (2002).

income below half of the average was amongst the highest in the OECD area.[199] However, cross-country comparisons of the relative income of retired people do not take into account that the level of homeownership is the highest in the OECD area. Even so, the raw non-housing consumption of the elderly is still only just half that of households in the 15 to 54 age range. However, if the income in kind of the elderly households (mainly government-provided health care) are taken into account, and adjustments are made using the OECD modified equivalence scales, the adjusted relative consumption level of the elderly rises to 74 per cent of that of the 15 to 54 age group. The relative income levels reflect the reliance of the bulk of the current retired population on the first-tier age pension.[200] This age pension provides a flat rate, but means-tested, benefit for all residents over 65 (62 for women, rising to 65) equivalent to one-quarter of male total average earnings with no earmarked financing. Private saving is only an important source of income for the elderly in the highest quintile of pensioner households. Although incomes in retirement are low, at present, this is not reflected in high labour force participation, the number of elderly that work being in line with the median experience in the OECD area.

The income adequacy of retirees is expected to improve markedly in the future without putting pressure on public finances. The level of public pension spending is currently among the lowest in the OECD area. This position is unlikely to change in the next 50 years, as the expected increase in public pension spending is among the lowest in the area. This muted increase in pension outlays despite the old-age dependency ratio rising in line with the OECD average reflects falling effective state pension replacement rates as the proportion of retirees receiving a full state pension is likely to decrease substantially (Table 19).

Table 19. **The evolution of state pension benefits**

	2001	2041	Change
	Per cent		
Proportion of elderly receiving:			
Full age pension	54	33	–21
Partial age pension	28	42	14
No age pension	18	25	7
Average age pension relative to pension with no means testing	83	73	–10
	Per cent of GDP		
Government spending on age pensions			
Current rules	2.9	4.6	1.7
With no means test	3.5	6.3	2.8

Source: Commonwealth Treasury of Australia (2002).

Nonetheless, the income position of the elderly is projected to improve markedly, as income from private retirement saving should rise strongly. Indeed, private retirement wealth is projected to increase seven-fold by 2030 compared with its level in 1998, when it was equivalent to just under five years payment of the basic state pension. Official simulations suggest that the ratio of disposable income of retirees to disposable income in the five years before retirement should reach 70 per cent by 2050.

Policy

These future pension developments are driven by a policy reform in 1992, when the government generalised the second tier retirement saving system that had first been introduced following an agreement between employers and unions in 1986.[201] Subsequent reforms have made provision for voluntary retirement saving. All employees earning over A$ 450 per month (around 12 per cent of average full-time earnings) have to join a superannuation fund,[202] and the current contribution rate by employers is 9 per cent of employee salary. At retirement (from 55 onwards, to be raised to 60 by 2025), individuals can choose to take either a lump-sum benefit or one of several types of income stream. In practice, apart from public sector workers in defined benefit schemes, nearly all people have so far taken lump sums, given the extent of adverse selection that occurs in the annuity market. Also, most lump sums are still only small, reflecting the fact that the compulsory superannuation system is still maturing. Superannuation funds also act as a vehicle for the third tier of provision: voluntary saving. All employees can make voluntary contributions, and the government has introduced legislation to provide a co-payment for low-paid workers. The 1992 reform was accompanied by the establishment of a strong "prudent-man" regulatory regime for superannuation funds; the government has now announced its intention to require funds to submit risk-management plans.[203]

The current tax regime for retirement saving is effectively close to the expenditure tax system used in most OECD countries, but this result is achieved in a complicated fashion.[204] For a simple case in which a person pays the same marginal tax rate throughout his life, the internal rate of return on pension saving almost equals the pre-tax rate of return (Table 20). Consequently, the system is close to one in which contributions and investment income are not taxed and only benefits are taxed, although the Australian system taxes all three elements.[205] However, beyond such a straightforward case, the system becomes complex. For example, a lump sum withdrawal from a superannuation fund at retirement can be taxed up to eight ways. Moreover, there are upper limits on both contributions and benefits, with the former being age-related. In addition, the tax rate on superannuation contributions and benefits is set independently of the income tax rate schedule and this can alter incentives when income tax rates are changed.

Table 20. **The effect of taxation on portfolio returns inside and outside a superannuation fund**

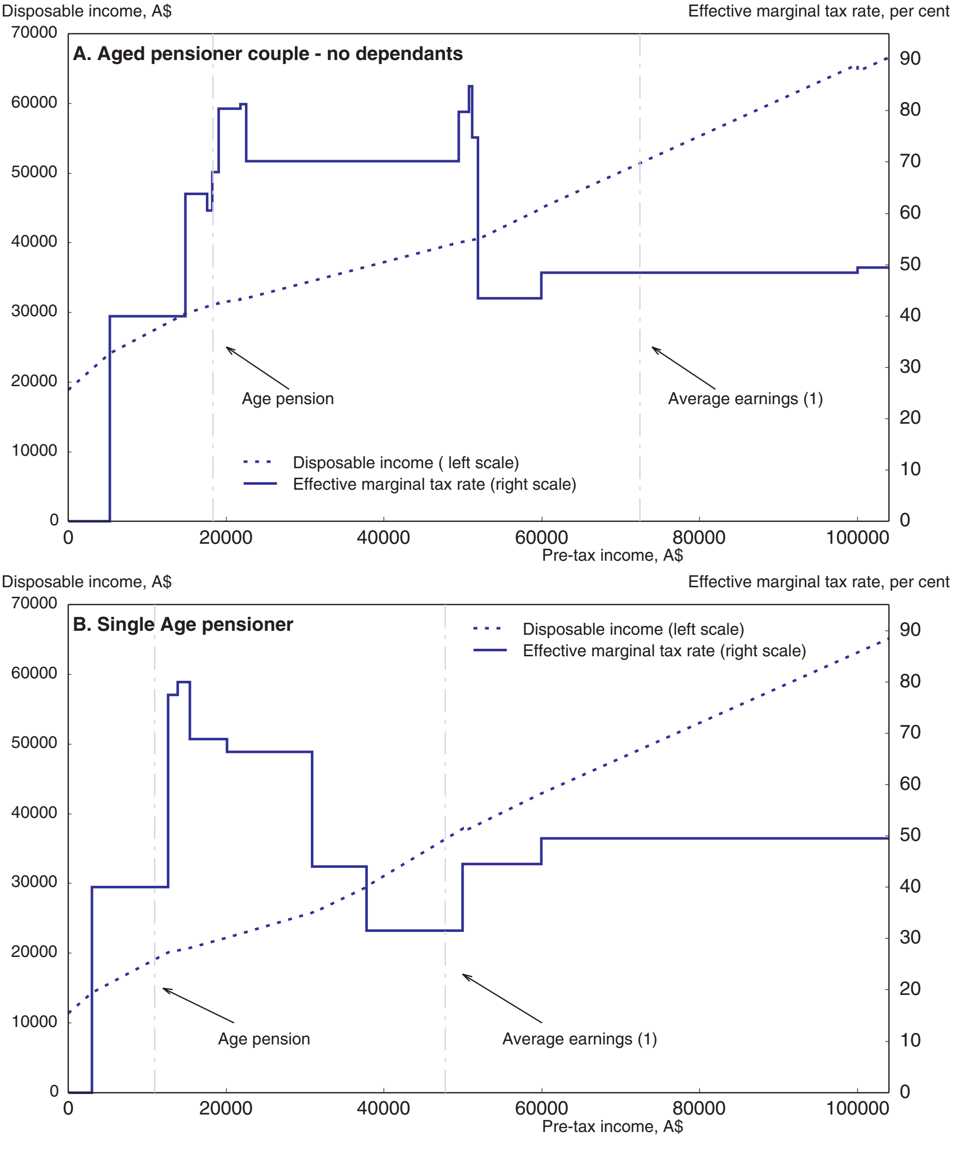
Marginal tax rate of saver	10 year holding period		20 year holding period		Pre tax return
	Inside fund	Outside fund	Inside fund	Outside fund	
18.5	7.9	7.4	7.7	7.4	8.0
31.5	7.8	6.4	7.6	6.4	8.0
48.5	8.9	5.2	8.1	5.2	8.0

Note: A balanced portfolio is assumed to consist of 40 per cent bonds, 40 per cent Australian equities and 20 per cent foreign equities.
Source: Rothman (2000).

Together with the income tax system, the means-testing of the age pension results in very high implicit marginal income and wealth taxes for retired persons (Figure 39). Two means tests are applied, with the test that results in lowest pension being employed. The first test reduces the age pension by 40 per cent for all income that is above a certain threshold.[206] The second test reduces the age pension by A$ 3 each fortnight (A$ 78 per year) for every A$ 1 000 of assets in excess of an asset test threshold.[207] At retirement, the present value of such a reduction in the age pension is about A$ 570, if the payment is discounted by the difference between the long-run real interest rate and the growth of real wages and the asset is drawn upon evenly over the expected life of the recipient. If there is a less than full draw down of asset, the loss in the present value of the pension is higher. The majority of age pensioners are not affected by the assets test. Both means tests exempt owner-occupied housing, although the assets test allows a higher threshold for those with no house. There are other significant opportunities to avoid or minimise the substantial effective benefit-withdrawal rate of the asset test, such as purchasing a complying lifetime pension.

There is some evidence that such high effective tax rates have already had adverse effects on labour supply and saving. The income of the elderly clusters around the level provided by the flat-rate pension. Moreover, the extent of the concentration is much greater than in other countries with flat-rate pensions but no means-testing.[208] Labour supply after the age of 65 is likely to be reduced, as suggested by the recent slight increase in part-time employment when marginal pension reduction rates fell in 2001. A further consequence of this means test is to create an incentive for retirement before 65 when the age pension commences. In such a case, private saving can be used to support consumption in the period before the state pension is paid. This reduces the assets available at age 65 and so lowers the means-test reduction after age 65. In effect, for many early retirees, 40 per cent of the cost of this option is met by the state. Moreover, the

Figure 39. **Effective marginal tax rates for the elderly**



1. Average earnings refers to total earnings in August 2002 for two employees for the first panel and for a full time adult for the second panel.

Source: Department of the Treasury and Australian Bureau of Statistics.

means tests tend to distort asset allocations: more than 40 per cent of those receiving a lump-sum payment in the twelve months to June 2002 used the proceeds to invest in assets, such as houses, that are exempt from the asset test.

Given the responses that have occurred in the past, it seems likely that interaction of mandatory retirement saving and means testing will generate significant behavioural responses in the future. Many people will move over the threshold for the assets test, as average superannuation wealth is likely to rise to almost three times the current threshold. The move to early retirement is likely to be accentuated, given the difference between the age at which the state pension is paid and the age at which superannuation wealth can be drawn without penalties. Indeed, the asset test could effectively reduce retirement wealth, with the greatest proportionate effect being felt on people somewhat below average income. Such an incentive effect could be countered by a progressive increase in thresholds for the assets test as the retirement saving system matures. Any change in the assets test, though, would need to be financed. If income taxes were raised, this too would have incentive effects that would have to be weighed against the improvement of incentives for saving. On the other hand, an increase in indirect taxes would minimise the impact on incentives to save.

Apart from incentives to retire early built into the current pension and tax system, early retirement is supported by other benefit programmes. The proportion of the population receiving state benefits starts to increase markedly at age 55 and, for men, almost doubles by age 60. In the age group 60-64, one quarter of the male population receives the disability support pension while almost one in eight receives a form of unemployment benefit. Most of the unemployment beneficiaries receive a benefit known as the mature age allowance that does not require active job search. However, this scheme will be closed to new entrants in July 2003. Thereafter, people in this age group will have to draw the Newstart allowance that imposes work search tests on the individual.

Conclusions

The decision, taken in 1992, to introduce a three-tier pension system, based on a significant private sector provision has placed the provision of retirement income on a sustainable path but a number of problems remain. On the positive side, the reform may contribute to Australia having one of the smallest increases in public pension outlays in the next 40 years in the OECD area, while bringing an increase in the wellbeing of the retired. On the negative side, the means testing of the basic age pension is likely to raise incentive problems that will become progressively more serious with the growth of mandatory saving, especially for lower income groups. At the very least, the assets test should be eased and, given the long-term horizons for retirement saving, an early abolition might be warranted. A further reduction of the pension withdrawal rate for the income means-test should be considered, given the high marginal effective tax rates for many elderly people, but the budgetary consequences limit the scope for major changes in this area. In any case, changes in the means-test should take priority over any changes to the income tax treatment of superannuation, where the key for future policy will be to ensure that the current effective expenditure tax basis remains in place. However, due to the income testing of state pension benefits, the age at which superannuation benefits can be drawn with no tax penalties should be aligned on the standard retirement age to limit incentives for early retirement. The government should carefully monitor the gradual abolition of the special unemployment benefits for the elderly to ensure that people do move into employment. Finally, given the growing importance of mandated private pensions, the authorities have a particular responsibility to ensure that the regulatory regime for superannuation funds keeps abreast of changes in financial markets and resolves questions concerning the purchase of assets by funds from related companies.

Helping developing countries to achieve sustainable growth

Main issues

A reduction in poverty in the non-OECD area will contribute to the achievement of globally sustainable economic growth. Although developing countries themselves have the major responsibility to implement policies that result in improved living standards, trade and aid policies of OECD countries can help to reduce poverty in developing countries. Australia can contribute to poverty reduction by allowing products from poor countries open access to its markets and by targeting its aid on areas which are most likely to raise living standards of the poorest groups in the developing countries.

Performance

The Australian economy has become markedly more open and oriented to trade with developing countries in recent decades. The import penetration rate has risen from 15 per cent in the second half of the 1980s to 22 per cent in 2001. The growth of imports from developing countries has been very high, rising by 12 per cent annually, in real terms, over that period (Table 21, Panel A), with a particularly rapid increase in imports from low-income countries, notably China. Even imports from the least-developed countries have grown significantly faster than overall imports but accounted for only 0.2 per cent of total imports in 2001 (Table 21, Panel B). Textiles and clothing are one area where low income countries now dominate the market (Table 21, Panel C).

The foreign aid programme has stabilised at around ¼ per cent of Gross National Income after a long period of decline. Real expenditure on aid is projected

Table 21. **Australian imports from developing countries, 1980-2001**

	Developing countries					OECD countries	World
	Low income countries		Middle income countries		All		
	Least-developed	Other	Lower	Upper			
	Per cent change, annual rate, real terms[1]						
Growth of imports							
Food, raw materials	2.5	6.9	5.3	–0.1	–3.6	2.1	2.3
Textile and clothing	–2.8	11.1	4.4	1.0	9.6	–2.7	3.0
Other manufacturing	29.7	19.0	9.9	12.8	14.7	2.7	4.1
Total	4.0	16.0	9.9	7.3	11.9	2.5	4.2
	Per cent						
Origin of Australian imports							
Food, raw materials	0.9	10.7	11.5	9.7	32.8	63.5	100.0
Textile and clothing	0.4	59.2	5.7	2.3	67.6	25.9	100.0
Other manufacturing	0.1	9.6	3.9	4.5	18.1	74.4	100.0
Total	0.2	14.8	5.0	5.8	25.8	65.6	100.0
	Per cent						
Structure of imports by regional grouping							
Food, raw materials	29.3	5.8	17.3	14.2	10.1	6.1	6.8
Textile and clothing	13.2	28.3	7.6	3.0	18.5	2.2	6.1
Other manufacturing	57.5	65.9	75.1	82.8	71.3	91.6	87.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. Nominal increases have been deflated by the Australian GDP deflator. The country aggregations are those used by the Development Assistance Committee for 2003.

Source: OECD International Trade Database.

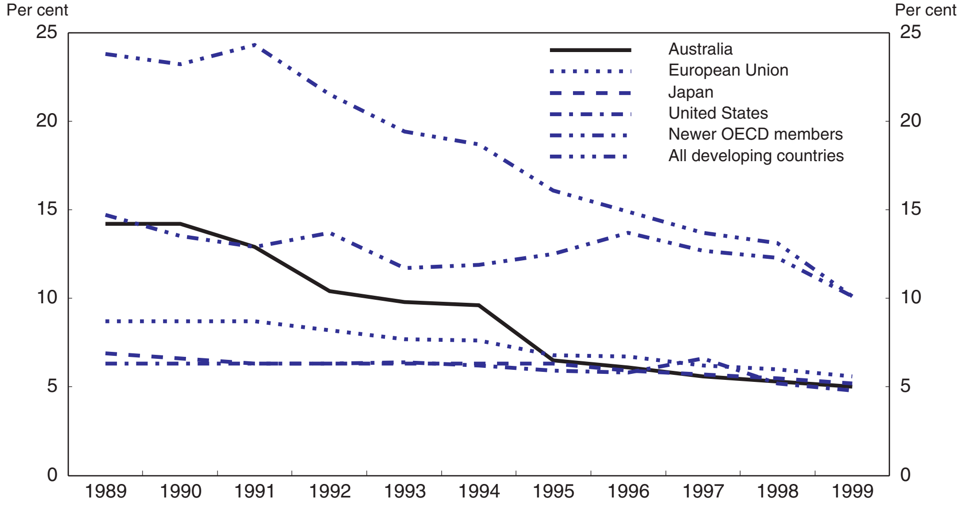
to rise 3 per cent in this fiscal year. Outlays are concentrated on the areas of most concern to Australia: the nearby Asian and Pacific countries where poverty has been accentuated by significant political instability. In 2000, twelve countries accounted for 80 per cent of bilateral aid, with one country, Papua New Guinea, receiving 30 per cent of bilateral aid. Tied aid represents a slightly greater-than-average proportion of bilateral aid than for all OECD countries. About one-quarter of total aid is disbursed through multilateral programmes in line with the OECD average.

Policies

For the past two decades Australia has proceeded on a largely unilateral path of opening its economy to foreign trade to developed and developing countries alike. From an unweighted average of 14 per cent in 1989, average tariffs on manufacturing goods have fallen to around 5 per cent in 2001, bringing them in line with those in other industrial countries (Figure 40). Quotas have been entirely abolished. High tariffs have been concentrated in a few sectors – autos, textiles, clothing and footwear. A phased reduction in tariffs in these areas is underway, with the government reviewing further tariff cuts in clothing and footwear[209] (Table 22). Tariff peaks are concentrated in this area, where there is also significant tariff escalation resulting in the effective rate of protection for clothing (at 34 per cent) being twice that for textiles, with cotton entering tariff free.

In 1994, in the context of falls in the overall tariff level, the Generalised System of tariff Preferences for all developing countries, in place since 1966 and amounting to a 5 percentage point advantage, was restricted to least-developed countries and South Pacific island territories. Given the low level of general tariffs, the reduction accorded to least-developed countries meant they have faced zero tariffs on many customs lines since 1994. Indeed the average tariff paid on least developed country imports was only 1.1 per cent in 2001. This was in line with the position in the EU but a markedly lower proportion than for the United States, Canada or Japan. The government has announced that the tariff preference for the least-developed countries and East Timor will be replaced by tariff-free entry for

Figure 40. **Average tariff rates by country**



Source: World Bank.

Table 22. **Combined tariff, budgetary and pricing assistance to agriculture and industry**
2001-2002, per cent of gross value-added by industry

	Tariff on output	Effective tariff support	Budgetary and tax assistance	Regulatory and pricing assistance	Net subsidy equivalent[1]
Agriculture, forestry, fishing	**0.1**	**–0.2**	**2.1**	**0.8**	**2.8**
Dairy cattle farming	0.0	–0.3	2.1	13.9	15.7
Grain, sheep and beef	0.0	–0.2	1.6	0.0	1.5
Horticulture and fruit	0.9	0.6	1.6	0.0	2.3
Other crops	0.0	–0.3	2.7	0.0	2.4
Other livestock	0.0	–0.3	1.4	0.0	1.1
Fishing	0.0	–1.3	3.4	0.0	2.1
Forestry	0.7	–0.7	4.7	0.0	4.0
Mining	**0.0**	**–0.5**	**0.6**	**0.0**	**0.1**
Manufacturing	**5.6**	**3.7**	**1.5**	**0.0**	**4.6**
Food, beverages and tobacco	4.6	3.4	0.3	0.0	3.7
Textiles, clothing and footwear	24.3	19.2	6.7	0.0	25.1
Wood and Paper products	6.3	4.4	0.5	0.0	4.9
Printing, publishing and media	2.2	1.3	0.2	0.0	1.5
Petroleum, chemical products	4.9	3.4	1.0	0.0	4.3
Non-metallic mineral products	2.9	2.2	0.3	0.0	2.5
Metal product manufacturing	5.5	3.4	0.7	0.0	4.1
Motor vehicles and parts	14.8	10.4	10.3	0.0	11.2
Other transport equipment	1.9	–1.6	4.4	0.0	2.8
Other machinery	4.2	1.6	1.4	0.0	3.0
Other manufacturing	6.2	3.5	1.1	0.0	4.2

1. The total net subsidy equivalent has been adjusted by the Productivity Commission to take account of programmes included in both tariff and budgetary assistance.
Source: Productivity Commission (2002).

all goods, but will be subject to a local content rule. Such a move will primarily help a few Asian exporters of textiles and clothing under current trade flows, but Australia's initiative goes beyond those offered by other major developed countries in so far as it is unqualified in any way and all goods will be covered from the implementation date of 1 July 2003. Australia has made little use of non-tariff barriers, with only 0.7 per cent of all tariff lines affected. In particular, it has no quotas on textiles and clothing, having implemented the Agreement on Textiles and Clothing immediately. Australia also has a few regional trade agreements with areas in the southern Pacific area, some small Pacific islands and Papua New Guinea.

Planned regional and bilateral trade agreements between OECD countries may risk displacing some exports of developing countries. In the past, Australia has only negotiated such bilateral agreements with New Zealand, Canada and Singapore. Recently, however, Australia has announced that it will start negotiations on a bilateral trade agreement with the United States which, if concluded, would more than double their extent. The complete liberalisation of trade between these two countries (including agricultural products) would bring a net creation of global trade and economic benefits to both countries, with trade diversion effects likely to be limited, as tariff rates are already low for most Australian imports (Berkelmans *et al.*, 2001). In the few areas where tariffs are higher, such as textiles, clothing and footwear, any future reductions in barriers could more than offset the limited diversionary impact on developing country exports of a bilateral agreement with the United States. Aside from its static effects on trade, the agreement could give added momentum to global liberalisation.

Since the mid-1990s, there has been a significant change in aid policy, with the adoption of an over-riding goal of reducing poverty. Until then, aid was expected to serve three goals simultaneously: humanitarian, commercial and foreign policy. The refocusing of aid policy has led to spending increases likely to directly impact on target populations in relatively poor countries. Major increases have been made in spending on basic health, education and the control of infectious diseases (Table 23). Human capital formation has been improved by training significant numbers of primary and high school teachers. In a number of major aid recipients, this policy had successful results with, for example, elementary school enrolment (for five and six year olds) in Papua New Guinea almost doubling between 1998 and 2000.

There has also been a greater focus on governance issues where an effective partnership can be made with governments in aid receiving countries. In most countries, governance has become a significant component of Australia's aid programme. The governance programme focuses on improving economic and financial management, strengthening law and justice and increasing public sector effectiveness. These objectives are achieved through capacity building programmes, including technical assistance and training (more than 17 000 trained between 1999 and 2002) and through action to support legal reforms and improve the quality of police forces in a number of countries. Australia has also programmes of economic and trade reform (such as capacity building efforts for complying with sanitary regulations on Australian food imports).

Some aspects of the aid programme arguably reduce its impact on poverty alleviation. An area where improvements could be made is in the university scholarship programme. In 1997, an official report noted that "there is good evidence that the scholarship programme has been at the expense of more cost-effective in-country and in-region training, and at the cost of support for basic education and higher-education capacity building which yield much higher development returns".[210] Since then, the number of scholarships has been halved. but the programme still absorbs 10 per cent of the bilateral aid programme, directly benefiting only a limited number of students.

Table 23. **The structure of bilateral aid programmes by sector and country**

2000

	Australia	EU countries	United States	Japan	New Zealand	Austria	EC	Development Banks
	Per cent of total bilateral aid							
Basic well being	21.0	16.5	13.6	15.5	10.5	16.0	13.0	20.4
Basic and secondary education	6.3	6.3	1.9	0.7	4.8	1.9	5.2	8.3
Basic Health	5.7	2.2	3.5	0.5	2.4	7.0	2.3	3.2
Other health	5.8	3.7	7.1	0.6	2.0	0.5	2.3	3.3
Water	3.2	4.3	1.1	13.6	1.3	6.7	3.1	5.5
Governance and civil society	16.2	5.7	6.1	1.3	6.7	9.6	9.2	0.5
Agriculture, forestry, fishing	6.5	4.9	4.0	6.1	3.9	2.6	5.8	15.0
Other sectors	6.7	12.2	22.4	11.3	18.5	2.5	19.8	8.9
Social services	5.2	5.1	18.7	1.1	3.0	1.5	3.2	6.7
General environment protection	1.1	2.0	1.1	5.0	1.8	1.1	1.9	1.0
Other general programme assistance	0.5	5.1	2.5	5.2	13.6	0.0	14.7	1.2
Other production and infrastructure	9.2	10.7	15.4	33.8	5.2	3.2	20.1	24.3
Tertiary level education	11.6	6.0	0.7	0.2	27.3	13.0	0.2	0.7
Food aid	6.1	1.0	12.1	0.4	0.9	0.4	6.1	0.0
Emergency assistance	8.1	9.0	9.0	0.6	2.6	8.1	12.3	0.2
Multi-sector	6.6	6.2	9.2	1.0	4.8	3.6	6.8	9.0
Debt-related actions	1.1	10.9	1.3	10.4	0.0	32.9	0.0	0.0
Administration, NGOs and unallocated	7.0	17.5	7.1	13.6	19.8	8.2	8.0	11.4
Memorandum item:								
Total ODA (per cent of GNI)								

Source: Development Assistance Committee statistics.

Conclusions

Australia has pursued a policy of unilateral tariff reduction, without waiting for matching cuts in its partners' tariffs. This policy has brought significant gains to the economy. The direction for trade policy in the next ten years has been clearly established by the government: the creation of free trade by 2010. From the point of view of developing countries, the primary gains are likely to come from a speedy phase-out of tariffs in textiles, clothing and footwear. The recent decision to give completely free-trade access to all 49 least-developed countries is a welcome step. However, the simultaneous decision to open negotiations for a free-trade agreement with the United States could negate some of these benefits were it to lower the advantage that certain least-developed countries obtain from tariff-free entry and to divert trade from other low-income developing countries. Given that poverty reduction can occur in countries other than least-developed countries, notably other low-income countries, the government should pursue further liberalisation of the textiles, clothing and footwear sector in parallel with these negotiations for an Australian-United States free-trade area.

The Australian aid programme has undergone a major change in emphasis, now having one clear objective: poverty reduction through sustainable development. Programmes that were clearly aimed at giving commercial advantage to Australian companies have been ended and spending on basic education and health expanded. The geographical coverage of aid has been narrowed to allow better control but elimination of the large tail of countries that receive small amounts of bilateral aid might improve effectiveness by allowing a scaling-up of projects elsewhere. Major changes have occurred in the structure of the aid budget to favour the goal of poverty reduction. Nonetheless, further movement away from university scholarships and food aid towards improving basic development outcomes for the poorest groups may be justified. The growing emphasis on improving governance is welcome, though it can only be successful through effective ownership. The introduction of incentives has made outlays more dependent on partner country performance.

Managing natural resources in a sustainable fashion

Main issues

The Australian economy makes intensive use of natural resources. While issues of sustainability occur in a number of areas, this section concentrates on problems related to land quality and water. Dryland salinity requires an effective government response as it imposes external costs. With regards to water, the main issues are balancing environmental and agricultural needs and ensuring that there is a legal framework in place in order to allow the effective allocation of scarce water.

Performance

A large portion of the soil in Australia is affected by high levels of sodicity, acidity and salinity. Of these three problems, sodicity (excess sodium in the soil causing solidification of the soil and erosion) is naturally widespread (Table 24). Acidity, that mainly reflects adverse consequences of fertiliser application, tends to be concentrated in certain regions. Both of these problems are largely private in nature. Dryland salinity (a process whereby salt builds up in the soil) reflects changes in land use, *i.e.* the clearance of mature vegetation (trees and shrubs) and its replacement by shallow-rooted annual crops that use less water so gradually raising the water table to the level of natural salt deposits.[211] This problem evolves slowly, taking up over 50 years to become fully manifest. Past changes in land use will result in the area affected by salinity doubling between 2000 and 2050, still leaving only a small proportion of land affected.

There are a number of areas in Australia where water systems are stressed. In 2000, water withdrawal was close to the sustainable yield[212] in the three areas where most of the population is located (Table 25). No estimates are available of the overall sustainability of groundwater extraction. However, in 2000, the National Land and Water Resources Audit (NLWRA) estimated that around 30 per cent of groundwater management units were over-using resources, while another 32 per cent were close to full use of resources. As in other countries, agriculture is the major user of water. It is noticeable that dairying, the only sector that still receives extensive, though now declining, government assistance, uses a substantial amount of all irrigation water despite profitability of water used in the industry being markedly below the average in irrigated agriculture.

Policies

Of the three problems that threaten land quality, only dryland salinity requires government action due to its off-farm impacts. The losses to farmers from the increase in dryland salinity over the next twenty years are estimated to diminish agricultural profits by just 1.5 per cent (representing 0.016 per cent of GDP) (Natural Heritage Trust, 2002). However, salinity affects the broader community. Existing buildings and structures may be damaged and water may need extra treatment before becoming fit for human use. Such costs are estimated to amount to A$ 355 million per year (0.058 per cent of GDP), outweighing the costs to agriculture by almost a factor of four. In addition, increased salinity is likely to threaten a number of species with extinction and will degrade wetlands.

In the light of these costs, the Commonwealth government has launched the National Action Plan (NAP) for salinity and water quality. This programme is additional and complementary to the Natural Heritage Trust (NHT), providing targeted funds in response to questions whether the NHT had achieved adequate returns on investment in this area. The NAP will set targets and standards on salinity

Table 24. **Areas where soil conditions constrain agricultural yield**

	Saline soils				Acidic soils		Sodic soils	
	2000		2020					
	Area in '000 hectares	Portion of agricultural land (%)	Area in '000 hectares	Portion of agricultural land (%)	Area in '000 hectares	Portion of agricultural land (%)	Area in '000 hectares	Proportion of agricultural land (%)
New South Wales	89	0.1	286	0.4	4 095	6.3	24 731	38.0
Victoria	287	2.0	689	4.9	2 754	19.5	8 008	56.6
Queensland	62	0.0	145	0.1	6 192	4.2	42 191	28.7
South Australia	472	0.8	670	1.2	20	0.0	7 635	13.6
Western Australia	2 169	1.8	2 602	2.2	4 602	3.9	14 615	12.5
Tasmania	26	1.4	35	1.9	677	36.9	504	27.5
Northern Territory	0	0.0	0	0.0	2 973	4.2	11 533	16.2
Australian Capital Territory	0	0.0	0	0.2	4	13.3	1	3.7
Australia	3 106	0.7	4 426	0.9	21 317	4.5	109 219	23.1

Note: The Table shows the area and proportion of total agricultural land affected by salinity, sodicity or acidity in each state. Affected areas are where yields are judged to be 95 per cent or less of potential yield.
The Northern Territory and Australian Capital Territory were considered to have very minor salinity problems and were not included in the Audit salinity hazard areas.

Source: *Australians and Natural Resource Management* 2002, *National Land and Water Resources.*

Table 25. **Water run-off and diversions in Australia**

	Mean annual run-off	Volume diverted	Diversions relative to run-off	Diversions relative to sustainable yield
	Gigalitres		Per cent	
North-East Coast	73 411	3 182	4.3	n.a.
South-East Coast	42 390	1 825	4.3	81
Tasmania	45 582	451	1.0	3
Murray-Darling	23 850	12 051	50.5	97
South Australian Gulf	952	144	15.1	88
South-West Coast	6 785	373	5.5	23
Indian Ocean	4 609	12	0.3	3
Timor Sea	83 320	48	0.1	0
Gulf of Carpentaria	95 615	52	0.1	1
Lake Eyre	8 638	7	0.1	5
Bullo	546	1	0.2	
Western Plateau	1 486	1	0.1	0
Unallocated		962		
Total surface water	387 184	19 109	4.9	
Ground water use		4 171		
Total	387 184	23 280	6.0	
Demand by sector				
Irrigation		17 356	(74.6)	
Urban		4 686	(20.1)	
Rural		1 238	(5.3)	
Total		23 280	(100.0)	

Note: For the Murray Darling Basin area, the sustainability ratio excludes catchment areas for which for which there are no data for the sustainable yield.
Source: *Australian Water Resources Assessment* 2000: *National Land and Water Resources Audit* (Copyright 2001).

and water quality that are agreed either bilaterally and multilaterally between the Commonwealth and the State governments. A large part of the initial expenditures will be used to build the capacity to develop integrated catchment or regional area salinity plans in twenty-one key areas. The initiative will cost A$ 1.4 billion split equally between the Commonwealth and States, over a seven-year period.

It is difficult to design economic instruments that can adequately deal with the issue of salinity. Under the Natural Resource Management Ministerial Council (NRMMC), pilot projects addressing salinity will be implemented during 2003 with additional pilots possible in 2005.The possible remedial actions vary considerably across water basins, ranging from reforestation or the plantation of perennial crops, such as lucerne, to civil engineering works. Such cost-benefit studies that have been undertaken illustrate that reducing the area currently affected by salinity may be very costly to achieve, and more modest goals may have to be set. One avenue that the strategy suggests is subjecting land clearance in areas where salinity is a problem to a licensing process. Most states have introduced legislation that separates the right to clear land from the ownership of the land. The licensing process will require the evaluation of external costs over long periods.

In contrast to management of soil resources, water resources can be managed through market mechanisms provided that the correct legal infrastructure is in place. In 1994, the Council of Australian Governments (CoAG) decided to introduce a fundamental reform of water polices leading to a market based system by 2005. In order to ensure progress towards this goal, the Commonwealth pledged financial transfers to the state governments in this period, provided that certain milestones were reached on time. In urban areas, the process of reform is practically complete and by 2002 nearly all states and local authorities had introduced consumption-based billing and full-cost pricing in urban areas.

As part of the same initiative, the rural water industry has also been reformed. In 1994, governments decided constituents should be given a greater degree of responsibility in the management of irrigation areas, for example, through operational responsibility being devolved to local bodies. At the same time, while not covering the scarcity rent, pricing was to be based on the full-cost for new projects but, for old projects, prices needed only rise to cover operating maintenance and depreciation costs. Prices were supposed either to reach this level by 2001, or be on a path to reach this level by then. In both its 2001 and 2002 reports the National Competition Council concluded that substantial progress has been made in removing subsidies to irrigation water supply and moving existing water extraction networks onto a sustainable basis. However, even in states where progress towards sustainability has been limited, pricing has been almost completely reformed in those areas where water extraction was regulated because of shortage. The main subsidies were given in unregulated areas. The National Competition Council will continue to monitor reform.

The part of reform where progress has been slowest has been in ensuring that priority is given to environmental protection in allocating water resources. In areas where river systems are stressed, notably in the Murray-Darling Basin and parts of Queensland, there has been opposition by farmers to the reduction in water quotas.[213] The Commonwealth government has now stated that farmers whose water rights are reduced should be compensated, so improving the transparency of policy, as it will enable the environmental gain to be balanced against the cost of change.

Considerable progress has been made in establishing the basic requirements for markets in water rights (Table 26). Indeed, limited water trading occurs in most States, although it is most prevalent in the Murray-Darling Basin. As yet,

Table 26. **Progress in establishing tradeable water rights**
Position in December 2002

	Security	Transferability	Transparency
New South Wales	A law to set 15 year access licences, subject to a 10 year plan has been passed and is being introduced Compensation can be granted if allocation are changed in the 10 year plan period	Allowed within a given water source, subject to environ-mental use, rights can be held independently of land	A register is being established, includes third party rights
Victoria	Licences 10 years, Rights and bulk entitlements are indefinite, emergency reductions possible	Licences, rights and bulk entitlements are all transferable. Trading zones have been established	Register for rights but not for licences or bulk entitlements
Queensland	Allocations 10 years, can be changed with compensation, no compensation if changes after ten years	Rules have been established allowing transfer of allocations	Register for water allocations, including security interests
Western Australia	Licences can be fixed or indefinite, compensation can be paid if an "unfair" change is made	Allocations can be transferred within a source but there are provisions to protect third parties and the environment	Register for water allocations, including security interests, special conditions noted
South Australia	Licences are perpetual but can be changed to satisfy environment demand for water, without compensation	Water allocations are transferable and not attached to land	Register for licences, special conditions noted
Tasmania	Water rights existing prior to 1 January 2000 cannot be changed. Subsequent rights can be changed without compensation	Allocations are transferable	Licences and allocations are on a public register. Priority of allocations is noted

Source: Council of Australian Governments (2002).

standardised contracts are not available and many states have restrictions on trading outside the irrigation district where the water is currently used. These constitute barriers to effective trading notably in the Murray-Darling area that straddles four states and where trading offers possibility to move water to its most productive use. The CoAG has found that a number of key impediments such as the unreliability of water allocations during the period of tenure need to be removed.

Conclusions

Progress is being made in ensuring that the use of natural resources, notably water, becomes more sustainable. Urban consumers now pay the full cost for the distribution and treatment of water and efforts are being made to ensure that irrigation users also pay the full costs of running the current infrastructure. However, neither urban nor rural consumers pay for the right to extract water from rivers. All jurisdictions have put in place legislation to enable full cost recovery of water extraction and delivery. Sustainable water allocations now have to be established. It is 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. Some farmers will see their extraction rights reduced when such minimum flows are set and so some form of compensation or temporary adjustment package may have to accompany reforms. To obtain the full gains from more efficient allocation of water, barriers to trading between irrigation districts also need to be eliminated. There is, however, less scope to use economic instruments to overcome the problem of excess salinity of water and soil. Rather, cost-benefit analysis should be used to establish the appropriate resources devoted to containing soil and water salinity.

IV. The economic impact of migration in Australia

Introduction

Migration has played a crucial role in the development of Australia's society and economy. The nature of migration flows has for a long time been the subject of deliberate policy by the Australian authorities – Australia's geographical position and structure indeed give more opportunity for active and fairly precise control over migration flows than is available to almost any other OECD country.

This chapter looks at migration and its interactions with economic developments and economic policies in Australia. After a brief survey of the past history of immigration into the country over the last century, the evolution of immigration policy and the detail of existing arrangements are outlined, covering both entry policy and the situation of migrants once in Australia. The economic aspects of immigration are dealt with in terms of their impact on the labour market, on output and incomes, on public finances and on trade and the balance of payments.

A concluding section suggests that, insofar as migration policy is assessed in terms of its economic effects in Australia, current policy is effective. It is not obvious that there would be noticeable economic benefits to existing Australians if there were higher average inflows, even if there are some plausible but difficult to verify arguments that suggest this, nor that there would be significant economic costs. In the second half of 1990s, tighter criteria for entry as a skilled migrant, intended to improve labour market outcomes among immigrants, reduced the proportion of the lower skilled in permanent immigration. Restrictions on eligibility for certain welfare have some budgetary effect but probably little effect on incentives for most migrants. Labour market arrangements, notably the relatively high minimum wages, may make the integration of some humanitarian and family immigrants slower than necessary. More flexibility in the award system might not only improve the working of the labour market generally, but also accelerate the integration of lower skilled immigrants (and Australians) into the job market.

The composition of Australia's population[214]

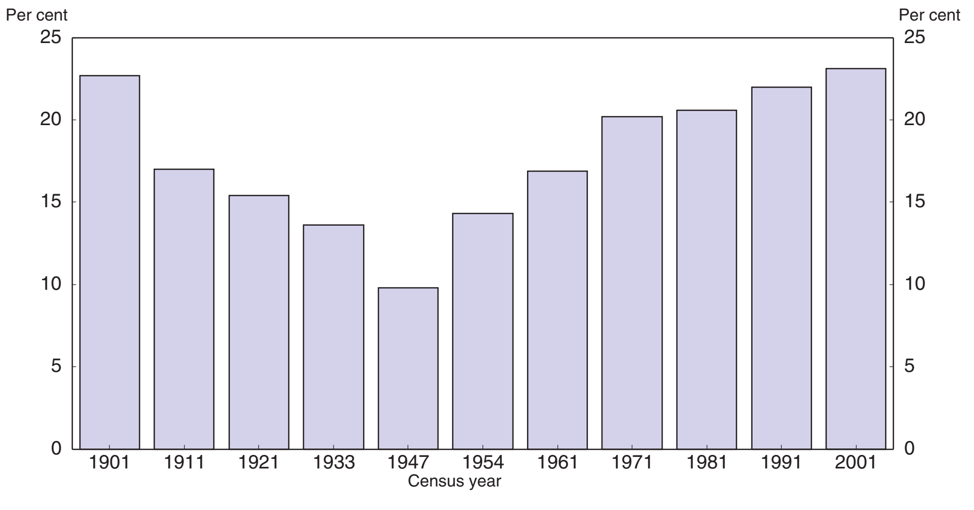
About one quarter of Australia's current population of 19 million was born outside Australia, while around 40 per cent are either an immigrant or the child of an immigrant. Just over two per cent of the population is estimated to be of aboriginal or Torres Strait Islander origin. Of the working age population, almost one in three was born abroad, as were one-third of the over-65s. Among OECD countries only Luxembourg exceeds these levels, while Switzerland is comparable.[215]

In 2001 the proportion of overseas-born in the population was about the same as a century earlier, having reached a low at the end of the second world war and then increased almost continuously (Figure 41). The national origin of the overseas-born also began to change quite significantly from the 1960s onwards, with further reductions in the share of UK-born citizens and a much greater diversity of other immigrants (Figure 42). Furthermore, their age relative to the Australian born declined, though remaining substantially higher – in June 2000 the median age of the total population was 35 years, that of foreign born residents was 45.

Recent inflows and outflows

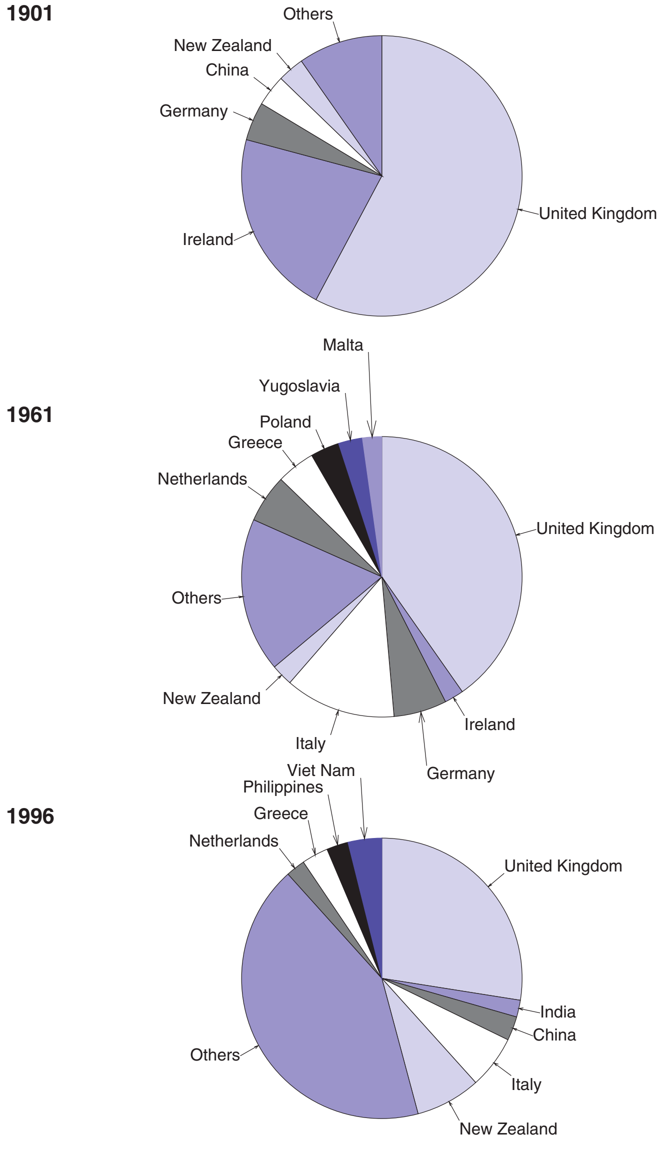
Until the early 1970s, permanent migrant inflows consisted overwhelmingly of settlers of European origin, with the ex-colonial link with the United Kingdom[216] showing clearly – in the 1960s, 45 per cent of immigrants still came from the United Kingdom and Ireland. After the second world war and up

Figure 41. **Overseas-born as a percentage of the total Australian population**



Source: Department of Immigration and Indigenous Affairs.

Figure 42. **Foreign-born by origin, principal countries at birth at selected censuses**[1]



1. Only countries whose share of foreign-born population exceeded 2 per cent are shown.
Source: Department of Immigration and Indigenous Affairs.

until the 1970s, the most significant change was an increase in the share of immigrants coming from non-English speaking European countries such as Italy, Greece, Yugoslavia and Turkey. Subsequently there has been a considerable inflow from a number of south-east Asian countries, notably Vietnam, the Philippines and China, as well as from India and South Africa, and from New Zealand. New Zealand and Australia operate a common labour market under the Trans-Tasman Agreement with flows in both directions which are quite sensitive to relative economic conditions in New Zealand, Australia and the rest of the world. While the increase in inflows from New Zealand during the 1990s was dramatic, a record net inflow in 1999-2000 only slightly exceeded the previous peak reached in 1988-89, whereas in 1991-92 there had been near balance with inflows of about 9 000 New Zealanders only just exceeding outflows.[217]

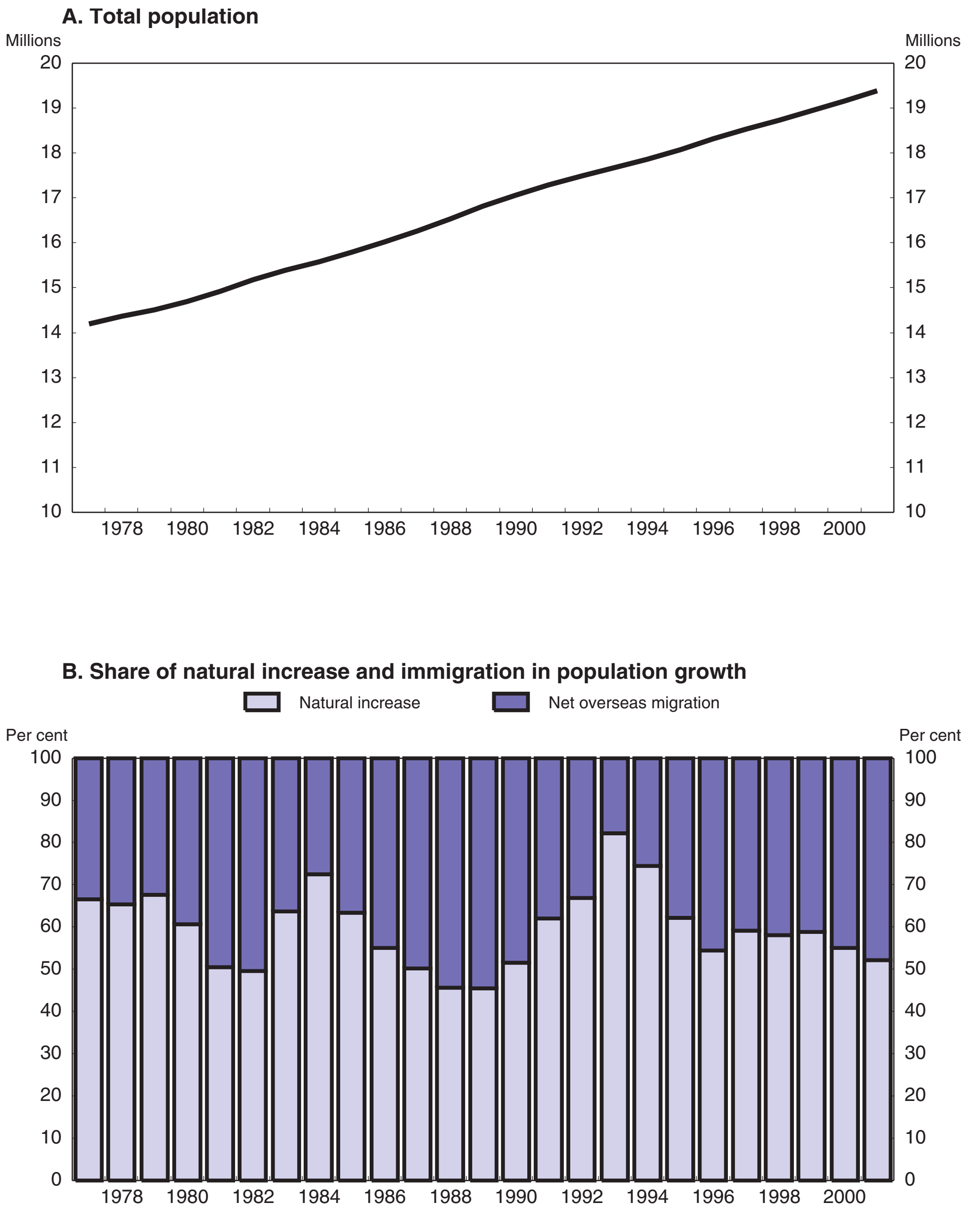
Net immigration has been increasingly important for population growth relative to births, and it is expected that its relative importance will rise given current levels of fertility. In recent years the importance of "long-term temporary" inflows (those without permanent visas but intending to stay for more than one year) has increased. Thus, in 2001-2002, net inflows of permanent migrants were around 40 000 (89 000 arrivals and 48 000 departures) but net inflows of long-term temporary migrants were higher at 93 00 (264 000 arrivals and 171 000 departures). Of the net population gain of some 99 000 from migration in 1999-2000,[218] 86 500 people were of working age, *i.e*. about one in four new entrants to the working age population are immigrants.[219, 220] Since the second world war, some 6 million settlers have arrived in Australia, and the resident population has grown from about 7½ million to some 19 million by 2001 (Figure 43).

The Australian-born emigrate too, mostly to English-speaking countries; in recent years around one third went to the United Kingdom, around 15 per cent to the United States and some 10 per cent to New Zealand; 20 per cent go to Asian countries. These data are for long-term departures, meaning an intended stay of over one year; it is not clear what proportion intend to permanently settle abroad. Emigrants are more likely to be female than male.[221]

Migration policy

From the end of the second world war until the early 1970s, immigration policy was active, involving subsidised passage schemes for emigrants from a number of European countries (mainly the United Kingdom and Ireland but at various times also including Greece, Italy and Turkey). Immigration during this period continued to be "whites only", with very few exceptions. Beginning in the mid 1960s and definitively in the early 1970s, the whites only policy was abandoned, although overall numbers were reduced after 1972 in response to rising unemployment. The increase in immigration from Asian and other non-traditional countries arose partly from this change in policy and partly from a series of asylum

Figure 43. **Population growth: natural increase and net migration**
1977 to 2001



Source: Australian Bureau of Statistics.

seeker flows from Vietnam and then from other countries *via* an active policy of re-settling refugees.

The current set of arrangements, broadly in place since the early 1980s, distinguishes three basic elements in the types of visas issued to entrants to Australia:[222] first the distinction between permanent settlement and temporary stay, secondly between short-term and long-term temporary stays, and thirdly whether holders of (short- or long-term) temporary visas have the right to take employment. In turn, permanent settlement visas are awarded under three programmes: humanitarian, family reunion and skill (Table 27).

Only the permanent migrant flow is subject to an overall ceiling on inflows; this is applied under three main categories of immigrant – family, skill and humanitarian – and relates to gross permanent inflows rather than to overall net flows, which are affected by the balance of the large temporary flows as well as permanent departures or emigration. During the 1980s the planned intake of permanent migrants grew, reaching 145 000 (0.8 per cent of the population) in 1989-90, but was cut back again for most of the 1990s to around 0.5 to 0.6 per cent of the population. In the expansion of the 1980s the skill stream expanded relatively faster than the family category and both were subsequently squeezed in the early 1990s (Figure 44). But, the expansion since the mid-1990s has been heavily weighted towards the skill stream. The range of family connections that give rise to eligibility to apply for permanent settlement has been restricted, and what had been known as the "concessional" family stream became subject to a more targeted points test to improve skill levels for this group and included in the skill stream.

These changes increased the proportion of permanent immigration over which short-term control can be easily exercised; controlling the skilled inflow can be achieved by varying the level required in the points test described below. But in the 1990s, the number of long-term temporary entrants increased rapidly even while the numbers gaining permanent residence under the Migration Programme were being restricted; this reinforces the tendency to align entry policy on labour market conditions, since entry on a long-term temporary visa is largely conditional on being appointed to a specific job or on business activity (and the visa is liable to be rescinded if the person becomes unemployed or ceases to meet the business conditions) (Figure 45). This may have contributed to the apparent negative correlation between unemployment and migration inflows. Net inflows of temporary entrants probably cannot continue to rise rapidly if the flows are indeed temporary (the maximum duration of such visas is 4 years, although they can be renewed); some of the increase in the permanent programme between 2001/2002 and 2002/2003 is likely to be used by skilled people already in the country on temporary visas, particularly successful overseas students.

The central part of the process of selection for skill-stream permanent migrants is the points test. This assigns points according to a number of characteristics

Table 27. **Types of entry visa for Australia (2000 to 2001)**

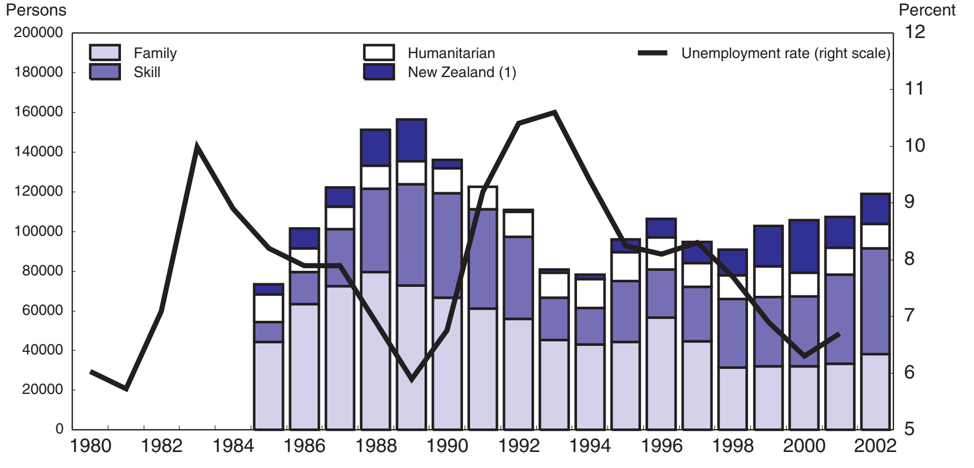
	Short term		Long-term temporary		Permanent settlement		
	Tourism	Other (short-term business, etc)	Students 3 months to 5 years	457 visa class > 3 months up to 4 years	Humanitarian (once accepted) Onshore and offshore	Family	Skill[1]
Number issued in 2000/1	3 598 792	260 383 (Business Visitor Visas) 76 500 (working holiday-offshore)	146 577 86 277 offshore 60 300 Onshore	40 136 17 178 offshore 22 958 Onshore	13 733 7 992-offshore 5 741-onshore	33 470	44 730 37 085-offshore 7 649-onshore
Average length of stay	Not available	Not available	3 years estimated	3 yrs	n.a.	n.a.	n.a.
Percentage with right to work (of which restricted)	0	100% with limited right to work	43 755[2] students granted PTW	100% with conditions. No conditions on dependants	100	100	100
Points system applied	No	No		No	No	No	Yes[3]
Occupation list applied	No	No		No	No	No	Yes
Labour market test applied	No	No		No – Salary and skill level criteria to meet	No	No	Yes[4]
Eligibility for social security benefits, public health care	Public health care available to nationals of countries which Australia has reciprocal agreements with	Public health care available to nationals of countries which Australia has reciprocal agreements with	No	No	Immediate	After 2 years[a]	After 2 years[a]

1. This category includes 6 404 visas granted under the Employer Nomination Scheme (ENS) and Labour Agreements, 1 021 visa grants under the Regional Sponsored Migration Scheme (RSMS), 85 visa grants under the State/Territory Nominated Independent (STNI) category, and 7 364 visa grants under the Business Skills Class.
2. All students can apply, but if granted, permission to work is limited to 20 hours per week while the course in which they are enrolled is in session. Dependents can also apply for permission to work, if granted this is generally a flat 20 hours per week, however, dependants of masters/doctorate students have no restriction on the hours that they are able to work if granted permission to work.
3. Business Skills Class visas are assessed under a different points test to other classes in this category. The ENS, RSMS, Distinguished Talent and STNI visa categories are not points tested.
4. Labour market testing is undertaken for ENS. There are, however, exceptions for some ENS cases, *i.e.* if the position is on the Migration Occupations in Demand List (*e.g.* senior academic or religious workers), the visa applicant can put up a case to show that there is nothing to be gained by labour market testing. Business Skills Class visas and Labour Agreement visas are not labour market tested.

a) A special social security benefit, below the level of normal benefits and highly means-tested (on both income and wealth), exists for immigrants who find themselves in severe difficulties during the first two years.

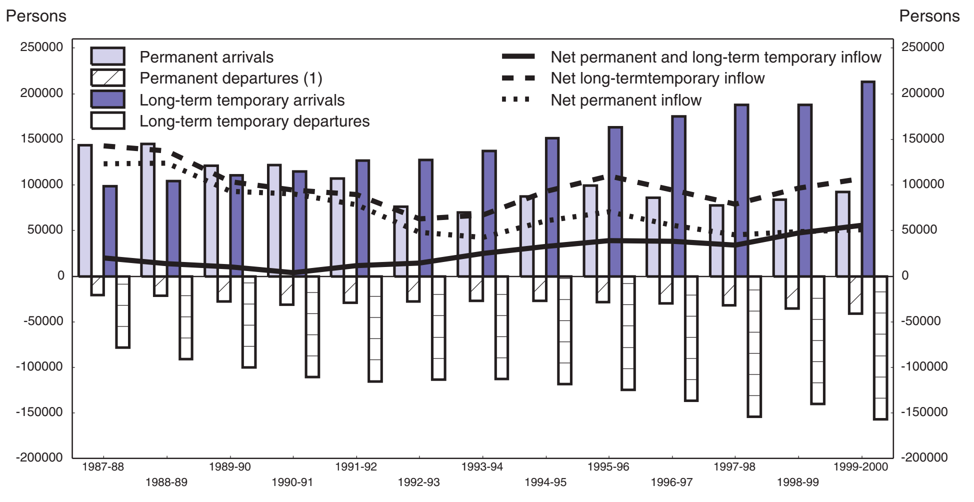
Source: Department of Immigration and Multicultural and Indigenous Affairs.

Figure 44. **Permanent migration by main visa category**



1. Net permanent arrivals from New Zealand. The 1991 figure was –1 527 *i.e.* permanent departures for New Zealand exceeded arrivals from New Zealand.
Source: Department of Immigration and Indigenous Affairs.

Figure 45. **Net permanent and long-term temporary migration, 1987-2000**



1. Includes departures of both foreign-born and Australian-born.
Source: Hugo (2002).

of which the main ones are the level of education, age and English language skills. Under each of these headings the maximum number of points available is 60, 30 and 20 respectively, out of a maximum possible of 145 (including points available under a number of other headings; see Annex IV for more detail[223]). Additional points in one heading can make up for shortfalls in others, subject to threshold requirements in most cases.[224] The minimum requirement for 2002-03 is 115, up from 110 in 2001-02. A number of schemes give additional points or vary the required score, including those related to specific occupations (the MODL or migration occupations in demand list) and to specific destination regions in Australia. There are also occupation-specific schemes where the points test is not applied, although some "basic requirements" of educational level, English language proficiency and work experience are necessary; under this heading the Skill Matching database is used to circulate the details of potential immigrants to regions and employers who may wish to nominate them if they have a specific need. The Employer Nomination Scheme allows for a relatively small number of non-points tested admissions, where employers have made specific agreements with the immigration authorities to recruit people with particular skills. An important part of the skill stream, known as business skills, is designed to admit entrepreneurs or potential entrepreneurs willing to invest in the Australian economy.

The points test may be the most visible development in Australian immigration policy, but a majority of permanent immigrants still enter on visas without points testing. Most of these enter through family connections, but more than 10 per cent of total permanent settlement visas are allocated on humanitarian grounds. The Employer Nomination Scheme also allows for a relatively small number of skilled but non-points tested admissions, where employers have made specific agreements with the immigration authorities to recruit people with particular skills. Long-term temporary visas are issued without a points test; they are granted under a number of programmes, may be valid for up to four years (five years for students) and may also be renewed. Temporary visas may be increasingly viewed as improving the chances of getting a permanent visas since they help to acquire attributes useful under the general skills scheme – from education, work or business experience. The working holiday scheme also attracts large numbers of young people who often work for short periods in agriculture or the hotel and catering industries; this may also serve as a recruiting ground for future permanent applications.

Integration policy

For as long as immigrants were predominantly of UK-Irish origin, similar to the existing Australian population, "integration" was relatively unproblematic. Agreements to resettle displaced Europeans after the war led to the first large influx of non-English speaking immigrants, and assisted passages were also made available to some migrants from these countries, notably from Italy and Greece. Many such immigrants were recruited to work on the Snowy Mountains scheme, a major hydroelectric construction project where immigrants made up two thirds of the workforce during the 1950s; a major effort was undertaken, in part for safety reasons, to teach English to these immigrants and this led to the establishment of the Adult Migrant English Programme (AMEP).

A range of measures exists to help humanitarian entrants, including English-language tuition and special support for those who may have suffered trauma prior to arrival. In the case of non-humanitarian visa holders, a significant policy measure after arrival in Australia directed explicitly towards integration of immigrants (accounting for more than half of the Department of Immigration and Multicultural and Indigenous Affairs' direct expenditure on non-humanitarian immigrants) is English-language tuition for non-native English speakers. They are granted up to 510 hours of classroom tuition which can be taken immediately or later on[225] (and can also be interrupted and completed later).[226] There are a number of other smaller programmes.[227] Otherwise immigrants are directed to "mainstream" services such as health, housing, education and labour market access.

The intention is that all these services are able to give appropriate attention to the needs of immigrants rather than having separate immigrant-specific programmes. To assist in this, a wide range of material on provision and access to government services is published in languages other than English and grants are available to ethnic organisations to subsidise support to their communities. The idea of "Multicultural Australia" is considered to be very important, hence resources are put both into supporting immigrant-origin based community organisations and into services to assist integration. Many of these organisations are grouped into state- and Commonwealth-wide umbrella groups who are consulted on immigration policies.

As in other countries, racist sentiment against many of the recent arrivals does exist, as it did in the past against many of the now more well-established communities, and the indigenous population as a group suffer too, probably more than immigrant groups.[228] There are particular concerns about local concentrations of immigrants in some areas. This concerns mainly certain suburbs of Sydney and Melbourne, respectively the largest and second-largest cities in Australia. Relatively high unemployment and low incomes characterise these areas, yet they remain attractive to immigrants: recently, 600 humanitarian asylum-seekers, mostly from Afghanistan and detained while their applications were being processed, were given temporary protection visas and released in areas seeking more migrants and population growth, but not in Sydney. Within 6 months over 60 per cent of them had moved precisely to these areas of ethnic concentration. However, the tendency of some ethnic groups to concentrate in particular areas has been a transitory phenomenon.

In the longer run, what matters more than the existence of such immigrant concentrations *per se* is whether immigrants attracted to them for the family or social and cultural support that they give[229] may subsequently be disadvantaged. Children of immigrants in such areas do have low levels of educational achievement, but the important question is whether they are lower than the same children would achieve elsewhere. There is no direct evidence on this for Australia. However, work on "ethnic enclaves" in the United States suggests that this may be the case: residence in such areas tends to lower the English language ability of immigrants (from non-English-speaking countries) and their children, which in turn is associated with lower educational achievement (see Chiswick and Miller, 2000). As the same authors note, however, the other benefits that immigrants get from at least initial residence in such areas may outweigh linguistic disadvantages; Chiswick *et al.* (2002a) also observe that immigrants with higher linguistic ability tend to avoid these areas in the first place, perhaps biasing average achievement levels downwards. Despite these problems, it is nevertheless observed in the PISA study that the combined reading and mathematical scores attained by Australian children are high, and vary little according to whether the child is an immigrant, a second generation immigrant, or Australian-born of Australian-born parents. This suggests that the educational system overall performs quite well for foreign-born children taken together, though the relatively high education level of some immigrants may obscure lower achievement levels among the children of the low-skilled and/or low English-language ability immigrants.

Given the strong forces that seem to lead almost universally to geographical concentration of immigrant groups[230] it seems unlikely that policy directed to avoiding concentrations *per se* would be useful, rather policy needs to focus on specific problems due to clustering that may hamper eventual integration.[231]

The goal of immigration policy – steering a path between competing interests

The formation of immigration policy cannot be said to be aiming for any one particular goal: the stated aim is that it should be in the interests of "all Australians",[232] which in practice means balancing the views of different groups. These are taken into account by the Government each year in consultations with a wide range of organisations, and this has led to quite frequent modifications of the overall size and composition of the immigration programme. The Government also sponsors[233] a range of research work on policy-related issues, frequently basing policy changes explicitly on the results on such work. In recent years, much of this work has concentrated on economic issues.[234]

Employers' organisations tend to be in favour of higher immigration flows than in recent years, believing that this encourages a growing home market, and are in favour of promoting higher-skilled flows.[235] Trade unions appear to be less concerned with whether the figure for immigration is too high – it might be expected that they would be concerned about the effect on wages – as with ensuring that labour market regulations are respected.[236] Trade unions are however among those expressing doubts about whether the increasing emphasis on skilled immigration is either, on the one hand, a reflection of inadequate education and training provision in Australia itself or, on the other hand, reducing opportunities for skilled Australians.[237] Environmental groups have begun to argue that at least some areas, principally around Sydney, of Australia are now so populated that the environment cannot safely support increased numbers. The concern of many ethnic organisations is to increase immigrant numbers to allow more family members to come from their countries of origin.

Economic aspects

Labour market outcomes

On the labour market, immigration of people of working age increases the supply of labour and might thus be expected to exert downward pressure on wages in the short run, other things being equal. It is clear that in Australia other things are not generally equal, notably investment behaviour. Since immigration is a permanent characteristic of the economy, investment decisions can be presumed to be based implicitly on an assumption of a continuing increase in the supply of labour, with the impact of immigration not very different (in these aggregate terms) from that of the natural increase in population. Hence the accumulation of capital proceeds along with migration, and there is no fall in the capital to labour ratio that might cause a decline in wages. One might nevertheless expect that wages (or unemployment) might be affected in the short run by significant variations in immigration around its longer-term trend.

Indeed, the main variations in flows of permanent migrants into Australia occur through policy changes: there is generally "excess demand" for entry, so changes in actual flows are determined by the number of visas the authorities make available. As seen earlier, some of the major swings in the overall numbers of immigrants accepted have been in response to labour market pressures: inflows have been reduced in periods when unemployment increased – in 1971-75, again in the early 1980s and also the early 1990s.[238]

Studies that have been undertaken of the impact of migration flows on wages, for Australia and for many other countries, come up with mixed results. Some show little or no effect of any kind, some show a positive effect of immigration on wages and some show the "expected" negative effect. Of whichever sign, the effect is rarely strong or precisely estimated.[239] Labour market institutions could prevent wages from adjusting easily to supply and demand, however. In Australia this may well have been the case in the past, and though the labour market is now more flexible the system of award wages puts a floor on wages in many sectors. Approximately 23 per cent of workers in occupations covered by award wages actually earn the minimum wage for their sector. This clearly truncates the wage distribution (at least for the relatively unskilled) and potentially obscures the effect of changes in labour market conditions, in this case an increase in supply, on wages, since they can only adjust downwards at the lower end of the scale if the award wage is modified. This phenomenon is not specific to migrants but would apply equally to all participants in the labour market. However, while the award system might modify the impact on wages of an increase in the supply of labour (though not, in itself, the effect of a reduction in supply), the effect of this ought to be felt in unemployment – if the wage does not adjust under pressure from supply changes, the unemployment or participation rate should do so. However, recent literature is unable to demonstrate that this occurs in Australia.[240]

Thus, although many feel that immigration should be cut back when the labour market is slack and that it can be increased when unemployment is relatively low the statistical evidence on the relation between migration and wages or unemployment has not been able to show conclusively that this is necessary to avoid exacerbating labour market problems. This lack of evidence across many countries may be due to the fact that migration flows themselves respond to labour market pressure,[241] either spontaneously or through policy changes as in Australia, or because the capital stock adjusts quite quickly in the short run, but it is difficult to choose between these and other possibilities on the available evidence.[242]

Finally, many immigrants arrive with a substantial amount of saving which they use to establish themselves, thus adding to aggregate demand at the same time as to supply. This is particularly true for those entering under the business skills scheme, who commit themselves to invest in job creating enterprises in Australia. Even those without substantial savings may add to aggregate demand if they have access to capital markets for housing investment, for example. Such effects would also tend to obscure supply side effects on wages or unemployment.

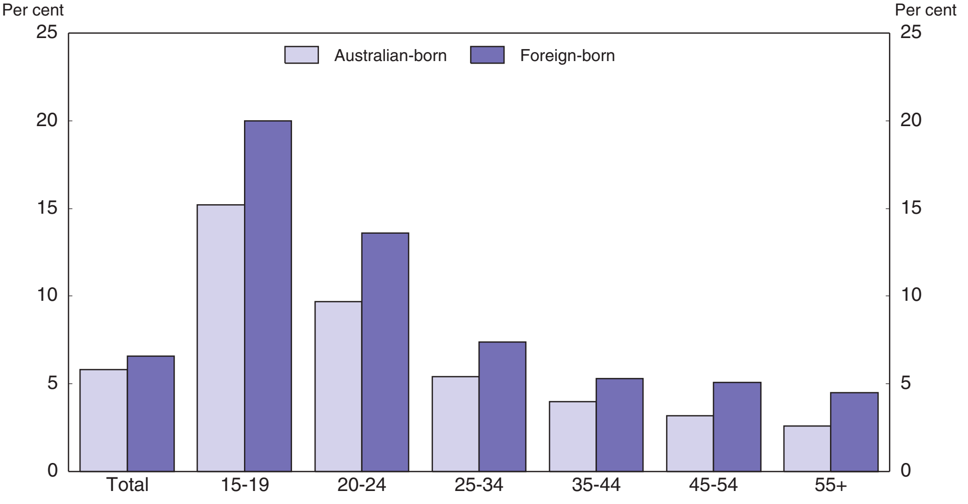
Integration

Although average levels of unemployment among immigrants are higher than for the Australian-born, and participation rates are lower, (Figure 46) this is heavily influenced by high unemployment among the low-skilled, especially humanitarian migrants and especially in the period immediately following immigration, and obscures the evolution through time. Most studies show that economic integration of immigrants occurs relatively quickly in Australia, in the sense that on many criteria – notably unemployment rates – immigrants overall become statistically very similar to the Australian-born after 10 years and much earlier for migrants in skilled categories. Data from the first Longitudinal Survey of Immigrants to Australia show, for example, that business and skill migrants have unemployment rates much lower than the Australian-born within 4 years after arrival. Differences between different regions of origin do seem to persist (Figure 47); but

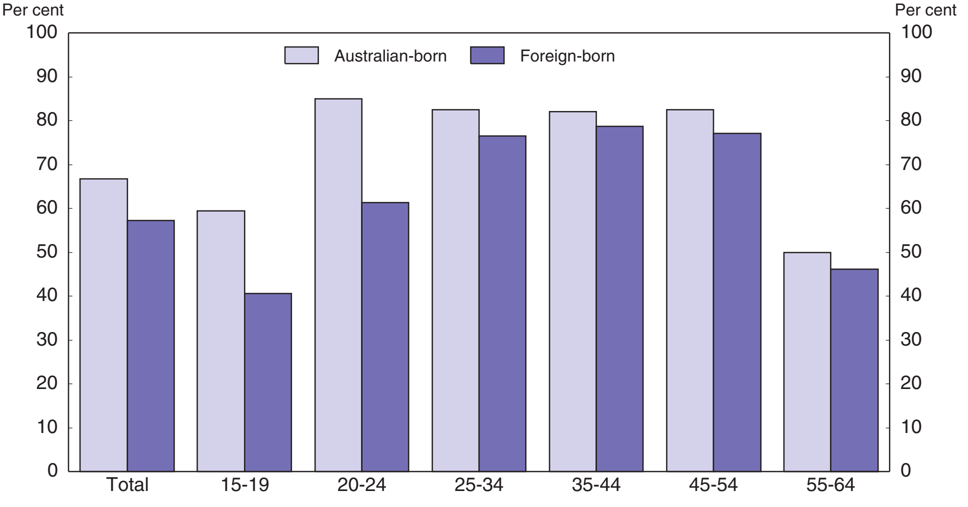
Figure 46. **Unemployment and participation by age, Australian-born and foreign-born**

August 2002

A. Unemployment rate



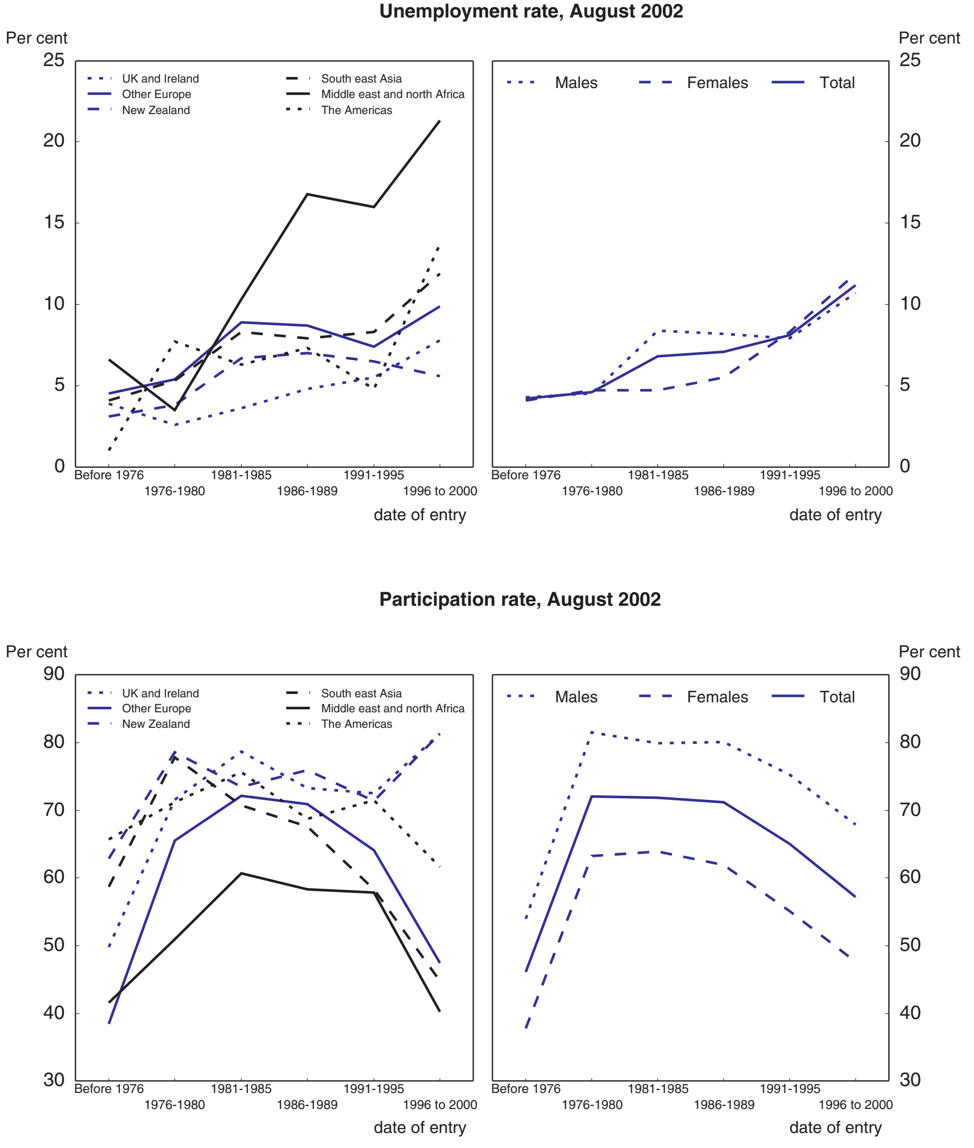
B. Participation rate



Source: Australian Bureau of Statistics.

Figure 47. **Unemployment and participation by date of entry, country of origin and sex**

1977 to 2001



Source: Australian Bureau of Statistics.

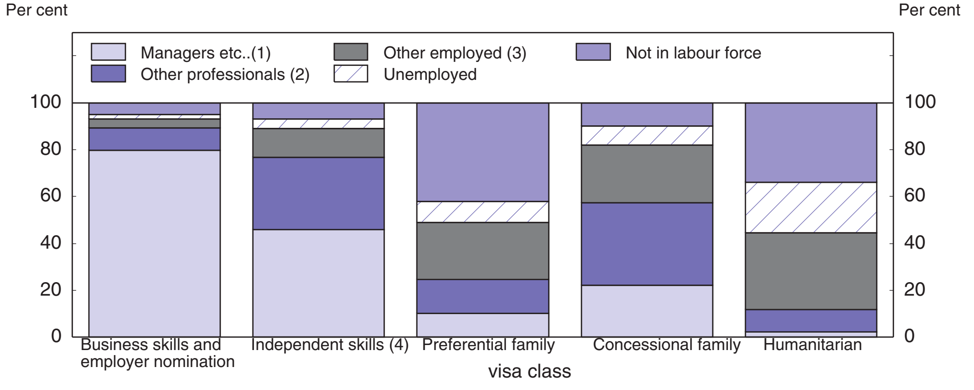
the children of immigrants also perform as well as those of the Australian-born. This successful integration is no doubt partly a result of the fact that, despite the changes in the mix of countries of origin, the immigrant population is still quite similar to the existing population in terms of education and language ability.

The groups who do less well economically appear to be those who are most different culturally and linguistically. While the children of immigrants on average do as well as those born to the Australian-born, the children of low-skilled non-English speaking immigrants do appear to remain disadvantaged beyond the difficult initial period of installation for newly-arrived families (Taylor and McDonald, 1994). Wooden (1993) notes that "hidden unemployment", by which he means withdrawal from the labour market by discouraged unemployed, is greater amongst non-English-speaking immigrants, emphasising that convergence in official unemployment rates is not sufficient to demonstrate labour-market integration. A more nuanced result on integration as measured by language ability is found in Chiswick *et al.* (2002b) where English-language ability is measured in terms of speaking, reading and writing skills. In the LSIA longitudinal study, initial differences between immigrants with different kinds of visa at the level of speaking ability disappear after 3½ years, but they persist for reading and writing skills. In a statistical model to explain these differences, Chiswick *et al.* find that the impact of certain variables, notably age and gender, increases over time.

There are significant differences in unemployment rates among immigrants with different types of visa. Miller (1999), using Australian Bureau of Statistics data on immigrants, found that the 1987 unemployment rate of unsponsored immigrants (who would generally have been subject to a points test) was significantly lower than that of all other visa categories.[243] The same study found that when individual labour market characteristics (such as age, qualifications and English language ability) were taken into account in addition, the effect and significance of the visa category itself was much diminished or disappeared. The implication is that the points selection system does improve the economic integration of migrants, as measured by unemployment rates, and that it succeeds precisely because it focuses on characteristics closely related to employability. Distinct patterns of employment among immigrants with different classes of visa can also be seen (Figure 48).

The impact of English language ability is also reflected in patterns of welfare recipients among immigrants. Birrell and Jupp (2000) use census data to show that in 1996 the percentage of foreign-born in receipt of some welfare benefit was a little lower, for all age groups, than among the Australian-born. But for English-speaking immigrants these welfare recipient rates were much lower than for the Australian-born, while for non-English-speaking groups[244] they were much higher. This study also showed that use of welfare tended to decline as a function of the length of time immigrants had been in Australia for nearly all groups, including the

Figure 48. **Immigrant occupational status by visa class, 1996-97**



1. Managers, administrators and professionals.
2. Para-professionals, tradespersons and clerks.
3. Salespersons, personal service workers, plant and machine operators and drivers, and labourers and related workers.
4. *i.e.* Those assessed under the points scheme.

Source: Longitudinal Survey of Immigrants to Australia, permanent immigrants from 1993-94 surveyed 42 months after arrival.

non-English-speaking (exceptions were females from English-speaking countries). Much of this decline appears to occur within five to ten years of arrival and is particularly marked for some non-English-speaking male age groups – for all language ability groups, welfare recipient rates were lower among foreign-born males aged 20-44 who had been in Australia for at least 10 years than for Australian-born in the same age group.[245] For females the same is true for age groups up to 39 years. Above this age the situation is reversed, perhaps due in part to a greater propensity to be eligible for disability benefits related to the greater tendency for the foreign-born who arrived some decades ago to have been in manual occupations.

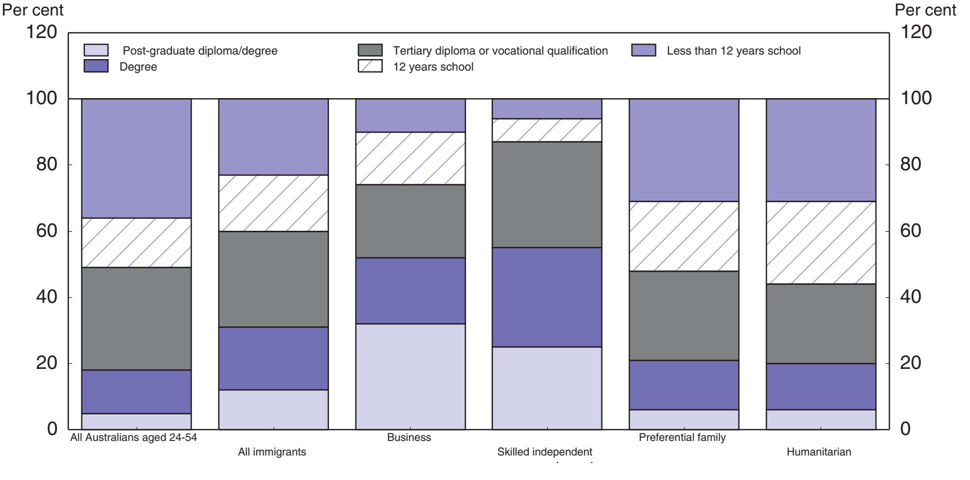
Impact on output and incomes

In the aftermath of the second world war, one of the slogans associated with immigration policy was "populate or perish". This was motivated essentially by military considerations, in view of the perceived vulnerability of an enormous but very sparsely populated country with several very densely populated countries to the north. In addition, and more relevant in the current context, the idea that the population needs to grow to maintain *economic* viability had some influence. The hypothesis that somehow Australia would become economically non-viable in the absence of immigration is somewhat stark and untestable empirically; more prosaically, migration's impact on output and incomes is of interest.

No empirical work satisfactorily assesses the overall impact of immigration on output or incomes in Australia. Analysis of this therefore depends on inferences from the characteristics of migrants and from empirical studies of certain issues. The current migrant intake is higher skilled than the Australian workforce on average (Figure 49), so it would be expected therefore that immigration is currently serving to raise overall productivity per hour worked. This effect, probably small, is reinforced by the higher proportion of people of working age in the immigrant population is high (Figure 50), which would more than offset the tendency to somewhat lower participation rates, so that the net effect of immigration increases per capita output in Australia.

Research sponsored by the government has looked at the impact of various incremental *changes* in immigration policies since 1995-96. Most of these changes – increasing the proportion of migrants selected through points testing, increasing the emphasis on English language skills, reducing the average age of migrants (both within the points-tested and family visa categories) – will have increased both the average skill level of migrants and their likely participation rate once in Australia. Econtech (1998), looked at changes in the programme up to 1997-98, and estimated that by 2008 the changes other than the reduction in programme size would increase average labour productivity by about 0.18 per

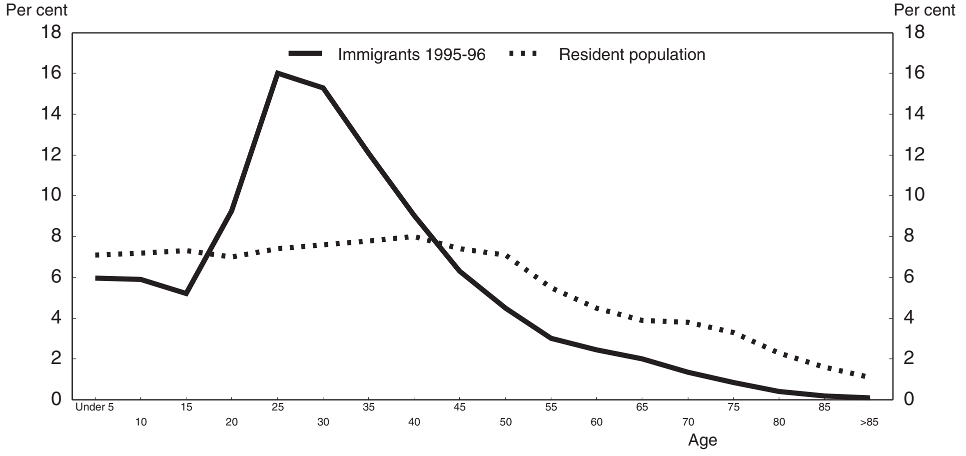
Figure 49. **Educational qualifications: immigrants and Australians**



1. Immigrant data from LSIA 1, *i.e.* immigrants arriving in 1993-94.
2. The catagory "All Australians" includes the foreign-born.

Source: Year Book Australia 2002 and Longitudinal Survey of Immigrants to Australia (LSIA).

Figure 50. **Age distribution: permanent migrants and resident population**
1996



Note: In 1996 the Australian population was 17.9 million and there were 99 000 permanent immigrants.
Source: Econtech (1998) and Australian Bureau of Statistics.

cent;[246] the effect of the reduction in programme size would reduce this to an increase of about 0.12 per cent. Much of this increase is due to higher skill levels[247] but some is due to higher participation rates that follow from the relative reduction in the intake of both older people and family reunion. These are very small numbers, but it may be noted that the actual change in population associated with these changes is about 1¼ per cent after 10 years, itself a small number compared with the current 25 per cent immigrant share of the current population.

A later study, Econtech (2001), focuses on per capita consumption rather than per capita output, finding that cumulated programme changes since 1995-96 increased per capita *consumption* by considerably more than per capita *output*, largely due to the lower investment needs from a lower population and workforce (over this period the planned permanent inflow has still fallen), but to some extent also because the change in composition of immigrants – more highly skilled, more business visas – meant that they brought more wealth with them, which could be used to finance some of the investment.[248]

Unfortunately, these calculations do not distinguish the effect on existing residents' output and incomes from the overall effect, which includes the output and income directly attributed to the immigrants. The immigrants can reasonably presumed to be significantly better off, on average, than if they had not migrated; but these simulations do not show directly that existing residents are also better off.[249] One study has looked directly at this issue for Temporary Business Residents. This study found that most of the improvement in living standards accrued to the migrants themselves initially but that the existing population also benefited and increasingly so over time (Access Economics (2002c). In addition, the Government has recently commissioned a study which will examine the impact of the 2002-03 planned Migration Program on both the existing population and new migrants compared with no Migration Program over the next 20 years. Peter and Verikios (1996) use a simple neo-classical model to look at the effect of migration on existing residents' incomes. They estimate that the migration intake of 1991-92 did in fact reduce existing residents incomes in the long run, by an amount whose present value was about 0.8 per cent of GDP. This resulted partly from the fact that increased immigration shifts income from labour to capital (in such a model) and that about 30 per cent of the Australian capital stock is owned by foreigners, and partly from a dilution of existing residents "equity" in public sector capital.[250] However, this result is likely to be an overestimate, and quite possibly the wrong sign: a number of studies show that immigrants are net contributors to the budget (see below), and immigrants bring with them a certain amount of capital, both contrary to the assumptions in Peter and Verikios (1996).

Economies of scale is sometimes raised by business and others as an argument for increased immigration. There is doubt about the importance, and maybe the existence, of economies of scale at the economy wide level, even if they may exist at the level of individual plants.[251] And if they do exist, an important question would be the degree of increasing returns. Business lobbies tend to argue for higher population growth in order to achieve higher growth of gross incomes and therefore market size, as well as to provide adequate labour supply. The growth of Sydney, Australia's largest city and its main financial centre, may be an example of a clustering effect, but it is not easy to show that there are externalities such that the benefits of this growth are felt outside the migrant groups themselves and the enterprises they work for, or that productivity growth itself is enhanced.

Empirically, little work on this exists for Australia. A recent cross-country study has used trade flows and factor proportions theory to calculate implicit scale elasticities for a number of manufacturing industries (Antweiler and Treffler (2002). A third of manufacturing industry showed no degree of increasing returns, while in others the scale elasticity ranged from 1 to 1.4 (doubling the scale increases output by 2.8 times). If the average for the whole economy were, say, 1.2 then doubling settlement immigration to an annual inflow of around 1.2 per cent would increase potential per capita GDP growth by 0.12 per cent compared with the current immigration programme. Earlier work for Australia (Perkins *et al.*, 1990) estimated the elasticity at 1.28 for the whole economy. Despite these estimates, macroeconomic models of Australia do not generally incorporate economies of scale.[252]

Economies of scale may be thought of as positive externalities, but some externalities may be negative. Sydney, for example, is one of the few areas in Australia where congestion appears to be a significant policy concern, so some of the externalities to immigration in this area may be negative.[253] In popular discussion, water supplies are also seen as a constraint on population. This may be the case in some ultimate sense but in any foreseeable future it is more a matter of appropriate water pricing, and perhaps urban planning policy, so as to ensure that where water is in short supply for household use its supply to agriculture is not subsidised and that urban development is not encouraged in areas where water supplies may be a constraint.[254] Both negative and positive economic externalities to existing residents from immigration are thus difficult to identify and may be small, so any attempt to estimate a trade-off between them is somewhat heroic; Nevile (1990) nevertheless estimated an "optimal"[255] annual population growth rate as lying between 1.1 and 1.6 per cent. Current and expected population growth (if immigration remains around current levels) is at the low end of this range.

Income distribution: winners and losers from immigration?

In practice it may be that per capita incomes of existing residents of Australia do increase on average as a result of current immigration flows, but it would be surprising if the gains were large overall or uniformly distributed; it would be also surprising if there were not at least some people whose incomes would grow faster if immigration were lower (*i.e.* those with whom immigrants compete most directly in the labour market). Even though there may be no significant aggregate impact on wages in Australia, this does not exclude adverse effects for some sectors. Indeed, the labour market testing that is an important part of immigration policy only makes sense if some such effects exist.[256]

There is no recent work identifying either clear favourable or clear adverse effects on specific groups. Garnaut (2002) identifies some likely "winners" such as urban landowners. He notes that, although highly educated Australians may lose out from competition due to the increased emphasis on skilled immigration, such groups also own a disproportionate amount of Australian wealth and therefore benefit from rising asset prices. Australians with low levels of education and skills may lose out, especially in times of high unemployment and in areas where there are regional concentrations of refugees; the changes in property prices and rents that benefit the better-off may also act against those, mainly low income, people who do not own property. Garnaut concludes, nevertheless, that economies of scale may offset many of the losses so that it may be the case that few Australians see their living standards reduced by immigration even if "there is a tendency for established patterns of immigration to widen the dispersion of income".

Geography

There is a tendency for national groups to concentrate in certain suburbs[257] but there are no obvious economic consequences other than those associated with integration discussed earlier. The fact that this tendency is observed in practically all migration movements suggests that it is beneficial for migrants themselves. This may extend to more than just psychological and social benefits; it may help to improve job market integration, at least in the early period after immigration, rather than be a barrier.[258] At the state level, it seems that states with relatively high population growth tend to receive more immigrants than others, whereas domestic migration (*i.e.* moves between states by the Australian-born) tends to be out of all states except Queensland and Western Australia, notably to Queensland (and more recently Victoria). Some of this latter movement could conceivably be a response to overcrowding that immigration might exacerbate, but although there is some debate on whether particular areas, notably Sydney, are sufficiently overcrowded to justify restricting immigration, there is no strong evidence.[259]

Entrepreneurship

It has been observed in a number of countries that immigrants often provide a disproportionate number of entrepreneurs.[260] In some countries this is often in the retail and catering or construction sectors; in Australia the increase in the variety of types of food available in restaurants over the last two decades is clearly related to the immigration from Asia in this period.[261] Relatively high entrepreneurial activity may be the result of a choice by migrants or a reflection of the difficulties they may have in finding employment compared with becoming self-employed. For example, there is some evidence for Australia that self-employment can be a response to poor prospects in the labour market for the unskilled immigrants (Le, 1999).

The immigration programme itself is likely to generate relatively high levels of entrepreneurship among migrants since one of the specific ways to obtain a visa is through the business skills programme, outside the general skills test (although a system of points is also applied) or family reunification routes. The current programme was first introduced in 1992 and considerably expanded after 1993. One of the rapidly growing classes of visa is the temporary business visa which works in a similar way but without a points test; such visas are for up to four years.[262] A survey of Business Skills migrants three years after arrival (in the year July 1996 to June 1997) shows that as many as a quarter may no longer be engaged in a business activity by then; some attrition is to be expected amongst entrepreneurs setting up new businesses, even in this period of strong economic growth, so this probably represents quite a successful outcome overall.[263] The main countries of origin for business migrants are somewhat different from that for the "average" migrant, with Indonesia, South Africa, Taiwan, China and Malaysia taking the first five places in 2001-2002.

Fiscal impacts

Migrants affect public finance on both the expenditure and revenue sides and these effects will depend on the characteristics, behaviour, rights and obligations of the migrants. If the typical migrant were similar to the typical Australian-born person then there would not be much to say, per capita budget quantities would be essentially unaffected by migration.[264] In Australia migrants do differ from the Australian-born, most notably (as far as their fiscal effect is concerned) in terms of their age on arrival and their skill. Research sponsored by DIMIA has calculated the fiscal impact of immigrants in some detail using the longitudinal survey data (Access Economics, 2002a; 2002b). Different classes of permanent entry visa are distinguished and the first longitudinal survey allows observations to be taken at 6, 18 and 42 months after arrival (Table 28).

As can be seen, business and skilled independent category visa holders (on average within each class) make a strongly positive contribution to the budget immediately with family migrants taking a few years to make a positive contribution. This is not the case for those with humanitarian visas, though it can be noted that despite the considerable short run impact the per capita cost of such entrants is substantially outweighed in the long run by the "surplus" from most other categories. It can be expected that the temporary business visa class would be the most lucrative for public budgets since they have no access to these public transfers for the duration of their temporary visa and in general earn higher incomes on average (and pay taxes). Even if the temporary business visa holder applies for and receives permanent status which he or she can do at any time during the temporary visa period, he or she will be subject to the two year waiting period from the grant of permanent residence. An earlier study (Centre for International Economics, 1992) showed a negative budget impact from immigrants in the short run, changing to a surplus in the longer term. The difference between the results for the short term of the earlier study and that shown in Table 28 may partly be explained by the considerable fall in unemployment between the two studies, especially among immigrants, the introduction of the 2-year waiting period for social welfare benefits, and perhaps the impact of the continuing switch in immigration policy towards higher skills and better English language ability.

The fiscal impact varies over time, as Table 28 clearly shows,[265] and calculation of generational accounts for immigrants might give a more complete picture and allow comparison with generational accounts for the Australian-born.[266] In particular it would take better account of the impact of immigration on pensions and old-age health care expenditure. Future immigration, especially if the bias against older people is maintained in both the family and skill streams, is likely to reduce

Table 28. **Budgetary impacts by migration category**
A$ million per 1 000 migrants

Visa type	Year 1	Year 4	Year 10	*Memorandum item*: whole of government (= Commonwealth plus States) effect, Year 10
Family				
Revenue	2.9	4.6	5.6	6.6
Expense	4.8	5.7	5.6	5.5
Net operating surplus	–1.9	–1.1	0.0	1.1
Skilled Australian sponsored				
Revenue	3.7	5.3	6.6	7.3
Expense	4.3	4.5	4.8	3.7
Net operating surplus	–0.6	0.7	1.8	3.5
Business skills				
Revenue	14.9	13.7	16.3	15.6
Expense	4.4	1.8	–0.3	–1.1
Net operating surplus	10.5	11.9	16.6	16.7
Independent				
Revenue	8.0	14.7	18.7	16.3
Expense	4.1	2.6	–0.7	0.1
Net operating surplus	4.0	12.1	19.4	16.2
Humanitarian				
Revenue	1.5	2.7	3.4	4.3
Expense	11.9	8.3	9.3	8.5
Net operating surplus	–10.4	–5.5	–5.9	–4.2
Total				
Revenue	5.6	8.7	10.9	10.1
Expense	5.3	4.4	3.3	3.4
Net operating surplus	0.3	4.4	7.6	6.7

Note: These calculations are based on the characteristics of immigrants arriving in 1993-95, but facing the tax and social security system as in 2001; this includes the two year waiting period for social security eligibility. Negative expenses arise from reduced interest payments due to accrued surpluses.
Source: *Access Economics* (2002a), Table 5 and (2002b), Table 6.

the rate at which the population ages, although this only to a relatively limited extent.[267] (It is interesting to note that this has not been true over the past 50 years. Population simulations show that if there had been no immigration at all since 1950, the age structure of the population in 2000 would have been almost the same as the actual outcome for that year (Kippen and McDonald, 2000).

Generational accounts have not been constructed for immigrants to Australia. Ablett (1999) calculated generational accounts for immigrants on the assumption that they differ from Australian-born only in their age, finding that, under that assumption, present and likely future immigration was beneficial for the budget. An alternative comparison would be to construct the information in Table 28 calculated for the Australian-born as a comparator. Without such a comparison, the main implication of this information for policymaking purposes is probably only that no non-humanitarian category of immigrant is very expensive to the budget in the medium term, though it is probable that the long-run impact of old-age pension payments is underestimated in this analysis.

Trade, FDI *and balance of payments*

Immigration may affect the balance of payments in a number of ways. Migrants may initially bring money with them. Subsequently they may send money back to their country of origin or bring more in. They may bring more in either as personal transfers or perhaps as much larger flows related to entrepreneurial activity – investment or banking flows, for example. The links between their countries of origin and Australia that migrants create are likely to generate future trade (including services) and investment flows in both directions.

Estimates of the direct impact of migrants on the balance of payments are surprisingly few. One estimate for the mid-1990s based on the LSIA suggests that immigrants and temporary residents taken together bring in around A$ 1.5 billion annually, including both capital and current account flows.[268] Balance of Payments figures show larger amounts. At the end of the 1980s capital account transfers due to migrants showed a net inflow of over A$ 2 billion (inflows of A$ 2.6 billion and outflows of A$ 0.4 billion). By the end of the 1990s the estimates were somewhat lower, even in nominal terms, at around A$ 1.6 billion net, compared with total exports of goods and services in 2001 of some A$ 150 billion. This decline is somewhat surprising given the increasing emphasis on types of immigrant that are likely to have high net worth, although migrant inflows themselves are also lower than in the late 1980s.[269]

This might not be thought of as significant for the balance of payments, providing the equivalent of only about 1 per cent of total exports of goods and services. On the other hand, this revenue, generated by an inflow of people of some 0.6 per cent of the population, would finance around 0.2 per cent of private consumption and investment even before those immigrants contribute to domestic production.

In the long run, trade and investment flows related to the international connections that migration generates may be more important than these flows of remittances and of capital directly related to the period of migration itself. But such more indirect effects are not easily measurable.[270] A 1995 study in the food industry suggested that such effects were detectable but might be rather small.[271, 272]

The relative expansion of the business skills stream is likely to increase the tendency of migration to promote trade – migrant entrepreneurs can be expected to be both more likely to consider foreign trade and better able to undertake it, at least with their country of origin. Whether this is an additional gain for Australia, beyond that obtained from an equally effective entrepreneur without a "bias" in favour of trade with a particular country or countries is not so obvious however. The benefits from maintaining an open economy are well-known, but with Australia already an open economy it is not clear that trying to increase the propensity to trade through migration policy would increase these gains.

It is not only immigration but also emigration that generates international links, of course. There is little direct evidence that emigrants from Australia maintain contacts that increase Australian external trade, but it is likely. Anecdotal evidence suggests at least that temporary emigrants acquire valuable human capital or contacts when they travel abroad, with reports that returning Australians with overseas experience attract higher salaries in sectors such as banking and finance than less-travelled Australian-born.[273] More formal evidence from Ireland also documents this phenomenon (in which self-selection may also play a role, of course), showing that a set of Irish graduates who left to work abroad in the early 1990s and who later returned to work in Ireland, earned higher salaries in Ireland than their contemporaries who had not spent any time abroad.[274]

Conclusions

This chapter is not an assessment of immigration policy itself, but looks rather at migration's economic effects, though it does consider policy when its aims are defined in economic terms. Migration policy, which used to be highly selective in terms of countries of origin, has now become highly selective in other terms, focusing on family connections, skills and those in humanitarian need. Over the last decade, the balance has shifted strongly towards selection on the basis of skills, including through the tightening of points testing as it applies to other than close family. The importance of the points tests (which largely takes age, English proficiency and educational qualifications as a proxy for level of skill) has increased.

With about one in four of new entrants to the labour market coming from abroad, immigration policy is likely to have important implications for the labour market. Although such high levels of immigration would (rightly or wrongly) be seen as a problem for labour market adjustment in many other OECD countries, the fact that Australian immigration has always been of this order of magnitude means that the inflow is not a "shock". Labour market institutions and company behaviour, such as investment decisions, are well adapted to migration flows, which may well be part of the explanation for why the econometric literature finds it difficult to detect any influence of immigration on the labour market.

Nevertheless, unemployment rates are somewhat higher for recent immigrants than for Australian-born, and this higher unemployment is concentrated in humanitarian entrants and, to a lesser extent, close family migrants.

These categories include a higher proportion of people with low English proficiency and/or skills, groups, like unskilled Australian-born, which are the most affected by the lack of flexibility of the award wage system. Over the last six years, the government has strengthened the criteria for entry as a skilled migrant and has increased the proportion of migrants that arrive in the Skill Stream. The considerable fall in the differential between immigrant and Australian-born unemployment rates overall in the 1990s can be taken as evidence of the success of this policy although it is also due to the favourable economic background. Unless measures are taken that might reduce the risk of unemployment among the low-skilled – which may mean implicitly accepting some weakening of the protection given to the wages of the *employed* low-skilled by the award system – it is likely that in any future slowdown, with rising rates of overall unemployment, the differential may widen again. To the extent that the differential is due to discrimination and language problems, efforts to maintain or improve policies in these areas need to be continued.

The Australian immigration system is one of the most sophisticated in terms of the degree of detailed information used in selection. It is based to a considerable degree on academic research, and has focused increasingly on selecting immigrants that will increase the incomes of existing residents and avoid budgetary costs. The estimates of the benefits from recent policy changes do not in fact seem to be very large, especially set against the degree of reliability of the kinds of models used to generate them, but they do seem to move outcomes in the directions wished for by policymakers (and it can be hard to judge what "large" means in this context). Only humanitarian immigrants in fact have much negative budgetary impact, even before rights to welfare benefits for recent non-humanitarian immigrants were significantly reduced. The rapid decline in average welfare recipient rates in the period after immigrants arrive, to levels below those for Australian-born, suggests there is no overall problem of welfare-dependency incentives among immigrants. The 2-year waiting period before most immigrants are eligible for full welfare payments has been estimated to provide A$ 700 million over 4 years (about 0.1 per cent of Commonwealth government revenue) in direct fiscal benefits and to have some impact on labour market behaviour. Its impact on either the numbers or the nature of immigrants is likely to be small given the nature of the measure (some welfare safety net remains in place) and the degree of control already exerted on inflows.[275]

Although this increased emphasis on economic aspects of immigration may have come at the cost of reduced inflows of family members, and some reduction in welfare rights, the process for deciding on each year's programme involves considerable consultation with many groups in society, so it is presumably reasonably well in line with overall public opinion. So long as Australia remains an attractive place for immigration while at the same time it is felt that there is a ceiling on the rate at which immigrants can be absorbed, some form of selection policy is needed; the current emphasis on skilled migration has been successful in improving labour market and fiscal outcomes.

At least at the higher skill end there have been changes in the nature of migration flows in Australia in recent years which may – it is too early to say – put limits on the extent to which Australia can select her immigrants. The rapid rise in the number of skilled immigrants on long term temporary visas may be due to the demands of the improving Australian labour market coupled with restrictions on the number of permanent visas available; however, along with the rising number of skilled Australians emigrating it may be a sign of an increasingly internationally mobile skilled labour force for which Australia may have to compete with other countries.

Notes

1. Similarly high household debt-income ratios prevail in the United States, Canada, the United Kingdom and New Zealand.
2. The transition to GST on 1 July 2000 created a strong financial incentive to bring forward expenditures not taxed at all under the old wholesale sales tax from the second half into the first half of 2000. Such shift was most pronounced for residential investment, which contributed heavily to its strong growth in the first half of 2000. Its subsequent steep fall weakened economic activity substantially in the second half of the year.
3. Under the First Home Owner Scheme (FHOS), A$ 7 000 have been made available to first-time purchasers of new or established homes as from 1 July 2000. An additional grant of A$ 7 000 was given to first-time home buyers purchasing new homes as from 9 March 2001. This additional grant was reduced to A$ 3 000 from 1 January 2002 to 30 June 2002, when it expired. Hence, at present, the grant under the FHOS amounts to A$ 7 000.
4. Housing affordability from the perspective of the average owner-occupier is measured by the ratio of average household disposable income to the ("qualifying") income required to meet payments on a typical dwelling (expressed as an index). In calculating qualifying income, a deposit of 20 per cent with repayments equal to 30 per cent of income is assumed using a conventional 25 year loan. An increase in the index represents an improvement in affordability.
5. There are three separate series for house prices in Australia which survey different samples of dwelling sales. The series used here are those produced by the Commonwealth Bank/Housing Industry Association.
6. Fiscal years begin 1 July.
7. The ANZ Bank (2002) proposes estimates of the "fair value" of housing, based on the housing affordability approach for owner-occupiers and on an earnings discount model for an average residential investor. Both methods suggest that house prices are far from entering a situation of irrational exuberance as they are only now approaching their fair value and have some further scope for appreciation.
8. As indicated by the broad-based NAB (National Australia Bank) quarterly business confidence index.
9. The 13¾ per cent decline in ANZ job vacancies in December was heavily affected by the timing of Christmas.
10. The peak unemployment rate was 10.9 per cent in December 1992 and the previous low was 5.4 per cent in June 1981.
11. This is discussed in Chapter III.

12. Persons unemployed for 52 weeks or more.
13. However, in mid-1992, when the economy had completed the first year of the current upswing, the youth unemployment rate was more than 33 per cent.
14. This supports estimates that CPI inflation remained within the 2 to 3 per cent range from mid-2000 to mid-2001 if adjusted for the price-level effect of GST.
15. The trimmed mean inflation is calculated as the (weighted) mean of the central 70 per cent of the quarterly price change distribution of all CPI components. The weighted median inflation is the inflation rate for that item which is in the middle of the total distribution of price changes. For more details see Box D: Underlying Inflation in Reserve Bank of Australia (2002), Bulletin, "Statement on Monetary Policy", May.
16. The wage cost index measures the change in the hourly rate of pay for a fixed basket of "constant quality" jobs. It is thus a more reliable indicator of wage pressures than the widely used average weekly earnings which are also shown in Table 5. The latter are measures of the wage bill, which is likely to have been boosted by a shift in the composition of wage earners covered by the index from lower skilled to higher skilled jobs, which are typically better paid.
17. Most notably the NAB Quarterly Business Survey and the ACCI-Westpac Survey of Industrial Trends.
18. As shown in Figure 10, lower Panel, this inflation expectation measure tends on average to exceed actual inflation by a large margin. At a twelve-monthly rate of 4.1 per cent in the September quarter of 2002, it broadly equalled its ten-year average of 4.2 per cent.
19. However, trade union officials surveyed by the Australian Centre for Industrial Relations Research and Training expect inflation to be at 3½ per cent in the year to June 2003.
20. Econometric research by Gruen, D., J. Romalis and N. Chandra (1997) suggests a mean lag of about 1½ years between changes in the cash rate and its impact on economic growth.
21. Korea, New Zealand, the Unites States and China in particular, with Japan being the notable exception.
22. They found that an increase in the structural budget deficit by one per cent of GDP would raise the Australia-US ten-year real bond rate differential by about 30 basis points. If true, this would substantially reduce the efficacy of activist fiscal stabilisation policy is Australia. However, the authors also note that 'size' of the impact of fiscal policy on the interest margin is likely to be smaller in the current era of low public debt.
23. Headline CPI inflation jumped to 6 per cent around mid-2000, reflecting the transition from the old wholesale tax to the goods and services value-added tax (GST). Underlying inflation remained low, however.
24. The calculation is based on average nominal cash rates for the periods 1992 to 2002 and 1997 to 2002, when output growth averaged around 4 per cent. Neutral real cash rates are then calculated using as deflators alternative measures of inflation expectations (*e.g.* indexed bond rate differentials, measures of "underlying" inflation) over these periods. Adding to the such-derived alternative real cash rates the mid-point of the RBA's inflation target band (hence 2½ per cent) leads to about 5½ per cent for the nominal neutral cash rate. This has been laid out in more detail in the Reserve Bank of Australia Bulletin (2002), "Statement on Monetary Policy", August.

25. At one point in October 2002, the Australia-US ten-year bond spread reached almost 200 basis points.
26. This ended a period of marked divergences in the growth of credit and monetary aggregates, which had resulted from the substitution by banks of certificates of deposit by bank bills and offshore borrowing, with the latter two liabilities not being counted in monetary aggregates.
27. Broad money comprises the monetary aggregate M3 (currency plus bank deposits of the private non-bank sector) plus borrowings from the private sector by non-bank financial institutions, less the latter's holdings of currency and bank deposits.
28. The normative short-term interest rate r' ("Taylor rule") is defined as $r' = r^* + p + (p-p^*)/2 + GAP/2$. This makes r' the sum of the long-term (Hodrick-Prescott) trend value r^* of the real short-term interest rate, the actual (tax-adjusted) inflation rate p, one-half of the difference between actual inflation p and the inflation objective p^* and one-half of the output gap, defined as the difference between actual and potential output as a percentage of the latter. Accordingly, the usefulness of the Taylor rule depends crucially on the choice of the weights used, the assumed value of r^*, and the accuracy of the measurement of the output gap.
29. The actual and structural net lending position of the general government improved by, respectively, 7.1 and 5.4 percentage points of GDP over the period 1993-1999, compared with outcomes of 5.1 and 3.3 percentage points for the OECD area as a whole over the period 1994-2000.
30. The Australian budget year runs from 1 July to 30 June.
31. For a detailed discussion of the reforms see OECD 2000a and 2001a.
32. These principles include: achieving adequate national saving; moderating national fluctuations; maintaining Commonwealth general government net debt at prudent levels; pursuing spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the tax burden; maintaining the integrity of the tax system; and ensuring that policy decisions have regard to their financial effects on future generations (OECD 2000a and 2001a).
33. As pointed out by the paper, such a conclusion needs to be qualified by the observation that the findings of the study are based on aggregate data and therefore may not capture the demand effects of specific policies that may have in practice a larger demand impact (Comley *et al.*, 2002).
34. The benefits arising from the Commonwealth's medium-term fiscal strategy are discussed in detail in Budget Paper No. 1 of the 2000-01 Budget (May 2000).
35. Net worth is defined as financial and non-financial assets, less liabilities.
36. Based on estimates included in the 2002-03 Budget (May 2002).
37. Important initiatives include a further reduction in company tax as part of the implementation of the 2000 tax reform; a reduction in excise on petroleum fuels and draught beer; as well as initiatives in high priority areas, including support for older Australians, welfare reform, health, environment and measures strengthening telecommunication services – particularly in rural and regional Australia. For more details, see 2001-02 Budget (May 2001).
38. The May 2001-02 Budget projected a fiscal deficit in accrual terms of 0.1 per cent of GDP for the fiscal year, compared with a surplus of 0.5 per cent of GDP expected at the *Mid-Year Economic and Fiscal Outlook* (MYEFO) in November 2000. The underlying cash balance was expected to record a small surplus of 0.2 per cent compared with a mid-

year estimate of 0.7 per cent of GDP. The MYEFO estimates did not incorporate the discretionary tax cuts and additional spending, together amounting to A$ 3.7 billion, that featured in the May, 2001 Budget.

39. Economic growth forecasts for 2001-02 were revised upward from 3¼ per cent in the May 2001-02 Budget and 3 per cent in the MYEFO 2001-02 of October 2001, to 3¾ per cent by the time of May 2002-03 Budget.

40. On an accruals basis, the outturn was a deficit of 0.5 per cent of GDP.

41. An additional A$ 7 000 First Home Owners Scheme grant, funded by the Commonwealth, was made available in March 2001 to eligible recipients who bought or built a new dwelling, bringing the total to A$ 14 000. The additional grant payment was to cease at end-2001 but was extended to end-June 2002 at a reduced rate of $A 3 000 per eligible recipient (Budget 2002-03 Paper No. 1, May 2002).

42. Broad balance is projected on an accruals basis.

43. The 2002-03 Budget is the seventh Commonwealth budget presented under this fiscal strategy.

44. Changes in economic assumptions and new policy initiatives, have resulted in an upward revision of Commonwealth revenue of around A$ 3.4 billion in 2002-03 since the October 2001 MYEFO. This reflects higher projected income tax revenue from small unincorporated business, higher revenue from indirect taxes, additional funding to the Australian Taxation Office, and a deferral of several measures of the next phase of the business tax reform.

45. New policy decisions are estimated to reduce the fiscal balance by around A$ 0.7 billion in 2002-03, rising to around A$ 0.9 billion in 2004-05.

46. Initiatives to support the PBS are estimated to result in a decrease in the relevant expenses for the scheme of A$ 384 million in 2002-03, rising to A$ 510 million in 2005-06. The package of measures to develop and improve the work capacity of people with disabilities involves a rise in expenditure in 2002-03 and 2003-04, but is estimated to result in net savings of A$ 337 million over the period 2002-03 to 2005-06 (Budget 2002-03 Paper No. 1, May 2002).

47. The additional First Home Owners Scheme ended on 30 June 2002. The projected decline in housing expenses from 2003-04 is largely due to the halting in 2002-03 of the Goods and Services Tax (GST) transitional funding provided under the Commonwealth-State Housing Agreement.

48. A strong rebound to 4 per cent is projected for 2003-04.

49. On an accruals basis, a deficit of A$ 0.5 billion is now projected, compared with a previously estimated surplus of A$ 0.2 billion. The divergence between the cash and the fiscal balance measures mainly reflects timing differences between when revenues and expenses are recognised and recorded.

50. Major initiatives include: increased spending since the Bali terrorist attacks to support the victims and their immediate families, and for enhanced security arrangements; an immunisation programme against the Meningococcal C virus; a medical indemnity insurance package; and assistance to the sugar industry to facilitate structural adjustment (Commonwealth of Australia 2002-03 *Mid-Year Economic and Fiscal Outlook*).

51. According to the State and Territory estimates, the sector's receipts and payments are forecast to return to more moderate growth over the period 2002-03 to 2005-06, after strong growth in the previous two fiscal years. New South Wales and Victoria forecast lower property revenue in 2002-03, reflecting to a large extent, the end of the down-

ward cycle in interest rates. Moreover, the New South Wales cites significant declines in payroll tax and the abolition of debits from 1 January 2002 as factors contributing to lower receipts.

52. The 2002-03 Budget embodied the assumption of a further sale of a part of the government's shareholding in Telstra in late 2003, one year before that is currently assumed in MYEFO, subject to the government being satisfied with improvements in the telecommunication services, particularly in rural and regional Australia. The government attempts to promote a greater range and quality of services in such areas including through its response to the Telecommunications Services Inquiry and appropriate regulatory safeguards. Moreover, in November 2002 the government received the report of the Regional Telecommunications Inquiry into the adequacy of services in regional areas. The Government is considering the report's recommendations.
53. On the basis of the 2002-03 MYEFO estimates, the Commonwealth government net worth in the fiscal year is expected to decline to around A$ 46 billion, compared to a budgeted A$ 44 billion, mainly due to recent declines in the Telstra share prices which led to a downward revision to the market value of the Commonwealth's shareholding in the company.
54. In line with the objective of managing the reduction in net debt, the government envisages continuing the issuance of a new benchmark Treasury Bond with a 2015 maturity, in 2002-03, which will assist in maintaining the length of the yield curve and ensure, in the longer term, a smooth progression of available stocks into the 10 year bond futures contract (2002-03 Budget Paper No. 1, May 2002).
55. The government released in October 2002 a discussion paper of the *Review of the Commonwealth Government Securities Market*, inviting submissions from interested stakeholders by 6 December 2002. To further facilitate the consultation process, a reference committee has been formulated by the Treasurer, consisting of representatives from several key stakeholder associations. The purpose of the committee is to provide assistance on issues of detail emerging from the process.
56. As it is pointed out by the Commonwealth discussion paper, the majority of State and Territory government has proceeded to the funding of a part or all of the superannuation liabilities, mainly through the allocation of an asset portfolio to the superannuation fund.
57. Submissions on the Commonwealth discussion paper support, in general, the maintenance of a market for CGS, highlighting the potential efficiency costs from its elimination. As an exception, the submission by the finance house TD Securities supports the option of widening down the CGS market arguing that the maintenance of such a market is "inappropriate" given the government's commitment for balanced budget on average over the cycle and further sales of assets. Instead, the paper highlights the "ample opportunities" for expansion and development, for both market participants and the overall economy arising from deeper and more sophisticated financial markets under such option. For public submissions on the issue see at *http://debtreview.treasury.gov.au/public_sub.asp*.
58. Norway's Government Petroleum Fund, for example, managed by the Norwegian Central Bank, is restricted to invest only in foreign financial markets so as to reduce the risk for distorting the domestic financial markets. See Mylonas *et al.* (2002) and Commonwealth of Australia (2002d), *Review of the Commonwealth Government Securities Market*.
59. Mylonas *et al.* (2000); OECD (2002a, b).
60. See OECD (1999b, 2001a) and Dang *et al.* (2001).

61. The IGR provides a framework to assess the long-term budgetary implications of current policy settings, as required by the Charter of Budget Honesty Act 1998 (2002-03 Budget Paper No. 5, May 2002).
62. The IGR projections assume current trends in government expenditure and a constant ratio of revenues to GDP. The GDP share of non-demographic spending is also assumed to remain constant over time. As a result, the projections are subject to a high degree of uncertainty. However, sensitivity analysis of the projections, with respect to changes in underlying assumptions and trends, indicates that the broad policy conclusions of the central scenario still hold (2002-03 Budget Paper No. 5, May 2002).
63. The IGR projections assume that real average costs per student and post-secondary education participation rates will increase.
64. See also Chapter III.
65. The compulsory contribution rate stands currently at 9 per cent. The effect of the SG scheme depends on the extent that compulsory contributions substitute for voluntary saving. The savings offset for compulsory superannuation impacting on low income earners is uncertain, however a study by Morling and Subbaraman (1995) of the 35 years before 1995 estimated the offset to the voluntary superannuation of higher income earners of this period at three-quarters.
66. Double dippers are estimated to be a small percentage of the retired population and there is only little evidence of a significant non-investment use of the superannuation lump-sums. To ensure that superannuation benefits are used to finance retirement income, the government has legislated a phased increase in the preservation age from 55 in 2015 to 60 by 2025. Morever, the 2001-02 Budget removed the requirement for unemployed persons between 55 and the pensionable age to draw upon superannuation while unemployed for lengthy period (OECD 2001a).
67. A simplification of the arrangements for the taxation on superannuation benefits and their treatment in the Age Pension means test could encourage individuals to take such benefits as an income stream. Limiting the value of owner-occupied housing that is exempt from the Age Pension means test, would also be beneficial in this regards. The government is considering to change the rules on superannuation benefits in order to ensure that the effective rate of tax on an excessive component of eligible termination payment is not above 48.5 per cent. This results, under current arrangements, by the combination of tax on fund earnings (including contributions), the contributions surcharge and the taxation of benefits above the Reasonable Benefit Limit.
68. See Dowrick and McDonald (2002).
69. See Madge (2000).
70. These were discussed in detail in the 1995 and 1998, see OECD (1995) and OECD (1999b) *Economic Surveys of Australia*.
71. Other initiatives included: the introduction of measures to reduce or eliminate out-of-pocket expenses of patients – known as “no gaps” or “known gaps” options. The “gap” is paid by members and is the difference between the fees charged by doctors for in-hospital medical services and the combined health insurance benefit and Medicare Benefit Schedule fee which is covered by Medicare; the exploration of cost-effective payment models for day hospital and after care facilities; treatment of chronic and complex conditions; and rehabilitation.

72. The Lifetime Health Cover scheme, introduced in the 1999-2000 Budget, operates with a threshold age of 30 years. Members who join by the age of 30 and maintain their membership are rewarded with lower premiums while those who join after the age of 30 attract a penalty of 2 per cent of their premium for every year they delay taking out hospital cover.
73. The proportion of population under private insurance increased to 44.7 per cent by end-June 2001, compared with 42.8 per cent a year ago and only 30.1 per cent in December 1998. The decline in the corresponding proportion in 2002 reflects updated population estimates released by the Australian Bureau of Statistics during 2001-02, although the number covered by private health insurance remained unchanged from the previous years, at 8.7 million people.
74. The original Bill to enact this measure was rejected by the Senate and the government reintroduced it into Parliament in November 2002. The legislation was passed by the House of Representatives on 4 December 2002.
75. The main problems of the previous tax system in Australia, the government's 1998 tax package and the modifications to the original package to get the Senate's approval were discussed in detail in the 2001 OECD *Economic Survey of Australia*.
76. The efficiency effects of the Horizontal Fiscal Equalisation (HFE), the principle upon which the GST revenue is provided and distributed to the States, remain a controversial issue. The most recent contribution has been provided by the Report of Garnaut and FitzGerald (2002), commissioned by the New South Wales, Victorian and Western Australia governments. The report estimates an increase in national welfare of A$ 169 million from a move to a system of equal per capita distribution, pointing that this amount could represent an underestimate of the potential effects. On the other hand, a national forum conducted for the study, has criticised the Garnaut-FitzGerald findings on the grounds that they rely on a number of critical simplifying assumptions. The government would be open to considering any alternative method of allocation of GST revenue agreed among the States.
77. An important case is that of "small firm exemption" the thresholds of which ranges significantly across States and Territories ("the States"). In recent years, the States have introduced adjustments to the base, thresholds and rates on which payroll tax is applied.
78. Estimates on administration and compliance costs of GST were presented in the regulation impact statement that accompanied the GST legislation. There has been an agreement between the Commonwealth and States governments on an ongoing increase in the administrative costs of the GST aiming to manage the larger than anticipated GST workloads and to increase field services and compliance capabilities. The increase amounts to A$ 184.5 million in 2002-03 rising to A$ 235.8 million by 2005-06.
79. . The simpler GST reporting options introduced in 2001 have been used only by a relative small number of taxpayers, while around 90 per cent of business that submit quarterly returns have chosen to stay with the full calculation and reporting for the year 2001-02.
80. This is reflected in the November 2001 Dun and Bradstreet National Business Expectation Survey, according to which more than 90 per cent of executives stated that they were 'comfortable' with TNTS after 16 months and that there was a decline in the amount of time companies are spending on GST administration. The May 2002 survey results of the Yellow Pages and Business Index – Small and Medium Enterprises, confirmed such sentiment with only 6 per cent of respondents citing the GST as a concern.

81. In August 1998, the government established a Review of Business Taxation under the Chairmanship of Mr. Ralph to consult with the interested parties on the broad lines of business tax reform outlined in the government's tax package, Tax Reform: Not A New Tax, A New Tax System (Commonwealth Treasury 1998). The government announced on 21 September 1999 and 11 November 1999 its response the Ralph Review of Business Taxation (OECD 2001a).

82. The previous regime resulted in a number of problems for the taxation of wholly-owned groups of companies, including tax impediments to business organisation, high compliance costs, tax-avoidance through intra-group dealings, value shifting, double deductions and double taxation (Commonwealth of Australia 2000).

83. A protocol to amend the Australia/US Double Taxation Convention was signed on 27 September 2001 (negotiations with the United Kingdom and Germany are currently under way). Legislation to give effect to the protocol has subsequently been passed by the Australian Parliament but it has yet to receive the required approval from the US Senate. The protocol will remove withholding tax on certain dividends, enabling major Australian public companies to bring profits made by their US subsidiaries back to Australia without any further tax being payable. Other amendments include an updated list of taxes covered, and a new provision dealing with interposed trusts in relation to permanent establishments (Treasure's Press Release Number 074 of 2001).

84. See Review of International Taxation Arrangements: Consultation Paper (available at *http://www.taxboard.gov.au/int_tax/index.htm*.

85. The provisions of franking credits for foreign dividend withholding tax and the introduction of foreign income accounts have been deferred pending the outcome of the review of international tax arrangements.

86. The TVM calculates taxable income on the basis of cash flows and changing assets and liabilities, with adjustments to reflect tax policy effects. Hence, the method allows tax liabilities to be based on fluctuations of a company's balance sheet, compared with the traditional method of working out assessable income, and then substracting allowable deductions.

87. The government had announced its in principle support to the recommendation of the Ralph Review of Business Taxation to introduce the TVM and associated high level rules, subject to an extensive consultation process with representatives of the business community. The Board of Taxation was requested in August 2000 to undertake this consultation process for the evaluation of TVM. The Board reported that *i)* there was no appreciable community support for the TVM concept; *ii)* there was a widespread perception that, while the TVM may offer benefits in some areas, it would generate greater complexity in others; and *iii)* adopting the TVM would result in substantial transitional costs for tax advisers and business generally.

88. A discretionary, or non-fixed, trust is one in which not all the entitlement to its income and capital are fixed. The government announced in its August 1998 statement A New Tax System its intention to tax trusts as companies. This proposal was then restricted to the discretionary trusts only, and the government released in October 2000 exposure draft legislation (Board of Taxation 2002).

89. On the basis of the Board's report, there were about 340 000 discretionary trusts used in the 1998-99 tax year, and about 1.9 million individuals (or 20 per cent of the total number of individual taxpayers) received a distribution from partnership or trust. By comparison, in the same tax year there were about 600 000 companies, 500 000 partnerships and

90 000 fixed trusts. The report notes that the use of trusts in the recent past grew at the same rate as the use of companies.

90. The Treasurer announced, on 12 December 2002, changes to law to correct deficiencies in the provisions dealing with loans from trusts, in line with the recommendations from the Board of Taxation's report Taxation of Discretionary Trusts.
91. Under the current tax regime, income amounts of discretionary trusts that are not assessable to the trustee or beneficiaries (for example, due to a tax concession) may be distributed to beneficiaries tax-free.
92. Since the early 1990s, the government has introduced a number of changes to the tax treatment of trusts, which are discussed in detail in the report of the Board of Taxation for Discretionary Trusts. Integrity provisions (the alienation of personal services income measures) were introduced, for example, in July 2000 to prevent individuals from avoiding tax by diverting income gain from their personal efforts or skills to an entity such as a company, partnership, or trust. Such measures impose restrictions on the ability of an individual to retain personal services income in an entity and on deductions which can be claimed.
93. The top marginal rate of personal income is 47 per cent (or 48.5 per cent with medical levy) compared with a top corporate income tax rate at 30 per cent.
94. An international comparison of real GDP growth is provided by Annex Table 1 of the OECD *Economic Outlook* No. 72.
95. Prima facie, the East-Asian crisis should have hit Australia particularly hard, given its greater trade exposure to the crisis-affected region than most other OECD countries. The 2000 OECD *Economic Survey of Australia*, Chapter II, attributes the Australian economy's resilience to the Asian economic crisis and the subsequent global slowdown of economic activity to the judicious mix of sound macroeconomic and structural policies. This view is supported by simulations with the OECD INTERLINK model which suggest that a major contribution to the favourable performance over the 1998 to 1999 period owes to the particular combination of expansionary monetary policy and fiscal retrenchment adopted by the authorities at the time. Its resilience to the Asian crisis gave rise to Australia being labelled as a "miracle economy" by some observers, for example Krugman (1998) and Bean (2000).
96. Focussing on potential as opposed to actual output eliminates the effects of the business cycle from the analysis.
97. Of course, the results of growth decompositions have to be taken with a degree of caution as they can be quite sensitive to the model specification underlying the exercise. However, a purely mechanical decomposition of the actual growth of real per-capita GDP into the components working-age population, participation rate, employment rate and labour productivity also leads to the conclusion that improved labour productivity was the main source of higher economic growth in the 1990s. This is illustrated in OECD (2001), The New Economy: Beyond the Hype, Figure 3.
98. Productivity cycles are defined as the intervals between productivity peaks, as identified by the Australian Bureau of Statistics (ABS). Average growth rates over peak-to-peak productivity cycles are used as indicators of underlying rates of productivity growth, hence adjusted for the effect of the business cycle. The latest productivity cycle dates from fiscal year FY 1993-94 to FY 1999-2000 and the proceeding cycle from FY 1988-89 to FY 1993-94.
99. Multifactor productivity is defined as the difference between the growth of output and those of the growth of inputs of capital and labour, suitably weighted. The capital/

labour ratio is interpreted as an indicator for the "capital deepening" of the production process. Assuming a Cobb-Douglas specification of an aggregate production function and constant returns to scale, labour productivity growth can be represented as the sum of the growth of multifactor productivity and the change in the capital/labour ratio.

100. This implies that the acceleration of average annual labour productivity growth from the 1988-89 to 1993-94 cycle to the 1993-94 to 1999-2000 period by an extra 1 percentage point – the difference between average growth rates over the two respective periods – was entirely due to the pick up in the growth of multifactor productivity, with the capital deepening component to the acceleration even being slightly negative (–0.1 percentage point).

101. This issue was already taken up in the 2001 OECD *Economic Survey of Australia*. Reference to a growth accounting exercise led to the attribution of a comparatively low share in the overall productivity gain to the heavy use of ICT in Australia in the 1990s. This left over a substantial residual in the analysis of the productivity pick up which could not be readily explained by the "new economy".

102. In Australia (like in the United States and Finland), ICT investment accounted for over 50 per cent of the increase in non-residential investment in the late 1990s.

103. See OECD (2001d), Figure 6.

104. Nicoletti, Scarpetta and Boylaud (1999) found that countries with a high price level of ICT investment tend to have a lower degree of competition, as measured by indicators of economic regulation.

105. Countries such as the US and Finland which have large ICT-producing sectors experienced a significant increase in their multifactor productivity (MFP) growth at the macro level, in part because of very large increases in MFP levels in that sector, as well as because of increased use of ICT equipment in all sectors.

106. With trade-exposed parts of the farming sector and mining being notable exceptions.

107. A brief illustration of the interaction of the use of ICT and structural reforms in the wholesale trade sector – where productivity gains were most notable in recent years – can be found in Box 3 of the 2001 OECD *Economic Survey of Australia*. It draws on the thorough analysis of Johnston, Porter, Cobbold and Dolamore (2000). Another study by the Productivity Commission (2002b) on the Australian motor vehicle industry reports on the improvements in the flexibility and productiveness of automotive workplaces through industrial relations reform which allowed less restrictive work practices, *inter alia* facilitating team-based work and multi-skilling of employees.

108. In Australia, industrial awards generally specify minimum wages and conditions of work for most categories of labour. It is, thus, illegal to employ a worker at a wage or on terms which are less favourable than the relevant award, irrespective of whether a worker is a union member or not. Awards are oriented towards occupations and industries rather than individual workplaces, and many firms are still covered by multiple awards. The terms of awards may be reached by a settlement imposed by the Australian Industrial Relations Commission or similar industrial tribunals by the states, by a combination of conciliation and arbitration, or by conciliation alone. The central role played in the past by industrial tribunals in determining wages and employment conditions was based on the premise that it was in the public interest that the state intervened on an ongoing basis in the employer-employee relationship. See Wooden (2000).

109. For more details on industrial relations reforms, including the different types of collective (certified) and individual enterprise agreements employees (Australian Work-

place Agreements) provided by the WRA, see both the 2000 and 2001 OECD *Economic Surveys of Australia*, Chapters III.

110. These figures only refer to the role of awards in setting wage and salary increases and must not be taken as indicator for their role in influencing employment conditions in general. If agreements which are "add-ons" to awards are included, then award coverage is much higher, possibly over 80 per cent of the labour force.

111. There are uncertainties as to the beneficial effects of formalised individual bargaining on performance at the workplace level, especially if individual arrangements promote competitive behaviour within workplaces which could foster non-co-operative relationships.

112. Wooden, Loundes and Tseng (2002).

113. The Commonwealth government assumes in the projections of its Intergenerational Report 2002-03 (Budget paper No. 5) that, in response to labour market reforms, the NAIRU will decline to 5 per cent within a few years.

114. See the OECD (2001), Growth Project Background Papers, Vol. I-III, a summary of the main conclusions from this study in OECD (2001), and a summary of the analytical studies in OECD (2003), The Sources of Economic Growth in the OECD Countries.

115. Details on the estimation technique and the variables used are laid out in OECD (2003), The Sources of Economic Growth in the OECD Countries. Supplementary estimates and details on the model selection process for different specifications and sensitivity analysis can be found in Bassanini, Scarpetta and Hemmings (2001).

116. Only the coefficients for the United States, Canada and Switzerland turned out slightly higher.

117. The regressions also show that Australia outperformed the predicted per capita growth by a substantial margin (the residual country-specific effect), which may be attributable to the effects of structural reforms since the mid-1980s.

118. See also the discussion in Parham (2002a).

119. The "allowable matters" set out in the Workplace Relations Act are the following: classifications of employees and skill-based career paths; ordinary time hours of work, rest breaks, notice periods and variations to working hours; rates of pay (such as hourly rates and annual salaries), rates of pay for juniors, trainees or apprentices, and rates of pay for employees under the supported wage system; piece rates, tallies and bonuses; annual leave and leave loadings; long service leave; personal/carer's leave, including sick leave, family leave, bereavement leave, compassionate leave, cultural leave and other like forms of leave; cover parental leave, including maternity and adoption 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; pay and conditions for outworkers; provisions incidental to the allowable matters and necessary for the effective operation of the award.

120. For examples of the practice of pattern bargaining in the construction industry and its potential productivity-reducing effects see Productivity Commission (1999c).

121. For example, in the 2000-2001 period, more than 5 160 agreements with identical wage and wage-related provisions, covering more than 68 000 employees, were identified, and 5 280 pattern agreements with identical employment condition, covering nearly 72 000 employees.

122. Protected action means that it is exempt from civil liability. Unprotected industrial action is any action which occurs outside of a bargaining period.
123. Workplace Relations Amendment (Secret Ballots for Protected Action) Bill 2002 [No.2].
124. Workplace Relations Amendment (Improved Remedies for Unprotected Action) Bill 2002.
125. See the OECD *Jobs Study* (1994), Part II, Chapter II, and OECD (1999), *Employment Outlook*, Chapter 2, and OECD (2001), Innovations in Labour Market Policies – The Australian Way.
126. The minimum severance pay standard in most awards provides for 8 weeks pay for individuals retrenched after 4 year's service (lesser payments apply for shorter periods of service). Some awards and many agreements provide more. There is also a facility for orders for severance pay pursuant to the ILO's Termination of Employment Convention (C158).
127. The ABS (Small Business in Australia, 1999, ABS Cat. No. 1321.0) defines small businesses as businesses employing less than 20 people; they account for about half of total employment.
128. In July 1999, in the Survey of Investor Confidence of the Australian Chamber of Commerce and Industry (ACCI) about 54 per cent of small businesses indicated that they might have hired more staff had it not been for the unfair dismissal laws. ACCI's Pre-Election Business Survey of November 2001 found that small businesses ranked unfair dismissal laws as the fifth most important problem facing them. Concern about unfair dismissal legislation was also expressed in the Small Business Survey Programme on Employment Issues by the Certified Practising Accountants Australia, although only 5 per cent of the respondents considered the law a major impediment to hiring new staff. The results of this survey also revealed a high degree of false perceptions of the unfair dismissal legislation among small businesses, in spite of the Government's various educational initiatives on the subject.
129. See Wooden, Loundes and Tseng (2002).
130. OECD (2003), The Sources of Economic Growth in the OECD Countries.
131. Some public employment service functions continue to be run by the government.
132. The Work for the Dole labour market initiative was announced in the 1997-98 Budget. It aims to involve young job seekers in a work environment and give them the chance to engage with the community rather than being isolated from it. Participation in a Work for the Dole project involves a six month commitment of up to 30 hours per week. Work for the Dole services are managed by Community Work Co-ordinators, who are contracted by the Department of Employment and Workplace Relations to arrange projects with community groups or local government agencies.
133. See the evaluations by the OECD (2001e), the Department of Employment, Workplace Relations and Small Business (2000, 2001) and the Department of Employment and Workplace Relations (2002a), and the references to various other studies given there.
134. The Government Response to the Productivity Commission Independent Review of Job Network (2002a) is available on *http://parlsec.treasurer.gov.au/parlsec/content/publications/2002/JobNetwork.asp*
135. Poverty traps can be avoided by providing 'in-work-benefits'. For a discussion of possible options, such as easing income tests, or introducing an Earned Income Tax Credit scheme or a negative income tax, see for example, OECD (1999a), OECD (2001a), Disney (2000), and Ingles (2001).

136. An Interim Report was issued in March 2000 (RGWR, 2000b).
137. Over the period 1969 to 1999, the proportion of working-age population receiving income support has approximately quintupled, rising from 4 per cent to 21 per cent. The expenditure on income support, (excluding age pensions) as a per cent of GDP, increased from 1.3 per cent to 4.7 per cent over the period.
138. Another important initiative includes the reduction of the maximum rate of taper from 100 per cent to 70 per cent, as part of the "Working Nation" reforms to Newstart allowance in 1995.
139. A way of illustrating the disincentive effects of high METRs is considering increments to net income from a A$ 100-a-week increase in private income. In June 2001, for example, a single allowee (with no children) would face an METR of 80 per cent on incomes between A$ 100 and A$ 200 a week, and 78 per cent on incomes between A$ 200 and A$ 300 a week. The METRs can reach 93 per cent for families with four children, and over 100 per cent in case that there are dependant students, as means tests for different benefits sometimes overlap (Whiteford and Angenent (2001).
140. Department of Family and Community Services (2000).
141. Training credits of up A$ 800 will be granted to people who undertake Work for the Dole or Community Work. Training Credits form a comprehensive programme of work experience and training for unemployed people that can be used to cover the cost for a wide range of competency and accredited courses.
142. Specific measures to improve employment opportunities include extra Job Search Training places, more Work for the Dole places, new opportunities for community work, and enhancements to Intensive Assistance. In addition, Training Accounts for participating eligible indigenous and mature-age job seekers are available to help them paying for training. The new initiatives further include a new Transition to Work programme aiming to assist parents, carers and mature age people who move into work.
143. From July 2002, job seekers aged 18 to 39 years are required after six months of unemployment, and at least annually thereafter, to undertake an activity (community work, part-time work or study), with the Work for Dole being the default for those not having chosen an activity by themselves. Job-seekers aged 40 to 49 years are not required to undertake Work for Dole. For this group, the default is referral to a Community Work Co-ordinator. No changes to activity requirements apply to job seekers aged 50 and over (Budget 2001-02 Paper No. 2, May 2001).
144. To further improve participation, the AWT reform package incorporated a simplification of income test rules for working age pensioners and Parenting Payment recipients. Changes will also make it easier for people to get back onto welfare payments after taking up short-term work or whose job ends soon after they have stop receiving the payment. Also, a Literacy and Numeracy Training Supplement was introduced to help meet such costs as travel to courses (Budget 2001-02 Paper No. 2, May 2001). The changes to participation requirements for people receiving parenting payments and the introduction of the working credit will require legislative change.
145. Income recipients will accumulate credits (up to a maximum of A$ 1 000) in fortnights in which they have their income falls short of the A$ 48 threshold. In any fortnight that earned income exceeds the current test free area (A$ 62 per fortnight for Newstart recipients, and A$ 106 per fortnight for single working age pensioners, without children), this credit can be drawn down allowing earnings to be retained in full until the credit is exhausted (OECD 2001e). The implementation of the initiative has been

deferred to April 2003, from September 2002, as part of a wider strategy to ensure people understand the measure and take full advantage of it.

146. The government will provide funding of A$ 3.3 billion over three years beginning on July 2003 for arrangements associated with the Third Employment Services Contract.

147. Job seekers will receive Intensive Support after 3 months of unemployment, including job search training and lodgement of vocational profiles on the Australian Job Search Site allowing for automatic job matching. Intensive support is a professional employment service, under the AWT package, that provides individualised assistance to job seekers who have had, or are likely to, experience difficulty in getting a job.

148. The 2002-03 Budget envisaged a phased implementation of the new measure. Specifically, the new eligibility criteria would apply to all new DSP applicants from 1 July 2003. People who are currently receiving DSP (apart from those who are severely disabled or are within five years of Age pension age) would also be subject to the new criteria within five years of implementation (Budget 2002-03 Paper No. 2, May 2002).

149. Moreover, the bill provided for those who are not subject to new arrangements and do try out work of 30 hours or more a week, but find they cannot maintain this, to move back onto DSP under the current rules within a two year period.

150. This estimate is based on revised Disability Reform Bill (No. 2)

151. The government released in December 2002 a consultation paper on the next steps of welfare reform, inviting for submissions until 20 June 2003. An important issue in the paper is a possible reform of the structure of the current income support payments system for working age people ("Building a Simple System to Help Jobless Families and Individuals", available at *www.facs.gov.au*).

152. State and Territory governments have much of the responsibility for running schools and vocation and training programmes, and have often taken the initiative for reforms in their jurisdictions. One change in recent decades has been stronger emphasis on national approaches to assessing performance and qualifications, and the programmes discussed below are at Commonwealth level.

153. The survey was conducted in the framework of the OECD-sponsored Programme for International Student Assessment (PISA) for 2000. PISA assesses the performance of 15-year old students in three domains: reading literacy, mathematical literacy, and scientific literacy. The major focus for the 2000 study was reading literacy, with the other two domains planned to be the focus in 2003 and 2006, respectively. Australian students, on average, performed consistently well in all of the three assessment domains. In "combined reading literacy" only one country had a mean achievement significantly higher than Australia's. PISA defines as "combined reading literacy" the ability to understand, use, and reflect on texts in order to participate effectively in life (OECD, 2001c).

154. The findings of PISA (2000) suggest a relatively high overall variation in "combined reading literacy" performance (with 112 per cent of the OECD average between-student variation), with differences between schools accounting for a comparatively small proportion (21 per cent of the OECD average of student variation).

155. See Sweet (2001).

156. An additional important initiative includes the introduction in 1998 of the National Training Framework ensuring the quality and national consistency of the VET system, enhancing the industry-relevance of training assessment and removing the rigidity of previous curriculum approaches. See OECD (2001), *Economic Survey of Australia*; OECD

(2001), Innovations in Labour Market Policies: The Australian Way, and NCVER (2001a), Facts, Fiction and Future.

157. The New Apprenticeships programme was set out in 1998 to create a unified framework for the traditional four-year apprenticeships (in areas such as manufacturing, construction and public utilities), and the shorter- duration traineeships. The traineeship-type training, introduced in 1985, was originally mainly for 15 to 19 year-olds in services and white-collar areas, but was subsequently expanded to older workers and most industries. For a discussion see OECD *Economic Survey of Australia* 1999 and 2001, OECD (2001) Innovations in Labour Market Policies, and OECD (2002) *Employment Outlook*.

158. Another difference between Australian and European apprentices is that most of the growth in Australia in recent years has been concentrated in the 20+ age group. Only 6 per cent of 15-19 year old Australians were in apprenticeship/trainee schemes, compared with 70 per cent in Germany and Switzerland, and 40 per cent in Austria (NCVER, 2001b).

159. Trade and related occupations make up 38 per cent of New Apprentices in training but represent 15 per cent of all jobs in Australia.

160. The non-completion rate for trainees has averaged about 40 percent since 1985, rising to 45 per cent in recent years. Apprenticeship no completion rates are lower, at the order of 23 to 30 per cent (NCVER, 2001a). Research indicates that non-completion of New Apprenticeships in Australia is at a level similar to workplace mobility generally.

161. See EWRSBE (2000); and OECD (2001e, 2002*c*).

162. These contracts require that the employer agrees to provide facilities and expertise to assist the training of the New Apprentice in an agreed qualification. This may include specific on-the-job training, mentoring or time off to attend formal training. The Commonwealth commencement incentive is only granted after three months upon evidence that a training plan is in place and that the training has started. Moreover, the New Apprenticehips are encompassed by the Australian Quality Training Framework, which establishes audible standards both for training providers and for registration of the courses.

163. Of those participating in the New Apprenticeship scheme, 45 per cent are in low-skill service or labouring occupations.

164. In 2001, around 81.5 per cent of New Apprentices undertook an AQFIII programme (which is of equivalent level as traditional apprentices were in the past).

165. Over 94 per cent of Australia's secondary schools are currently offering VET programmes to their senior students, though a 1998 survey indicated that only 10 per cent of 15-19 year olds were enrolled in VET programmes. In 2001 over 169 000 school students undertook programmes that could lead to Certificate I, II, or III qualifications, as well as a senior secondary certificate. Over 10 000 school students undertook New Apprenticeships in 2001, of whom 5 755 were new commencements (ANTA, 2001).

166. ECEF replaced the former Australian Student Traineeship Foundation (ASTF) in February 2001. Building upon ASTF, it assists students to acquire vocational, enterprise, and career education and experience before they leave school.

167. Complementary measures to help young people make successful transitions to working life or further education include an online career exploration and information service, as well as The Real Game, an experimental career game.

168. The findings of PISA (2000) suggest that socio-economic background factors account for 16 per cent of within-school variation in Australia, and 64 per cent of between-school

variation, standing in both cases above the OECD average. Other areas of concern, on the basis of the PISA results, include the relatively low performance of boys in reading, particularly in relation to narrative texts. Boys from disadvantaged backgrounds were twice as likely as girls from similar backgrounds to be in the lowest quarter of reading scores. Overall, the findings suggested that boys were much less engaged in reading than girls. The relatively performance of Indigenous students – in all three assessment domains – is another area of concern. Although the above groups' performance was lower than the average, there were many individuals with good to very good results.

169. The rate of private internal return represents a measure of the returns obtained over time, relative to the cost of the initial investment to education. It is expressed as a percentage and is analogous to percentage returns from investing in a savings account. The estimations treat the costs of study, including foregone earnings, as the investment; and the gains in post-tax earnings above those school-leavers as the pay off. The estimates suggest that the comprehensive private internal rate of return to tertiary education ranges from 6.5 per cent in Italy to 17.3 per cent in the United Kingdom. The corresponding social rates of return range from 4.2 per cent in Denmark to 15.2 per cent in the United Kingdom. Australia was not covered by the sample (OECD, 2002d).

170. Similar conclusions apply to the returns to investment to upper secondary education. *Ibid.*

171. See Commonwealth of Australia (1993).

172. Most State and Territory governments maintain competition units and have appointed independent pricing regulators.

173. The National Competition Council is an independent authority, which provides national oversight of the NCP in order to "help raise the living standards of the Australian community by ensuring that conditions for competition prevail throughout the economy which promote growth, innovation and productivity".

174. This Act also formed the Australian Competition and Consumer Commission (ACCC), which is an independent statutory authority whose main tasks are to administer the Trade Practices Act and Prices Surveillance Act.

175. Three agreements signed by Australian governments in 1995 establish the National Competition Policy: the Competition Principles Agreement, the Agreement to Implement the National Competition Policy and Related Reforms, and the Conduct Code Agreement.

176. The National Access Regime has been reviewed by the Productivity Commission (2001b) with the conclusion that retention of it is warranted but that some significant changes to its current arrangements are required. The proposed amendments seek to facilitate efficient investment in essential infrastructure and to ensure that the access regime is better targeted and more workable. The Government's response to the review will be finalised after consultations with jurisdictions. An interim response is at *www.treasurer.gov.au/tsr/content/publications.asp*

177. See the discussion in the 2001 OECD *Economic Survey of Australia*, Chapter III.

178. The study of the professions by the National Competition Council (2000), in particular legal services and health and pharmaceutical services, identified a range of anti-competitive restrictions related to entry-qualifications, registration requirements, reservation of title or practice, disciplinary processes and conduct of business rules.

179. An interim response is at *www.treasurer.gov.au/tsr/content/publications.asp*

180. Short, Swan, Graham and Mackay-Smith (2001).
181. Similarly impressive savings are reported in Victoria's 2001 NCP Annual Report.
182. Electricity prices relative to the CPI.
183. Productivity Commission (2002c).
184. Australian Pipeline Industry Association (2001).
185. This has been discussed in the special chapter on "Enhancing environmentally sustainable growth" in the 2001 OECD *Economic Survey of Australia*, and is discussed below in the "sustainable growth" section of this Chapter.
186. Technical efficiency refers to the ability of railway management to produce outputs with a given set of inputs. It is computed, where possible, by accounting for all factors affecting productivity.
187. Australia's rail system is estimated to have achieved a technical efficiency of 69 per cent of best practice (United States, Canada and Japan, Ireland and Luxembourg).
188. Part XIC of the Trade Practices Act 1974.
189. There are a number of other obligations ensuing from the National Competition Policy that the Commonwealth has not met so far. These relate to restrictions on competition in health insurance arrangements, broadcasting and radio-communications legislation, export marketing arrangements for wheat, and automotive and textile, clothing and footwear tariff arrangements.
190. The Government had proposed measures to reduce Australia Post's reserved service and to open the postal market to increased competition in response to the NCC's review of the Australian Postal Corporation Act (1998). However, draft legislation to this effect was withdrawn from the Parliament in early 2001 as it did not attract the support necessary for passage.
191. Banks (2001).
192. A study of the Industry Commission (1995) suggested that the full implementation of the National Competition Policy alone would raise the level (not growth) of annual real GDP in the long run, once all adjustments have taken place, by 5½ per cent.
193. Empirical evidence for the contribution of financial development to economic growth through its effect on the level of investment – even in the case of countries with relatively high income levels – can be found in Pelgrin, Schich and de Serres (2002). For evidence on the links between financial development and growth over and above the links *via* investment, indicating impacts *via* overall economic efficiency see Leahy *et al.* (2001) and the references therein. Research by Rajan, R. G. and L. Zingales (2000) emphasises the particular importance of efficient financial systems for economic growth in countries which are less open to international trade and capital flows.
194. The reforms are based on the recommendations of the Financial System Inquiry (1997), chaired by Mr. Stan Wallis and widely known as the "Wallis Report". A brief overview is given in the 1999 OECD *Economic Survey of Australia*, Chapter III.
195. "Long-tail" insurance involves considerable lags between a claimable incident and the settlement of the claim, and contains uncertainties over the amount, timing and potential length of pay-outs.
196. Commonwealth of Australia (2002), Compensation for Loss in the Financial Services Sector, Issues and Options, *www.treasury.gov.au/contentitem.asp?pageId=&ContentID=402*

197. Features of CLERP were already discussed in the 1999 OECD *Economic Survey of Australia* in the context of the special chapters on Corporate Governance (Chapter IV) and on Entrepreneurship (Chapter V).

198. Such concerns led the OECD Ministerial Council to suggest that, as from the end of 2001, sustainable development should be integrated into *Economic Surveys* of the OECD.

199. Indeed, the median gross income of elderly couples was only just above one third of the median income of couples aged from 15 to 54, while less than one in four elderly couples had an income above 50 per cent of the median income of younger couples. However, the income level of younger couples needs to be lowered to allow for the fact that they have children.

200. Government benefits provide 90 per cent of the income for 45 per cent of people over 65.

201. This agreement resulted in a national wage award being reduced and the amount of the foregone increase being paid by employers into superannuation funds.

202. The Government announced in 1996 its intention to allow employees earning less than A$ 900 a month to opt out on a voluntary basis. Legislation to implement this policy has not been introduced into Parliament.

203. For a discussion of this regime see Galer (2002) and for its application to Australia, see Bruner (2002).

204. Under an expenditure tax, income from capital is only taxed when it is consumed, rather than when earned, as would be the case with an income tax. In most OECD countries, retirement saving is accorded such an expenditure tax treatment either by taxing contributions or benefits (but not both) as income and by exempting the capital income of the savings vehicle.

205. This is achieved by taxing contributions and benefits at 15 per cent (subject to a large tax-free element), while taxing the income of retirement saving funds at an effective rate of under 10 per cent.

206. Actual income from capital is not taken into account, rather an income is calculated based on an imputed rate of return of 5 per cent, representing a marginal wealth tax of 2 per cent.

207. For a single homeowner the threshold is A$ 145 250 (about three times average annual earnings). This is roughly equivalent to the present value of the age pension at retirement.

208. Whiteford and Stanton (2002).

209. In December 2002, the government announced that the tariff on autos would be lowered to 5 per cent by 2010. Clothing tariffs are already planned to fall to 17.5 per cent by 2005.

210. Simons (1997).

211. Such salinity is markedly different to wetland salinity. Dryland salinity stems from reduced water use while wetland salinity results form increased water use.

212. A sustainable yield for surface water is the amount that can be diverted from a river after taking into account the environmental needs of the river basin.

213. In many areas, water rights account for 70 per cent of land values.

214. Much of this and the following sections is based on DIMIA (2001a).

215. International comparisons are highly imprecise because of different statistical definitions. For example, in the case of Luxembourg (this is also true of Germany and some other European countries) foreigners are recorded as those with foreign citizenship, whereas in Australia many of the foreign-born have taken Australian citizenship and would not show up using the Luxembourg definition. On the other hand, some foreign citizens in Luxembourg were born there.

216. Australia became a self-governing federation in 1901, and in that year about 13 per cent of the total population, and over half the overseas-born, had been born in the United Kingdom or Ireland.

217. The next *Economic Survey of New Zealand* will include a chapter on migration.

218. The gain is not the sum of the two net figures for permanent and long-term temporary, because some people included in figure for permanent arrivals may be "category jumpers" included also in the long-term temporary figure. Thus in 1999-2000 net permanent arrivals were 51 000 and net long-term temporary arrivals were 56 000. An adjustment for the 2001-2002 data is not yet available and no data on flows are available for 2000-2001 due to computer system problems.

219. This "back of the envelope" calculation is based on a population aged 15 of some 250 000.

220. While Australia has better data on migration flows than most countries, problems remain. The numbers in this paragraph mostly refer to those from the arrivals and departures data based on border controls. This is different from the immigration visa data (which cannot, for example, pick up departures). In recent years, for example, visas granted for permanent or long-term (over one year) stay exceeded the number of recorded long-term entries by as much as 20-30 000. The main explanation is thought to be visas granted to people already in Australia recorded as "short-term" entries.

221. See Hugo *et al.* (2001). Data for departures are based on a question on the card for outgoing passengers, enquiring if they are leaving permanently. For 2001-2002 21 per cent, 17 per cent and 16 per cent of around 50 000 departures were for the United Kingdom, United States and New Zealand respectively; Singapore and Hong Kong accounted for 7 per cent and 6 per cent respectively.

222. All non-Australian entrants are required to have a visa. New Zealand citizens are automatically issued a visa upon arrival, which entitles them to settle and work in Australia (though not, in itself, to the full range of social security and other government transfer schemes).

223. The website of the Australian Immigration Service, *www.immi.gov.au*, has complete descriptions.

224. For example, applicants for points based entry must be under 45 years of age and have good ("vocational") English language skills.

225. An immigrant must register for courses within 3 months of being granted a visa and commence tuition within 12 months. The 510 hours must be taken within 3 years of the visa being granted. Humanitarian and other immigrants have the same entitlement to tuition; eligibility depends essentially on the applicant having a low (below "functional") level of ability in English. Tuition includes material on getting jobs, housing etc. Highly-skilled immigrants and those granted visas under the employer nominated scheme should already have sufficient English and are not eligible for the AMEP, their dependants may be eligible but would be required to pay a fee.

226. See Auditor General's Audit Report No. 40 2000-2001 on Management of the AMEP Contracts (Australian National Audit Office (2001)). Only 11 per cent of people exiting from AMEP do so with "functional English" (highest level aimed at under the course). On average only about 80 per cent of the time is used. On average 70 per cent of eligible people enrol (58-90 per cent for humanitarian, 60-65 per cent of family visa holders (1998, 1999 figures). The cost of the programme in 1996-97 was A$ 98.6 million, A$ 2 531 per participant (2000-2001 prices); in 1999-2000 the programme cost A$ 93.9 million, A$ 2 612 per participant, although the programme had by then been contracted out in an effort to reduce costs. Some 14 000 people exited AMEP programmes in 2000-01.

227. The Government also funds language tuition and assistance for school-age immigrants (humanitarian and non-humanitarian) to make the transition into Australian schools. Other programs specifically designed for integration of newly arrived humanitarian and non-humanitarian immigrants provide information about, and referral to other services, support the development of ethnic communities' capacity for self-help and assist other services to be more able to meet the needs of clients who are immigrants.

228. Few recent immigrants report racist sentiment as an element to dislike in Australia. Richardson *et al.* (2002) report that less than 7 per cent of immigrants find the resident population either racist or unfriendly (*i.e.* the two responses taken together), while almost 40 per cent of respondents cite the friendly population as a reason for liking Australia.

229. Vietnamese concentrations in Sydney, and a number of earlier concentrations, are initially due to the location of migrant hostels, perhaps reinforcing a tendency for the low-skilled or low-incomes groups, arriving without jobs, to concentrate more than others. Many migrants in "Vietnamese" areas are of Chinese origin, though having arrived from Vietnam. Other Chinese do not concentrate in these areas. (Jupp, 1995).

230. According to Jupp (1995), this tendency has been less strong in Australia than in other immigration countries, in part due to early opposition of the authorities to such concentrations. The author notes a refusal by the New South Wales government to give public assistance to a group of destitute Italians in 1881 if they attempted to settle together: "the customs of the country and other circumstances render it undesirable, indeed almost impossible, for them to settle down altogether in one locality. Even if this were practicable it would not be for their own good to do so." (Address to the Italian Immigrants, Sydney, 21st April 1881, reported in Jupp, 1995). Nevertheless, in 1991 there were 21 local government areas of 687 Australia-wide (9 in Sydney, 10 in Melbourne and 1 in Brisbane) where over 45 per cent of the population spoke a language other than English at home. None of these areas are dominated by any one language group, however (see Jupp, 1995; Table 5). A quarter of a million people, about 5 per cent of the population, live in these 21 districts.

231. For existing residents, concentrations of immigrants, particularly where incomes are low and unemployment is high, are sometimes viewed as bad in themselves, perhaps through association with crime or cultural hostility. These issues are outside the scope of this chapter.

232. Often interpreted as including future immigrants, although this renders the concept logically unclear.

233. In the past the Immigration Department had a large research section. From 1996 this was largely closed down and its work contracted out to the private sector and academia. Most research work on migration issues in Australia is financed under DIMIA projects, often with tightly-specified terms of reference.

234. By contrast, those whose main motives for migrating to Australia are explicitly economic are in a minority and less than one in six non-humanitarian migrants express dissatisfaction with life in their country of origin. About one quarter of immigrants say they were seeking "better employment opportunities" and about one sixth cite "dislike of economic conditions" in their country of origin. "Joining family", "better future for family" (which might, however, be thought of as including some economic considerations) and "other *e.g.* lifestyle, climate" are each cited by around one half of immigrants (Richardson *et al.*, 2002).

235. The Business Council of Australia (BCA), for example, would like to aim for a trend GDP growth rate of 4 per cent. Anticipating labour productivity growth of 3 per cent, it calculates that net immigration needs to be of the order of 130 000 people per year, rising to 180 000. At around 1 per cent of the population per year this is a much higher figure than in recent years (the current planned Migration Program of between 100 000 and 110 000 and Humanitarian Program of 12 000 of 110 000 are gross targets, to which estimated net inflows of New Zealanders and of long term temporary visa holders need to be added and from which emigration of around 30 000 needs to be deducted to compare with the BCA figure), though comparable with levels for much of the first two post-war decades.

236. The fact that this includes a quite comprehensive set of minimum wage agreements may explain the relative lack of concern expressed about a possible effect on wages.

237. As noted above, recent work shows that Australians leaving to live abroad are somewhat more highly skilled than immigrants (Hugo, 2001).

238. In recent years, the importance of temporary migration has increased considerably. It is likely to be much more sensitive to short-term labour market conditions than is permanent migration. Rapid growth in temporary inflows in the 1990s may have been a consequence of permanent programme not being expanded significantly as unemployment fell, unlike in the second half of the 1980s.

239. For a survey of literature on a number of countries (not including Australia), see Friedberg & Hunt (1995), for some evidence on Australia see Withers and Pope (1985). A recent paper, Borjas (2002), suggests that the "expected" negative impact of immigration on wages can be detected systematically, at least in the United States, provided biases due to the endogenous responses of native-born labour and earlier immigrants (such as their own decisions to migrate internally) can be controlled for.

240. See, for example, Tian and Shan (1999), Pope and Withers (1993).

241. Some studies allow for this endogeneity, but the range of results does not seem to be very different.

242. Other reasons include the relatively small variation in migrant flows compared with the size of national labour markets in most countries and difficulties in taking appropriate account of factors such as the skill level of migrants.

243. The categories identified in the ABS survey *Labour Force Status and Other Characteristics of Migrants* are: New Zealanders; Refugees; Family sponsored; Employer sponsored; Sponsored by other organisations; Unsponsored; all others. Employer sponsored immigrants had a lower unemployment rate than the unsponsored, but it was not statistically significant.

244. Strictly speaking, for immigrants from countries where immigrants to Australia typically have low English language abilities, since census data do not show English-language ability itself.

245. See Birrell and Jupp (2000), Table 4.

246. Econtech (1998) table 3, scenario 3 less scenario 1.

247. The Econtech model has a detailed treatment of labour productivity and activity rates according to skill levels and other characteristics. It uses a skill index based on the link between the qualifications and profession of a migrant and the earnings typically associated with them in Australia. This is unlikely to predict the earnings of an individual very accurately but is perhaps sufficient for looking at large groups.

248. It might be noted that this focus on per capita consumption – adopted because the government asked Econtech to focus on living standards rather than output – might modify the *a priori* conclusion on the effect of the overall migration programme. That is, migration increases per capita consumption by much less than per capita output, because it increases overall investment needs and because the average migrant does not bring as much wealth as already possessed by the average Australian.

249. Per capita consumption in Australia could fall but everyone involved actually have higher consumption than before or, conversely (but less likely), there could be a rise in per capita consumption in Australia even if both immigrants and existing residents were worse off. The first case would arise if immigrants' incomes were very low before arriving in Australia, and then rose while their level remained much lower than the Australian average, while incomes of existing residents rose only a little. The second would occur if immigrant were initially better off than existing residents in Australia but their incomes fell on arriving in Australia (remaining above the average in Australia) while incomes of existing residents fell slightly. The second scenario is obviously very unlikely and the first may be unreasonable too, they are quoted merely to show that a rise in average per capita consumption or GDP in Australia is neither necessary nor sufficient for migration to be "beneficial".

250. This might also be thought to include the resource rent from resource-based industries (which may include tourism as well as the extractive industries). If their long-run output is independent of population, a higher population (whether from immigration or natural increase) reduces per capita incomes. Although this argument is sometimes made, it seems unlikely that it is a very important phenomenon. Extractive industries provide only a small part of Australia's GDP, while the "output" and rent from the tourist industry is likely to increase as more labour is applied rather than being fixed and divided among a larger number of beneficiaries; although one can imagine a limit at some point if population grew so much that the wide open spaces and coastline were seriously diminished or overcrowded with visitors, this limit seems a long way off.

251. Although the image of Australia may be one of wide open spaces and plenty of land to exploit, the population is overwhelmingly urban (and was highly urbanised even at the beginning of the twentieth century) and new immigration goes almost entirely into existing urban centres, so any economies of population scale would have to arise either from the advantages of clustering or market-size considerations.

252. The Secretariat has not conducted econometric investigation in this area, but the conclusion can often depend on the null hypothesis: the null of a homogeneous aggregate production function may not be easily rejected by the data. But if the null hypothesis is that the scale elasticity may differ from unity, then the best estimate may well be that it exceeds unity.

253. Garnaut (2002) argues that the apparent problem of overcrowding in Sydney is less to do with any real overcrowding than with visibly high rates of unemployment and low incomes of certain migrants concentrated in particular parts of Sydney. He argues that

this problem is at least partly due to Australian labour market institutions that generate higher unemployment rather than lower wages when the supply of low skilled labour increases.

254. See Vourc'h and Price (2001) and the Sustainable Development section of this E*conomic Survey*.

255. Based on a trade off between positive externalities diminishing with population growth, and negative externalities increasing.

256. One set of theoretical literature discusses a "migration surplus" that arises as new immigrants increase the labour supply, driving down wages of existing residents who compete in the labour market with immigrants, but increasing returns to owners of capital. Such models, which become complicated when capital flows are introduced, are probably of limited application to Australia. Nevertheless, they do suggest that while the gains from immigration generally outweigh the losses, the distributional effects are large relative to the overall gains. See, for example, Borjas (1999).

257. But see Viviani (1996) who notes that, although certain suburbs contain high concentrations of, for example, Vietnamese, this is not the same as saying that this experience is typical for Vietnamese immigrants, two thirds of whom are geographically dispersed and relatively mobile. Many of those who are concentrated in disadvantaged areas are those who are relatively unskilled, older or with poor English abilities, and consequent high unemployment, characteristics shared with other inhabitants of these areas.

258. See Chiswick *et al.* (2002), who find some evidence (though at the margin of statistical significance) for Australia that "living in an immigrant/ethnic concentration area appears to raise the occupational status of immigrants…"

259. High property prices in Sydney are of course a consequence of wealth as much as of population pressure. However, if a disproportionate number of the high-income immigrants increasingly targeted by immigration policy are attracted by Sydney as the business and financial centre of the country, and if concern for the environment restricts the supply of land for new housing, the likely consequence would be property prices rising faster than elsewhere in the country with a resulting tendency for existing property owners in Sydney to "cash in" at some point and move away.

260. The opposite is true in a few countries. Some discussion of this can be found in OECD (2002).

261. And is perhaps the most obvious manifestation of "multicultural Australia".

262. Such migrants are monitored after their arrival. If they are deemed not to have engaged in sufficient business activity within three years, their visas may be withdrawn. In 2000-01 439 such visas were withdrawn, while 7 364 were granted. (McClaughlin and Salt, 2002).

263. See *www.immi.gov.au/facts/27business.htm*. OECD (2001) notes survival rates after four years for startup firms of between 40 and 60 per cent across a number of OECD countries (not including Australia). The data from the Australian survey does not indicate whether migrants have had any business failures and started again but, although it is not clear how much allowance should be made for this, the outcome still seems relatively good.

264. Per capita public debt would nevertheless be affected in general.

265. However, the figures shown for periods longer than 4 years after arrival are estimates and extrapolations since the LSIA data do not extend that far.

266. See, for example, Auerbach and Oreoupoulos (1999), who consider the fiscal impact of immigration on existing residents in the United States using a generational accounting approach. Note that their study shows there is not necessarily a simple answer to the question as to whether immigration is fiscally beneficial or not to existing residents; the answer may depend on assumptions about the existing debt burden and economies of scale in public service provision.
267. Although few immigrants are over 45 compared with the existing population, there are also relatively few immigrant children, and on average, the foreign born have fertility rates very similar to the Australian-born population (see Abbasi-Shavazi, 1998 quoted in Kippen and McDonald, 2000).
268. Rod and Murphy (1997) quoted in Hugo (2002).
269. Both the credits and debits items in the relevant parts of the balance of payments are likely to be underestimates of flows which are likely to continue, at some reduced level, after migrants cease to be treated as migrants in the payments statistics.
270. A 1990 study "Immigration, Trade and Capital Flows" (Bureau of Immigration Research (1990)) entirely ignored these aspects of the issue, concentrating on the potential impact of changes in migration on supply and demand but with no account taken of the possible impact of the geographical origin of immigrants.
271. See Rod and Webster (1995). The authors investigate the use made of the cultural and linguistic skills of persons from East Asia by exporters of food and beverages to Asia. It was found that relatively few successful exporters made use of these skills in their employees, although those that did agreed that this aided export efforts. Kipp, Clyne and Pauwels (1995) also argued that linguistic skills were under-utilised.
272. An informal comparison of changes in Australia's geographical direction of overall trade and changes in the origin of immigrants since the 1970s reveals no clear link between the two patterns.
273. Interview with representative of the Business Council of Australia.
274. See Barrett and O'Connell (2000). They observed a wage premium for returning males of around 10 per cent, controlling for a range of factors; no premium was observed for females.
275. And it should be recalled that although the Australian Council of Social Service reported "terrible hardship" arising from the introduction of the two-year waiting period, a safety net is in place for all immigrants immediately on arrival; many immigrants would no doubt accept this as acceptable treatment, or they would not continue to apply.

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Annex I

Policy issues in periods of declining public debt

There are ongoing debates regarding the costs and benefits of eliminating the public debt (see OECD 2002a, b and OECD 2001b). The main argument against this option is that an active debt market can only be sustained with a minimum volume of government debt issuance. Maintaining a minimum level of gross debt would reduce the costs of re-establishing the government bond market in the future when the ageing population is expected to put pressure on the government's net debt position, or if cyclical influences need to be accommodated.* A declining stock of government securities also raises issues for the implementation of monetary policy. Although the monetary policy actions are now more isolated from debt management ones, it is recognised that the monetary transmission mechanism may still be affected through the effect of the debt structure on market expectations (Mylonas *et al.* 2000). Moreover, it is sometimes argued that the absence of a liquid government debt could affect the functioning of the private bond market through two opposing channels: on the one hand, reduced government debt could be expected to make room for expansion of the private sector debt market; on the other hand, a significant reduction of liquidity in the government bond market may render it more difficult for private bond markets to expand and develop. In Australia, there is no evidence supporting the latter effect (Edey and Ellis, 2002).

Advocates of public debt elimination argue that such policy action would increase national saving and make more funds available for private use, leading in turn, to increased productivity and output growth, and thereby higher earnings. In the case of Australia, the overall macroeconomic effect – *via* reductions in interest rates associated with reduction in the supply of the Commonwealth Government Securities (CGS) – is expected to be "extremely modest". Moreover, the impact of changes in CGS may not be visible, in view of continuing changes in economic activity (Commonwealth of Australia 2002d).

Regarding the debate over whether private debt can fulfil all the desirable functions of public debt, some argue that corporate securities (even when they are government-sponsored) cannot achieve the same risk status as government debt and therefore cannot function in a satisfactory way as a substitute benchmark for a risk-free security. This in turn may affect the pricing of private assets and the development of corporate security markets. Others support the view that certain classes of corporate debt could fulfil similar functions to those performed by the public debt despite a different risk status. Market participants could use collateralisation or employ implicit government guarantees to upgrade certain types of private debt, making them closer substitutes for government debt with respect to risk characteristics. Some analysts argue that even when the risk and liquidity characteristics of private debt securities differ from those of government debt, they may still able to fulfil some functions of the latter. In any case, the need for, or existence of a risk-free security can be questioned: stock-markets function efficiently without risk-free shares, and government bonds are not devoid of risk when unanticipated inflationary episodes occur.

* See for example, Blythe, 2002.

Annex II

The new tax system

The main features of *The New Tax System* (TNTS), implemented on 1 July 2000, include:

- The introduction of a 10 per cent goods and services tax (GST) to replace the wholesale sales tax and a range of State based taxes, such as accommodation taxes.[1] The GST is broad-based, covering most goods and services, the main exceptions being basic food, most health services, education, childcare, and local government rates and charges.
- All GST revenue will accrue to the State governments, as a compensation for the removal of a range of narrowly based State indirect taxes and the abrogation of the Commonwealth General Financial Assistance Grants. The States have been guaranteed by the Commonwealth that, in each of the transitional years following the introduction of the GST, their budgetary positions will be no worse than in the absence of the tax reforms. The GST revenue will be distributed between the States according to horizontal fiscal equalisation principles recommended by the Commonwealth Grants Commission. These principles take into account differences in State revenue mobilisation capacity and their expenditure needs based on national standards of service delivery.
- The introduction of an income package to offset the effects on the cost of living resulting from the introduction of the GST. The package provides for cuts in the personal income tax rates, delivered through an increase in the tax-free threshold and reductions in marginal tax rates; increases in family assistance; and assistance for low income and older Australians. These measures ensure that most low- and middle-income individuals will benefit from an increase in real disposable income after adjusting for changes in the indirect taxation. The compensation package delivers personal income tax cuts worth A$ 12 billion per year. As a result, more than 80 per cent of taxpayers are estimated to have a marginal tax rate of just 30 per cent or less, compared to 30 per cent of tax payers previously. In addition, by increasing exemption thresholds for families to A$ 28 200 and lowering the benefit withdrawal rates (from 50 per cent to 30 per cent), the package reduces the marginal effective tax rates for low income working families from 85.5 per cent to 61.5 per cent over a substantial range of income, thereby reducing the disincentives for work. The package also delivers from 2000-01 increased assistance of A$ 2.4 billion a year to over 2 million families. It further provides for a 4 per cent increase in all pensions and allowances, ensuring that pensioners and other recipients will be 2 per cent better off than they otherwise would have been, regardless of the impact of the GST on prices.
- Simplification of the number and administration of benefits available to families.

– Simplification of the tax administration through: *i)* the replacement of all existing income tax collection and reporting systems, with a new, integrated "Pay As You Go" (PAYG) system; *ii)* the introduction of the Australian Business Number (ABN), as a single business identifier; and *iii)* the introduction of a new simplified system for reporting tax obligations and entitlements.[2] PAYG is a single, integrated system for reporting and paying withholding amounts, tax on business and investment income, and the GST. It replaces 11 existing systems, including Pay as You Earn (PAYE), prescribed payment system (PPS), reportable payments system (RPS), provisional tax and company instalments. PAYG's main advantage is that it aligns payment dates for different types of taxes. Under PAYG both individuals and companies pay tax on their business income tax at the same time. The new arrangements enable business to make one net payment (after offsetting credible amounts, such as diesel fuel credits and GST input credits), or to claim one net refund, quarterly, and abolish provisional tax and the uplift factor. Companies will have to pay tax earlier than in the old system, but the effect of the earlier payments will be more than offset by the GST cash flow benefits for all but larger firms.

Notes

1. Financial Institutions Duty (FID) and stamp duties on marketable securities were abolished in July 2001. The time limit for abolishing the debits tax (on bank accounts) has been postponed to 1 July 2005 and is subject to a review by the Ministerial Council for Commonwealth State Financial Relations. The need for retaining a range of other business stamp duties will also be reviewed by the Ministerial Council by 2005.
2. The new arrangements aim at reducing the number of times businesses have to report to the Australian Taxation Office (ATO). Under the new tax system, businesses who are registered for GST can use the "Business Activity Statement" (BAS) to report and pay their obligations for GST and PAYG instalments. Business not registered for GST, or individuals who have to pay PAYG instalments (such as self-funded retirees), can use an "Instalment Activity Statement" (IAS) for reporting and paying their PAYG obligations. The government introduced, in February 2001, significant changes, to simplify streamline the GST payment and reporting arrangements for small business, aiming at easing the compliance burden for tax payers in the PAYG system. (See Commonwealth Treasurer Press Release No. 007(2001) at *www.treasurer.gov.au*.

Annex III

Business tax reform implementation

Measures commenced before or on 1 July 2000

– Phased reduction in the company tax rate (34 per cent in 2000-01 and 30 per cent in 2001-02).

– Reform of the capital gains tax (CGT) arrangements through: removing indexation and averaging; lowering the nominal CGT rate, by subjecting only 50 per cent individuals' capital gains and 67 per cent of superannuation funds' capital gains to taxation; concessions for small business, venture capital and scrip-for-scrip rollovers.

– Removal of accelerated depreciation and balancing charge rollover relief, adoption of effective life depreciation.

– Introduction of measures to address the alienation of personal services income; broadening the tax base of life insurers; integrity measures relating to prepayments, losses and lease assignments, loss duplication, value shifting.

– Establishment of the Board of Taxation – greater community consultation in developing tax legislation.

Measures commenced on 1 July 2001

– The Simplified Tax System, which provides eligible small businesses with a cash basis of recognising income and deductible expenses, simpler depreciation and trading stock rules.

– The Uniform Capital Allowances system, which will reduce compliance costs by simplifying the many amortisation regimes currently in the law. It will also recognise certain capital allowance "blackhole" expenses.

– New thin capitalisation arrangements, to prevent multi-national corporations allocating a disproportionate amount of debt to their Australian operations.

– A debt/equity test, establishing a coherent and certain basis for classifying hybrid (part debt/part equity) instruments as either debt (eligible for "deductibility") or equity (eligible for "frankability").

Measures commenced or scheduled to commence from 1 July 2002

– Consolidation regime to allow groups of wholly-owned companies to be treated as single taxpaying entity.

– General value shifting rules, to ensure that appropriate tax treatment is given to capital gains and losses generated through arrangements which cause shifts in value between assets.
– A demerger mechanism in the tax law to improve flexibility in business structures.
– Simplified imputation arrangements, to streamline the operation of the existing imputation system.

Measures with commencement dates yet to be determined

– Taxation of financial arrangements (TOFA), providing a comprehensive and coherent framework for taxing financial arrangements.
– The issues of leasing, the treatment of partnerships and joint activities; the application of the uniform capital allowance regime to buildings and structures; and changes to the transfer pricing provisions.
– Introduction of a Non Resident Withholding Tax regime.
– Exemption from tax of temporary residents on their foreign source income to encourage skill intensive businesses to locate in Australia.
– Development of a Tax treatment of rights and blackhole expenditures, in consultation with the business community.
– General anti-avoidance rule. The Government is continuing to consider measures that will streamline the existing anti avoidance provisions along the lines identified by the Ralph Report.

The Government announced in May 2002 a review of international taxation arrangements. This review will consider, amongst other issues, whether to proceed with previously announced measures such as the provision of imputation credits for foreign dividend withholding taxes, and the introduction of foreign income accounts.

Source: National Submission and *Treasurer Press Release*, No. 016, 22 March 2001, Canberra.

Annex IV

Some aspects of Australian immigration policy

Points-based entry

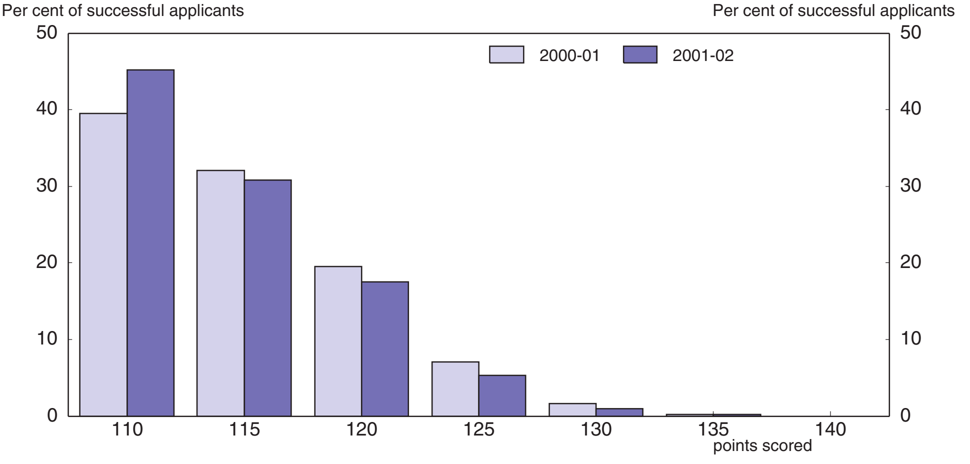
The central part of the selection process for General Skilled migrants is the points test, the main elements of which are outlined in the Box. In addition to core criteria for age, skill (including work experience) and English language ability, points can be awarded for a range of factors including those related to occupational targeting (the Migration Occupations in Demand List or MODL). In certain categories, migrants with close Australian relatives can benefit from a regional initiative designed to promote designated areas. The areas are designated by the states themselves, whose approaches vary; Victoria designated areas including the whole of its capital Melbourne, for example, whereas other states were more selective.[1] There are also occupation-specific schemes where the points test is not applied, although some "basic requirements" of educational level, English language proficiency and work experience are necessary; under this heading the Skill Matching database is used to circulate the details of potential immigrants to regions and employers who may wish to nominate them if they have a specific need. The Employer Nomination Scheme allows for a relatively small number of non-points tested admissions, where employers have made specific agreements with the immigration authorities to recruit people with particular skills.

Figure A1 gives some indication of the distribution of scores obtained by successful applicants in 2000-2002. It is not clear how well these scores represent the underlying distribution, since one has little incentive to apply with insufficient points (though where the shortfall is modest, applicants, may be put on a waiting list and be successful later via the skill matching database, for example) or to provide full information once the minimum pass mark (plus a margin in case the pass mark is changed) has been reached.

The National Office of Overseas Skills Recognition (NOOSR) facilitates the recognition of overseas qualifications in Australia and Australian qualifications overseas. NOOSR does this by publishing information on overseas education systems – which includes guidelines for gauging the educational level of overseas qualifications in Australian terms – and by assessing individual qualifications to determine their educational level. In assessing the comparative educational level of overseas qualifications, NOOSR takes into account a range of factors, including:

- the education system. This can include historical factors and influences, the organisation of the various sectors, the role of external moderation and examinations, and regulation and quality assurance measures;
- the status of awarding institutions in the country of origin. This can include the date of establishment of institutions, whether they are public or private, student and staff ratios, library and laboratory facilities, programs offered, and quality control mechanisms;

Figure A1. **Points test score distribution**



Note: The pass mark was 110 in both years; applicants do not have a strong incentive to report more points than necessary to pass nor to apply if they have less than that.
Source: Department of Immigration and Indigenous Affairs.

- programme entry requirements. This can include the level of education required for entry to programmes of study, the role of entrance examinations, and the competitiveness of entry;
- the programme structure, *e.g.* the level, length, structure, orientation, breadth and depth of programmes of study.

Occasionally NOOSR takes marks or grades into consideration.

Australian qualifications are an advantage to an applicant, partly because employers tend to prefer them and, more recently, because foreign students who undertake higher education courses at Australian institutions (during which they are entitled to work part-time to help support themselves) can apply for a permanent visa on successful completion of the course.[2] Previously it would have been necessary for them to leave the country after completing their course before applying to re-enter.

Non-points entry

Whereas in the past immediate family members (spouses, fiancés, children and parents) had unrestricted access to permanent visas, and more distant family members were accorded fairly generous access (under a scheme known as "Concessional" Family visas) provided they met some minimum conditions of education or employment, this access became much more targeted during the 1990s. In 1997, while spouses, fiancés and dependent children still have unrestricted entry, restrictions were introduced on the immigration of permanent residents' parents, which are now subject to an annual quota (500 for 2002-2003), with

Box A1. Australian points system – General Skills Categories

The principal applicant* has to score at least 115 points in 2002-2003 (maximum 145).

Skills

– Occupations which require diploma or advanced diploma level qualifications.	40
– Generalist occupations which require degree level qualifications, but which do not necessarily require training for a particular occupation.	50
– Occupations that require degree (or higher) or trade level qualifications where entry to the occupation requires training which is specific to the occupation.	60

Occupational Targeting

– Occupations/specialisations included on the MODL.	5
– **Applicant has a genuine job offer in a MODL occupation/specialisation.**	**10**

Experience

– Applicant has been employed in an occupation on the skilled occupation list for three out of the four years before applying.	5
– Applicants nominating an occupation which attracts 60 points under the skill factor, and who has worked in this nominated, or a closely related, occupation for three of the four years before applying.	10

Age (45 years old maximum)

– 18-29 years	30
– 30-34 years	25
– 35-39 years	20
– 40-44 years	15

Language skills

– Vocational – Applicants achieves a score of at least five on each component of the IELTS test (general training module).	15
– Competent – Applicant obtains an IELTS score of six or more for each of the four components.	20

* The principal applicant would typically be the main breadwinner in a family. Each member of a family needs a visa and all visas would be counted in the skill stream statistics.

Box A1. **Australian points system – General Skills Categories** (*cont.*)

Qualifications of spouse (includes *de facto* spouse)

– Applicant's spouse also meets the minimum requirements for skills (including work experience) age and English language ability. 5

Australian qualifications

– The applicant obtained a diploma, trade qualification or degree (this was introduced on 1 July 1998); or 10 points if the applicant holds an Australian PhD (doctorate degree) (introduced on 1 November 1999) from an Australian educational institution. 5

Bonus points

– Five bonus points if the applicant satisfies at least one of the following: 5
– six months Australian legal work experience in a skilled occupation within the previous four years;
– or commitment to bringing a high level of capital to Australia demonstrated by depositing A$ 100 000 in an approved Government investment for a minimum period of 12 months;
– or a high level of fluency in the national language of one of Australia's major trading partners;
– or a high level of fluency in a community language.

some 15 000 such people now "queued" having been granted a visa in principle, and around a further 7 400 applications submitted but yet to be decided. The Concessional Family stream was also redefined, covering all other family members (non-dependent children, siblings, nieces, nephews .and working age parents) and made subject to the usual points test with some additional points allocated for family connections; it was re-named Skilled Australian Sponsored (such entries are counted under the Skill heading rather than Family).[3] With these restrictions the number of family stream visas issued declined from over 60 000 in 1990-91 to under 40 000 in 2000-2001; over the same period the number of parents admitted fell from 10 300 to 500.

Business skill permanent visas, which account for around one fifth of the total permanent skill stream, are awarded under a number of different categories, each of which currently has a points test (distinct from the general skills points test detailed in the Box). These mainly relate to actual or intended ownership of an appropriate business in Australia. One subclass, the Investment-linked subclass, requires experience in managing business or investment assets and the making of an investment of at least A$ 750 000 for three years.[4] From 1 March 2003, legislative changes are proposed which will introduce two stage processing for most Business Skills visas. This will involve business people holding a provisional (temporary) visa and only being eligible for grant of permanent residence once active business or investment activity in Australia has been demonstrated. Investments will also be required to be held for four years.

Since 1985 the number of entrants under the Humanitarian programme has fluctuated between 11 000 and 16 000. Most humanitarian visas are issued "offshore", in contrast with the typical European experience of applicants arriving in the country and claiming asylum or refugee status on arrival. The authorities argue that this enables them to select people likely to be more deserving than those able to afford to pay for an illegal passage to Australia and try to discourage such activities, particularly following the substantial increase in the proportion of onshore visas at the end of the 1990s – the share was under 20 per cent in 1996-7 but 41 per cent in 2000-01.[5] Thus around 4 000 "offshore" places each year are reserved for people satisfying the UNHCR definition of refugee but a further 5 600 were granted onshore, *i.e.* to people already in Australia. The remaining offshore humanitarian visas are issued to people assessed by the Australian authorities as being in special need, but criteria such as family and community connections in Australia as well as the direct needs of the applicant are used to select them.

Unlike other immigrants, those with permanent offshore humanitarian visas are entitled to the full range of welfare and health benefits immediately a visa is granted. Some people arrive with a valid non-settlement visa and then claim protection; their ability to work or claim benefit will depend on their original visa and whether they apply in time for protection (generally within 45 days of arrival), but benefits are not usually available while applications are being processed. Unauthorised arrivals are generally detained while their applications are dealt with. Initially, applicants may be issued Temporary Protection Visas (TPVs) for up to three years which allow access to a narrower range of benefits (but more than for other immigrants), freedom of movement and permission to work in Australia while their applications are assessed. In 1999-2000, 871 TPVs were granted, 4 457 in 2000-2001 and 3 143 in 2001-2002.

In all non-humanitarian cases, applicants pay a non-refundable fee, currently A$ 1 745. Each dependant without sufficient English language ability has to pay a further A$ 2 485 to cover English language tuition in the AMEP (see main text). Some applicants sponsored by family in Australia may have to pay a refundable "Assurance of Support" bond in addition, A$ 3 500 for the primary applicant, A$ 1 500 for adult family members in the same application.

Notes

1. Once a migrant has a permanent visa there is no mechanism for preventing internal migration, however.
2. A number of Australian universities have "branches" in other countries – Singapore, Malaysia, South Africa, for example – which work partly by correspondence and partly by teaching staff from Australia travelling to the students. An Australian degree can thus be awarded to students without them having to spend any time in Australia. However, for the purposes of applying for permanent residence, overseas students who obtain an Australian qualification while not physically present in Australia must meet the minimum requirements for work experience, among others, to be eligible for a permanent residence visa. This is in contrast to overseas students who successfully obtain an Australian qualification in Australia who are exempted from the work experience requirements when applying for permanent residence.
3. There is no points test for applicants who apply for a small number of places under some state-specific and regional migration mechanisms.
4. The precise details of the schemes are complicated, see *www.immi.gov.au/facts/27business.htm*.
5. With some success. Anecdotal evidence suggests that the price of a passage and illegal entry to Australia from camps on the Pakistan-Afghan border, with "people smugglers", fell considerably when the perceived chances of success dropped after a number of high-profile incidents in 2001. The Australian government redefined certain island territories to be "offshore" to make it easier for entry to Australia proper to be refused.

Annex V

Calendar of main economic events

2001

May

The Australian Industrial Relations Commission (AIRC) awarded a safety net increase of A$ 13 per week for award rates of pay up to and including A$ 490 per week, A$ 15 to those earning up to A$ 590 per week and A$ 17 per week for award rates above A$ 590 per week.

The 2001-02 Budget was delivered by the Treasurer. In cash terms, an underlying cash surplus of A$ 1.5 billion was forecast for 2001-02. In accrual terms, a fiscal deficit of A$ 0.8 billion, or 0.1 per cent of GDP, was forecast for 2001-02.

The Commonwealth Government announced a package to assist thousands of HIH policyholders facing hardship as a result of the collapse of the HIH Insurance Group in March 2001. The HIH Support Scheme is funded *via* a special appropriation of up to A$ 640 million.

July

The Government introduced the uniform capital allowance framework into the taxation system. The framework replaced more than 25 existing capital allowance taxation regimes and created a simpler system that generates deductions based on the effective life of assets.

The Government introduced the R&D Offset scheme as the Government's principal support mechanism to increase the amount of R&D performed by small businesses in Australia. The R&D Offset scheme is available to all companies with an annual turnover of less than A$ 5 million. A tax rebate operates for R&D expenditure up to A$ 1 million per year at a rate of 37.5 cents in the dollar. Also introduced was a 175 per cent R&D tax concession for increased R&D activities undertaken in Australia.

A federalised corporate regulatory framework commenced operation in July 2001, completing a major legislative project to change the Corporations Law to a Commonwealth Act (based on a referral of power from the States). This followed High Court challenges to the previous State-based Corporations Law framework.

September

On 27 September 2001 Australia and the United States signed a Protocol to the Double Tax Convention. The Protocol, when it enters into force, will provide for reductions in the withholding tax rates on certain dividends and on royalties.

The 2000-01 Final Budget Outcome was delivered by the Treasurer. The underlying cash surplus was A$ 5.6 billion, compared to the estimate at the 2001-02 Budget of A$ 2.3 billion. The fiscal surplus of A$ 5.9 billion was A$ 0.5 billion higher than estimated at the 2001-02 Budget.

The RBA cut the official cash rate by 25 basis points to 4.75 per cent.

October

The 2001-02 Mid-Year Economic and Fiscal Outlook was delivered by the Treasurer. It forecast an underlying cash surplus for 2001-02 of A$ 0.5 billion, and a fiscal deficit of A$ 3.1 billion.

A writ was issued on 8 October 2001. Under the *Charter of Budget Honesty Act* 1998, the Secretaries of the Departments of the Treasury and of Finance and Administration publicly released a Pre-Election Economic and Fiscal Outlook for a general election on 17 October 2001, which forecast an underlying cash surplus of A$ 0.5 billion for 2001-02. In accrual terms, a fiscal deficit of A$ 3.1 billion, or 0.4 per cent of GDP, was forecast for 2001-02.

On 15 October, the Prime Minister announced that an independent review of the competition provisions of the *Trade Practices Act* 1974 and their administration would commence in 2002. The review is expected to report by the end of January 2003.

The Government released an Issues Paper, *Options for Improving the Safety of Superannuation* and formed a Superannuation Working Group (SWG) to conduct consultations.

The RBA cut the official cash rate by 25 basis points to 4.5 per cent.

November

A Federal Election was held on Saturday 10 November 2001. The Liberal-National Coalition Government was returned to office.

December

On 14 December, the RBA released a consultation document that outlined its proposed reform of credit cards. The reforms apply to the credit card schemes of Visa, MasterCard and Bankcard that it designated in April 2001.

The RBA cut the official cash rate by 25 basis points to 4.25 per cent.

2002

January

On 31 January, the Commonwealth and New South Wales Governments announced the combined sale of the government owned Freightcorp and National Rail Corporation Pty Ltd to National Rail Consortium (jointly owned by two publicly listed Australian transport companies) for a total transaction value of A$ 1 172 billion.

March

The Government's *Financial Services Reform Act* 2001 commenced on 11 March 2002. The Act implements a harmonised and improved licensing, disclosure and conduct framework for the financial services industry.

April

In April 2002, the Minister for Education, Science and Training announced a comprehensive review of the higher education system in Australia. The purpose of the review was to ensure that Australia's higher education institutions were best placed to contribute to the nation's future.

In response to the decision of the boards of Australia's largest medical indemnity provider, United Medical Protection and its wholly owned subsidiary Australasian Medical Insurance Limited (UMP/AMIL), to seek the appointment to the companies of a provisional liquidator, the Government announced that it would provide a short-term guarantee to the company and its provisional liquidator to allow members of UMP/AMIL to continue practising until 30 June 2002.

– The aim of the initial guarantee to the provisional liquidator was to stabilise the situation until 30 June and allow doctors to continue practising while longer-term solutions were developed.

May

The Treasurer announced a review of Australia's international tax arrangements. The review focuses on treatment of foreign source income under Australia's dividend imputation system, the foreign source income rules, treatment of conduit income and tax treaty policy.

The 2002-03 Budget was delivered by the Treasurer. In cash terms, an underlying cash surplus of A$ 2.1 billion was forecast for 2002-03. In accrual terms, a fiscal surplus of A$ 0.2 billion was forecast for 2002-03.

In the 2002-03 Budget, the Government announced that it would increase patient co-payments for the Pharmaceutical Benefits Scheme (PBS) from A$ 3.60 to A$ 4.60 per script for concessional patients and from A$ 22.40 to A$ 28.60 per script for general patients. The level at which co-payment safety nets will apply will be increase to A$ 239.20 for concessional patients (up from A$ 187.20) and A$ 874.90 for general patients (up from A$ 686.40).

– This initiative would result in savings of A$ 1.1 billion over four years and help restore the balance between government and patient contributions. The Senate has not yet approved the legislation necessary to introduce the increased PBS co-payments. However, the Government intends to put the measures before the Senate again.

As part of the 2002-03 Budget, the Government announced changes to the eligibility criteria for the Disability Support Pension (DSP) to recognise and improve the work capacity of people with disabilities. Following a number of amendments to the measures announced at Budget, people who claim DSP on or after 1st July 2003 will be assessed under new DSP eligibility criteria. In particular, the DSP eligibility criteria will change so that it is available to people who have a work capacity of less than 15 hours per week, rather than the current level of 30 hours per week. Additional funding will also be provided for up to 73 000 new places in services to assist people with disabilities.

In the 2002-03 Budget, the Government announced funding of A$ 3.3 billion over three years beginning on 1 July 2003 to improve the Job Network through better targeting and tailoring of employment services provided to job seekers and employers.

On 29 April 2002, the Boards of United Medical Protection (UMP)/Australasian Medical Insurance Ltd (AMIL), Australia's largest medical indemnity cover provider, sought to put the companies into provisional liquidation. This was granted by the New South Wales Supreme Court on 3 May 2002.

– On 1st May 2002, the Minister for Health and Ageing wrote to medical practitioners stating that the Commonwealth would guarantee to 30 June 2002 the obligations of UMP/AMIL and the provisional liquidator to pay any amount properly payable for a number of specifically defined types of claims. This guarantee was formalised on similar terms in a Deed of Indemnity between the Commonwealth and UMP/AMIL (and the provisional liquidator), and has been extended to 31 December 2003.
– The Prime Minister announced that, in relation to UMP/AMIL, the Government would extend the guarantee to 31 December 2002. He also announced at that time, a package of measures to deal with difficulties being experienced in the medical indemnity market more generally.

The Minister for Immigration and Multicultural Affairs, announced the Migration Program and Humanitarian Program planning levels for the year 2002-03: 100 000-110 000 places under the Migration Program and 12 000 places in the Humanitarian Program.

The Australian Industrial Relations Commission awarded a safety net adjustment of A$ 18 per week for all award rates of pay. The decision increased the Federal Minimum Wage from A$ 413.40 per week to A$ 431.40 per week.

The RBA raised the official cash rate by 25 basis points to 4.5 per cent.

June

On 25 June, the Commonwealth Government announced the sale for A$ 5.6 billion of the long-term lease for Sydney Airport to Southern Cross Airports Corporation. After the repayment of debt owed by Sydney Airport, Commonwealth debt will be reduced by A$ 4 233 billion. Sydney Airport is the last of the major Australian airports to be sold to a private sector operator.

The RBA raised the official cash rate by 25 basis points to 4.75 per cent.

July

From 1 July 2002, the rate of compulsory employer contributions under the Superannuation Guarantee system rose from 8 per cent to 9 per cent of an employee's earnings. This is the final rate rise mandated under the Superannuation Guarantee system.

New programmes and employment assistance were introduced in July 2002 as part of *Australians Working Together* (AWT) package (announced in the May 2001 Budget). Programmes introduced in July 2002 include Transition to Work services which assist parents, carers and mature age people to enter or re-enter the workforce and Training Credits for Work for the Dole participants.

Reforms to the General Insurance Regulatory Framework announced by the Government in November 2000, took effect from 1st July 2002 with a two year phase in period for new capital requirements.

August

The Treasurer announced that the Government would not be proceeding with the Tax Value Method (TVM) and in its absence would develop a systematic tax treatment of rights and blackhole expenditures with a view to implementing these changes by July 2005.

The Treasurer announced the Commonwealth Government's response to the Productivity Commission's final report "*Review of the Prices Surveillance Act* 1983". The Government accepted the Commission's recommendation that the *Prices Surveillance Act* 1983 (PSA) be repealed and a new part inserted into the *Trade Practices Act 1974* (TPA). The new part will preserve the existing powers of price surveillance.

The new part of the TPA is to include an objects clause consistent with the Treasurer's statement in September 1996 that prices surveillance will only be applied in those markets where competitive pressures are not sufficient to achieve efficient prices and protect consumers. In responding to the report, the Government considered that competition, rather than regulation, remains the best means of lowering prices and improving choices for consumers.

On 27 August 2002, the RBA released its standards in relation to credit card schemes. Firstly, a new transparent cost based methodology for setting wholesale "interchange" fees. Secondly, the removal of the restriction by the credit card schemes on the type of financial institutions that could offer credit card services. Finally, the removal of the restriction by credit card schemes that merchants may charge (surcharge) for accepting credit card transactions. These reforms are scheduled to commence, in a staggered process, in early 2003.

September

The 2001-02 Final Budget Outcome was a small underlying cash deficit of A$ 1.3 billion, which was in line with the forecast in the 2002-03 Budget. The fiscal deficit in 2001-02 of A$ 3.7 billion was A$ 0.7 billion larger than estimated at the 2002-03 Budget.

On 10 September 2002 the Government announced a A$ 120 million package of initiatives to assist the sugar industry to restructure and ensure its long-term sustainability. The package will be funded by a temporary 3 cents per kilogram levy on all sugar sold in Australia for domestic consumption.

The Productivity Commission released the *Independent Review of the Job Network* in September. The Department of Workplace Relations also released the *Job Network Evaluation, Stage Three: Effectiveness* in September.

The Government released the Productivity Commission's final report on the Review of the National Access Regime and its interim response to the report. This review fulfils the Commonwealth's obligation (Clause 5 of the Competition Principles Agreement between the States, Territories and the Commonwealth) to review the legislation which establishes the National Access Regime, to determine whether any restrictions on competition should be retained in the net public interest.

The Federal Government released the paper Compensation for Loss in the Financial Services Sector: Issues and Options for public consultation.

October

– On 23 October 2002, the Prime Minister announced a package of measures, at a cost of A$ 246.5 million over four years, to address rising medical indemnity premiums and ensure a viable and ongoing medical indemnity insurance market.

In addition to this funding, the Prime Minister also announced that the Commonwealth would meet the cost of unfunded Incurred-But-Not-Reported (IBNR) liabilities (up to 30 June 2002) of existing medical indemnity providers that have not set aside sufficient funds for these liabilities. This cost is to be recovered through a levy on doctors who were members of these organisations as at 30 June 2000, subject to certain exemptions.

Legislation to give effect to a number of these initiatives was passed by Parliament on 10 December 2002.

The Government publicly released the report by the Superannuation Working Group (see October 2001) and the Government's response to the report. In response to the report, the Government announced it would:

- introduce a requirement for all trustees of APRA-regulated superannuation funds to obtain a superannuation trustee licence to operate as a superannuation fund trustee, and for all superannuation funds to be registered with APRA prior to accepting contributions;
- introduce a requirement for trustees to prepare and submit to APRA a risk management plan for each fund, which would outline how relevant risks would be managed and monitored, including a fraud control plan;
- enhance disclosure of important fund information to fund members, APRA, and publicly through ASIC's electronic facilities; and
- introduce appropriate enforcement powers to underpin the new framework.

The Prime Minister announced further measures in relation to medical indemnity cover. These included: premium subsidies being made available from 1st January 2003 to certain groups of medical practitioners; a High Cost Claims Scheme under which the Commonwealth will fund 50 per cent of the cost of claims payments greater than A$ 2 million (up to the insured amount) made by medical indemnity insurers; enhanced risk management approaches; extension of the guarantee to UMP/AMIL until 31 December 2003 subject to court approval; prudential and product regulation; and monitoring of medical indemnity insurance premiums by the Australian Competition and Consumer Commission.

November

The 2002-03 Mid-Year Economic and Fiscal Outlook forecast an underlying cash surplus for 2002-03 of A$ 2.1 billion, and a fiscal deficit of A$ 0.5 billion. The budget outlook remained largely unchanged from the 2002-03 Budget.

On 24 November 2002, the Minister for Health and Ageing announced that the Government will provide funding of A$ 291.1 million over 4 years and funding in the order of A$ 9.4 million per annum in subsequent years for an immunisation programme against the Meningococcal C disease. In the first four years, the programme will progressively immunise all Australians between the ages of 12 months and 19 years.

On 7 November the Commonwealth Government released a discussion paper: AusLink Towards the National Land Transport Plan. This paper outlines a proposal for a new approach to planning, developing and managing Australia's land transport infrastructure to improve its efficiency. Following consultations, the Commonwealth plans to release a formal statement of Government Policy in 2003.

On 15 November all State and Territories agreed to implement all those recommendations from the Review of the Law of Negligence which go to establishing liability on a nationally consistent basis. The national implementation of the Review has been actuarially assessed as having the potential to reduce public liability insurance premiums by around 13.5 per cent initially, with further reductions to follow over time.

December

On 9 December 2002, the Government announced a A$ 368 million package of initiatives to provide relief to drought-affected farmers and communities hardest hit by the drought. The package is in addition to the A$ 360 million that the Commonwealth expects to provide to farmers in drought assistance.

The Ministers for Family and Community Services and Employment and Workplace Relations jointly released a consultation paper, *Building a simpler system to help jobless families and individuals*. The launch of the paper marked the start of a consultation process on the reform of the support system for working-age Australians.

On 13 December 2002, the Government announced its decision to further reduce the tariff rate for passenger motor vehicles from 10 per cent (to apply from 2005), to 5 per cent in 2010. The Government also agreed to a continuation of the Automotive Competitiveness and Investment Scheme (ACIS), which will provide industry with around A$ 4.2 billion over the period 2006-2015, to assist industry in their transition to the lower tariff environment. Industry specific assistance will cease on 31 December 2015. The decision followed Government consideration of the Productivity Commission's Review of Automotive Assistance.

The Independent Review of Energy Market Directions (Parer Review), commissioned by the Council of Australian Governments, reported to the Ministerial Council on Energy with a list of recommendations on the future direction of energy market reform.

The Council of Australian Governments signed the Corporations Agreement 2002, which underpins the current legislative scheme for the regulation of companies, takeovers, fundraising and the financial services industry.

On 12 December the *Terrorism Insurance Bill* 2002 was introduced into Parliament. The Bill establishes the framework to implement the Commonwealth Government's terrorism insurance replacement scheme. Under the scheme, terrorism risk cover will be deemed into eligible insurance contracts, notably commercial property and associated business interruption and public liability policies. Insurers will be able to reinsure the terrorism risk through the Australian Reinsurance Pool Corporation – a statutory authority established by the *Terrorism Insurance Bill* 2002.

The Commonwealth Parliament passed the Medical Indemnity Act and associated legislation to give effect to the IBNR scheme, the High Cost Claims Scheme, and the premium subsidy. The Medical Indemnity Agreement (Financial Assistance – Binding Commonwealth Obligations) Bill 2002 came into effect.

The Government introduced legislation, the Medical Indemnity (Prudential Supervision and Product Standards) Bill 2002, into the House of Representatives, dealing with the prudential regulation of providers of medical indemnity cover and mandatory minimum product standards.

2003

January

On 1st January 2003, the first element of the RBA's reform of credit cards commenced. Merchants are permitted to levy a surcharge on credit card transactions. International experience suggests surcharging will not be widespread.

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