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Australia

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Australia

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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– 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 2002 (1 000):	
Sydney	4 171
Melbourne	3 524
Brisbane	1 689
Perth	1 414
Adelaide	1 114

THE PEOPLE

Population, 31 December 2003 (thousands)	20 009
Number of inhabitants per sq. km, 2003	2.6
Natural increase, 2003 (1 000)	118
Net migration, 2003 (1 000)	132

Civilian employment, 2003 (1 000):	9 459
of which:	
Agriculture	373
Industry[1]	2 003
Other activities	7 083

PARLIAMENT AND GOVERNMENT

Composition of Parliament:

Party	Senate[2]	House of Representatives
Australian democrats	4	. .
Australian Labor Party	28	60
Family First Party	1	3
Greens	4	. .
Liberal Party of Australia	33	74
National Party of Australia	5	12
Country Liberal Party	1	1
Total	76	150

Present government: Liberal/ National Party coalition

THE PRODUCTION

Gross domestic product, 2003 (A$ million)	781 723
Gross fixed capital formation, 2003 percentage of GDP	24.6

GENERAL GOVERNMENT SECTOR, PER CENT OF GDP, 2003

Current disbursements	36.7
Current transfers	14.1
Current revenue	35.4
of which: Direct taxes	17.5

THE FOREIGN TRADE

Main exports, 2003, per cent of total exports:	
Food, beverages and tobacco	17.6
Raw materials	19.0
Fuels	19.7
Machinery and transport equipment	11.6
Other manufactured products	32.1

Main imports, 2003, per cent of total imports:	
Food, beverages and tobacco	4.7
Raw materials	1.8
Fuels	7.7
Machinery and transport equipment	45.6
Other manufactured products	40.2

THE CURRENCY

Monetary unit: Australian dollar

Currency units per US$, average of daily figures:	
2003	1.542
October 2004	1.364

1. Including mining, electricty, gas and water, and construction.
2. As from 1 July 2005.

Executive summary

Recent and prospective performance is good. The Australian economy is still benefiting from the programme of widespread and deep reforms that started in the 1980s and was especially intensive in the 1990s. These made it easier to set macro policies in a stability-oriented medium-term framework. The combination resulted in a thirteen year long economic expansion accompanied by low inflation, high resilience to external and domestic shocks, and very healthy public finances. The short term outlook is for continuing brisk low-inflationary growth.

Challenges lie ahead, but policy actions are required now. The main challenges lie in the medium and longer term, but to address them, further policy actions should not be delayed. Ageing will exacerbate the underlying rise in public health costs and to a lesser extent in public pensions, putting pressure on public finances. More fundamentally, although Australia has moved up the "league table" in terms of per capita incomes during the past decade, it has returned only to the relative position it already held in the early 1970s and remains well below the leading countries in terms of labour participation and labour productivity. Hence policies that raise both are desirable. Faster growth of output will also help counter the growing burden of social expenditure, reducing or eliminating the need to raise taxes or cut spending in other areas.

Participation rates should be encouraged to rise. As in many countries, participation rates of women are rising but those of men have fallen. There has also been a disconcerting long-term trend increase in inflows into the disability pension scheme by older workers, although part of it is a cohort effect. Policies have been proposed that would assess work capabilities of the entrants to the disability scheme more intensively. A number of "making work pay" measures have been introduced to encourage labour-force attachment of welfare recipients in the face of effective marginal tax rates on work effort that are comparatively high on modest incomes. It would be desirable to further reduce the high marginal tax rates themselves and give more attention to benefit entitlement conditions and activation and mutual obligation strategies. The low-skilled face additional barriers to enter employment, or remain in it, because of relatively high minimum wage scales, and remnants of the formerly pervasive and excessively legalistic industrial wage award system still discourage flexibility. Further reforms are needed in these areas.

Higher participation rates will not be enough in themselves. It is estimated that if Australian employment rates were raised to the highest among OECD countries, real GDP levels would be some 9 per cent higher than under the status quo in about twenty years' time, accompanied by strong positive impacts on public finances. Nevertheless, this would not suffice to fully offset the demographically-induced reduction in the relative size of the working-age population in coming decades. The growth of *per capita* incomes would fall below long-run trend rates and *a fortiori* below recent rates. Faster growth of labour productivity will also be necessary to boost *per capita* income growth to desired rates.

Further strengthening of competition is part of the solution. Australia has made remarkable progress from a very unsatisfactory starting point, but there remains unfinished business, including the removal of restrictions to competition which legislative review has shown not to be in the general public interest. Such restrictions were found in agricultural marketing arrangements, liquor licensing, compulsory insurance schemes, pharmacies, the professions and some occupations. Regulatory inconsistency arising from the co-existence of state and national regulators in both the electricity and gas sectors needs to be removed as planned. Urban water reforms have made significant improvements, but the pace of rural water reform has been slow. National land transport reforms planned under the A*us*L*ink* framework need to be effectively implemented and efforts should be made to promote competition in ocean shipping. Competition in fixed-line telecommunications should be promoted by strategies designed to facilitate further access by competitors. Telstra should be required to divest its cable network and its shareholding in a major pay-TV supplier provided independent assessment shows that the benefits of divestiture would exceed the costs, and efforts to open the postal services market to competition should be renewed.

Raising human capital will also help. Educational standards and outturns have both improved in the past 25 years, but there remain wide discrepancies in achievements, and many youngsters still leave school early with few qualifications. Aligning school curricula to better meet the aspirations of the pupils and the requirements of their future employers will help. An intensification of the more holistic approach to life-long learning will also encourage employees to remain longer in the workforce, and employers to retain them there.

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* 17 November 2004. *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* 23 November 2004.

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The Secretariat's draft report was prepared for the Committee *by* Helmut Ziegelschmidt, Vassiliki Koutsogeorgopoulou, Simen Bjornerud *and* Michael Wise *under the supervision of* Nicholas Vanston.

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The previous Survey of Australia *was issued in* April 2003.

Assessment and recommendations

Australia's reform programme was remarkable, and is still producing benefits

In the last decade of the 20th century, Australia became a model for other OECD countries in two respects: first, the tenacity and thoroughness with which deep structural reforms were proposed, discussed, legislated, implemented and followed-up in virtually all markets, creating a deep-seated "competition culture"; and second, the adoption of fiscal and monetary frameworks that emphasised transparency and accountability and established stability-oriented macro policies as a constant largely protected from political debate. Together, these structural and macro policy anchors conferred an enviable degree of resilience and flexibility on the Australian economy. The combination resulted in a prolonged period of good economic performance that shrugged off crises in its main trading partners as well as a devastating drought at home. The short-term outlook is for continuing strong growth of productivity and output, low inflation and budget surpluses accompanied by tax cuts.

But the reform agenda needs reinvigorating

The pace of reform has recently not been as strong as it could have been. However, there is now an opportunity for Australian governments to pursue a new nationally co-ordinated agenda to reinvigorate reform and meet future challenges, including:

- raising Australian per capita incomes towards the highest in the OECD area, and
- preventing the fiscal burden from rising significantly from current levels in the face of demographic pressures and rising underlying costs of delivering health services.

Maintaining high productivity growth and raising economic and social participation are key

Rising to these challenges will require policies that increase both productivity growth and labour inputs over the long term. These are ambitious objectives, but by no means impossible: Australian productivity levels are well below those recorded in several other OECD countries, as are participation rates among some working-age population groups. Hence policies should:

- Maintain stable macroeconomic conditions via macro policies that aim at low inflation and at least budget balance on average over the economic cycle. Such policies are important to manage risks around the short-term economic outlook, including the price of oil, exchange-rate volatility and adjustment in the housing sector.
- Promote higher productivity growth by further strengthening competitive pressures in the economy via: completion of unfinished business of the National Competition Policy (NCP) agenda and the adoption of an extended reform agenda, following the Productivity Commission inquiry into the future of NCP.
- Explore ways of ensuring optimal investment in regulated network sectors that operate across several jurisdictions.
- Ensure that the labour market functions more effectively by: promoting the negotiation of wages and employment conditions at the enterprise and individual levels; removing disincentives to hiring, especially of low-skilled workers; enhancing human capital by improved training and education; and creating stronger incentives to participate in the labour market, especially for older workers.
- Promote national water policies that aim at removing distortions in pricing as between classes of users.

Fiscal policy objectives include medium-term balance

Adherence to the fiscal target of budget balance over the cycle is important, largely because of the objective of improving the level of national saving over time, reinforced by the medium-term pressures arising from an ageing population and also the difficulty of unwinding discretionary increases in spending. As regards the near-term, the May 2004 Budget projects an underlying cash surplus of 0.3 per cent of GDP in 2004-05 and additional small surpluses in the forward years, after delivering further tax cuts and increased family assistance under the *More Help for Families* package.

Targeting small surpluses is appropriate

The medium-term anchor for fiscal policy is achieving balance over the cycle. The Australian Government (Commonwealth Government) also targets cash surpluses "while growth prospects are sound", as it is expected to be over the next few years. T*his policy of aiming at small surpluses when the economy is operating at or close to potential is appropriate at present, provided that it is accompanied by further personal tax reforms.*

Public sector net debt is diminishing, but the government bond market will be retained

Both budget consolidation and asset sales have resulted in a sharp reduction in the Australian Government net debt since the mid-1990s. The prospect of its elimination over the medium term raises the question of whether to maintain the government bond market and how to allocate the improving net position. Following a public review in 2002, the government decided to maintain the Commonwealth Government Securities market, given both the important role it plays in the efficient management of interest-rate risk and the wish to preserve diversity in financial markets. Consistent with a strategy of containing fiscal pressures arising from population ageing, the government now envisages the setting up of a "Future Fund", financed from future budget surpluses and revenues from asset sales to meet unfunded superannuation liabilities of civil servants – estimated at 10½ per cent of GDP in 2004-05. The fund would have outside managers and be invested in a diversified portfolio. The decision to purchase assets raises difficult questions about the regulation and administration of such a fund, with cross-country experience providing only limited guidance.

Commendable progress has been made towards reforming the tax system but issues remain

Following the introduction of a modern and broad-based goods and services tax and various improvements in business taxation in recent years, including a less complex and more internationally competitive tax regime, there is still unfinished business in the area of tax reform. A large gap between the top personal marginal income tax rate and the company tax rate creates an incentive for a redefinition of personal income as company income. Also, while the maximum marginal income tax rate is around the average by international standards, it cuts in at a relatively low income level, which may harm work incentives and discourage skill acquisition. An additional important issue is that of effective marginal tax rates which, despite recent reforms, remain high for many low income earners, deterring labour force participation, including by secondary earners and older workers. *The priority for tax reform should be the simultaneous continuation of policies which contribute to the lowering of these high effective marginal tax rates, and the raising of the threshold at which the maximum marginal income tax rate cuts in, consistent with budgetary objectives. A rapid abolition of remaining distorting State taxes, as well as a reform of the narrowly-based and exemption-ridden payroll tax – also under the States' jurisdiction – would further increase the efficiency of the Australian tax system and improve resource allocation.*

Ageing will result in lower participation rates and hence income growth

Maintaining high per capita income growth will become harder to achieve as the large "baby boomer" generation progressively moves into older working-age brackets and then into retirement. The proportion of the population in the age group under 55 years, where labour force participation is normally highest, will decline sharply during the next twenty years. Projections of the Australian Government are for a doubling of the population over 65 to around 25 per cent of the total over the next 40 years, while growth in the population of traditional workforce age is expected to slow to almost zero. Excluding an unprecedented rise in fertility rates, the age structure of the population is likely to stabilise thereafter with a far higher proportion of older people. Although immigration will continue to support the labour force, it can only slow but not stop population ageing, mainly because immigrants will age along with the rest of the population. Accordingly, the aggregate labour force participation rate may be some 9 percentage points lower than today by the early 2040s, and *ceteris paribus*, this would reduce the growth in real GDP per capita to about 1½ per cent per annum from the 2020s onwards, under the assumption of labour productivity growth of 1¾ per cent (the average of the last 30 years).

Public age pension spending will not rise much…

In such a scenario not only would per capita income grow more slowly than currently, but mounting age-related public expenditures would also raise budget pressures. The purely fiscal implications of public pensions are not especially preoccupying by international comparison, particularly because the compulsory private superannuation pension system is reaching maturity and the flat rate, means-tested pay-as-you-go public Age Pension element is small relative to average wages. Furthermore, (concessional) taxes are levied on the income and capital gains of the superannuation funds, and also on draw-downs on or after retirement.

… but public spending on health is projected to increase substantially

In fact, the authorities expect that the greatest pressures on public finances in future will come from spending on public health and long-term care. This reflects both demographic and long-standing medical technology trends. Across Australian health and aged care services, average annual expenditures per person on those aged 65 and over are around four times of those under 65, and rise to between six to nine times of that for the oldest groups. In addition, the demand for health services at all ages is likely to rise, induced by new medical technologies. Costs are expected to rise even faster, especially as regards the Pharmaceutical Benefits Scheme (PBS), reflecting the increased availability of new but more expensive drugs. Hence, health and aged care spending is projected by the Australian authorities in the *Intergenerational Report* to rise by as much as 5 to 6 percentage points of GDP over the next forty years. In consequence, the Government projects that the federal Government's budget balance would deteriorate from small surpluses currently to a deficit of 5 per cent of GDP in the early 2040s on business-as-usual projections of productivity and participation rates. The rise in the cost of the PBS alone accounts for 3 percentage points of this; it should be noted in this context that the projected long-term rise in unit health costs is unusually rapid by international comparison, though it reflects a continuation of long-term trends of the past. In addition, Government spending on aged care is expected to rise to 1¾ per cent of GDP by 2041-42, mainly as a result of an increase in residential care spending.

Policies can help offset ageing-related rising claims on resources

Three mutually supportive policy responses can help mitigate the impact of rising health and other ageing-related costs on budget balances and material living standards. First, policies need to *raise productivity in the health sector itself and transfer more of the costs to users of services*. Second, *policies directed to increasing the growth of productivity throughout the economy would help offset the rising resource cost of delivering health services irrespective of who is paying for them*. Third, *welfare reforms should encourage higher participation rates so as to boost output, reduce social spending and increase tax receipts.*

Delivery of health services should become more cost-effective, and more of the costs passed on to service users

As regards reforms to the health sector itself, disparities in efficiency across jurisdictions in a range of health care services indicate scope for governments to develop more cost-effective service delivery. C*o-ordination between different types of service providers and government levels should be improved, for example to avoid cost-shifting. Prevention could be reinforced, and the role of price signals in healthcare should be strengthened.* I*n particular, there is scope for further moves away from fee-for-service arrangements for paying doctors* which, in combination with universal insurance, tends to encourage oversupply of services. The Government has introduced measures to encourage increased take-up of private health insurance. S*teps should be taken to allow private insurance to cover a more comprehensive range of mainstream health services, including non-hospital treatments.*

Productivity growth should be raised via more product market reforms…

Productivity measures consistently show that output per hour worked in Australia, while rising briskly, remains well below that in technologically leading countries. This suggests there is further scope for catch up. Policies most prominent in this respect encompass those which foster competition in product markets and thus promote the growth of multifactor productivity and the wider use of new technologies. The NCP has set in train a range of major sectoral reforms, including a process of removing restrictions which legislative reviews have shown not to be in the general public interest. But there is still substantial unfinished business. Areas where reforms are yet to be completed include infrastructure services, agricultural marketing arrangements, liquor licensing, compulsory insurance schemes, pharmacies, the professions and occupations (for example, health and legal practitioners). B*ringing the reform programme to completion according to an announced timetable is important* *to avoid the impression that difficult reforms can be deferred indefinitely. Among jurisdictions, the federal government in particular should make stronger efforts to raise its own compliance rate*, which has been among the lowest of all Australian governments and is not commensurate with its leadership role in promoting enhanced product market competition. The Productivity Commission is currently undertaking an inquiry into the future of NCP in the lead up to a review of NCP by the Council of Australian Governments (COAG) in 2005. This provides a significant opportunity to address the unfinished business of the current NCP agenda, reinvigorate the commitment to reform, and extend competition and efficiency enhancing reforms to appropriate new areas.

… especially in network industries

Regarding infrastructure services, a fully competitive national electricity market, including full retail contestability, has yet to be realised, even across the contiguous eastern states. *As an important prerequisite, regulatory inconsistency, which arises from the co-existence of state and national regulators in both the electricity and gas sectors, needs to be removed as planned.* The National Competition Policy (NCP) road transport reform commitments, which cover a narrower range of reform modules than initially proposed by the National Road Transport Commission, are now almost complete. Like rail reform, other road reform is being pursued outside the NCP framework through a co-operative intergovernmental process. *Recently announced national land transport reforms planned under the AusLink framework need to be effectively implemented, to ensure efficient long-term investment and better integration of the network. Efforts should also be made to promote competition in ocean shipping with a current review by the Productivity Commission suggesting that repeal of the industry-specific regime for international liner cargo shipping will improve outcomes. More broadly, Australian governments should seek to establish an integrated reform agenda within a co-operative assessable framework covering all elements of land transport and shipping transport. Competition in fixed-line telecommunications should be promoted by strategies designed to facilitate further access by competitors, and Telstra should be required to divest its cable network and its shareholding in a major pay-TV supplier, provided independent assessment shows that the benefits of divestiture would exceed the costs. Another effort should be undertaken to open the postal services market to competition.*

Access regimes themselves do not automatically guarantee optimal investment in the network

"Access regimes" provide a framework for assuring (over time) that the monopoly elements of network industries are managed in a way that does not hamper the development of effective competition in upstream and downstream industries. But these regimes do not in themselves assure that decisions on network investments are made in a cost-effective and timely manner, and especially not if ownership and regulation of networks are spread over several geographical jurisdictions. Efficient infrastructure investment is a complex problem in any economy, as market signals by themselves often do not provide sufficient guidance, market power creates gaps between private and social rates of return, and investment decisions have significant redistributive impacts across regions. There is no obvious "best practice" approach to this problem, and the Australian approach will have to take into account the specific constitutional allocation of competences. But *in general, economic efficiency is most likely to be achieved if the analysis is undertaken at a national level, and decisions coordinated across levels of government*.

Water use policies are advanced, but there is unfinished business

While urban water reforms have made significant improvements, the pace of rural water reform needs to be accelerated. Australia faces particularly difficult water management issues because it is a dry continent. It has become a world leader in some respects in defining clearly a "property right" regime for water. But major issues still need to be addressed, including the *enforcement and trading of water property rights as well as the determination and pricing of appropriate environmental allocations*. Accordingly, the Council of Australian Governments' National Water Initiative of 2004 aims to improve the security of water access entitlements, ensure ecosystems health and encourage expansion of water markets and trading. C*ross-subsidisation of water usage as between urban and rural users, and also between different types of agricultural users, should be phased out over time*.

A reinvigorated reform programme, which requires jurisdictional co-operation should be developed

The review of NCP by COAG in 2005 will need to consider the appropriate framework for a reinvigorated, nationally coordinated reform programme including the role of *financial rewards and assessment processes*. I*t will also need to consider reform priorities and expanding the scope of reform efforts to new areas*. Health care, education and community services are such areas which offer a great potential for closer coordination of reforms across Australian governments to enhance efficiency, given Australia's brand of fiscal federalism with substantial constitutional powers and responsibilities residing with sub-central governments. This is all the more important as the ageing of the population will impact on government services, revenues and retirement income policies. Another risk to future growth is environmental degradation, which has inter-jurisdictional implications as the Constitution has left most environmental responsibilities to the states, but their interests differ depending on energy production patterns, biodiversity concerns and water-use. Hence, a co-ordinated regional and national approach is needed to deal with cross-state spillovers and the need to implement commitments made under international agreements, as well as to ensure that there is a sufficient range of instruments available to cope with environmental problems.

Competition law should continue to be applied vigorously

Vigorous competition law enforcement, reducing firms' power over price, also contributes to strong economic performance. The latest reform proposals recommended by the Dawson Committee focus on improving accountability, transparency and the timeliness of decision-making so as to provide greater certainty for business. A *more transparent and formal process for reviewing proposed merger clearance would be welcome and should make the* Australian *Competition and* Consumer *Commission* (ACCC) *more accountable*. The Dawson Committee found that the current merger authorisation process imposed commercially unrealistic timeframes for business, and proposed that the Australian Competition Tribunal decide merger authorisation cases on "public benefit grounds" without prior consideration of those issues by the ACCC. The Government has accepted this recommendation. This approach may involve some risks and it will be important that the ACCC provides investigatory and market expertise to assist the Tribunal in making its decision. M*ergers whose effects on competition are indirect or cumulative should continue to be closely monitored*. Areas of interest include combinations in recently-deregulated utility sectors, which could prevent the emergence of competition in new markets, and outlet-by-outlet acquisitions in the already-concentrated retail sector. However, the Dawson Committee recently found that the existing merger provisions can adequately deal with such issues. Corporations face civil fines for cartel violations, but these have been subject to a comparatively low statutory cap. The government's proposals to raise the fine level, to the greater of A$ 10 million, three times the gain from the violation or where the gain cannot be readily ascertained, 10 per cent of group turnover would bring Australia into line with other major jurisdictions. Fines against individuals are common but low; proposals to subject individuals to criminal penalties for hard-core price fixing and bid rigging will improve deterrence if the legal problems involved in defining the offence can be resolved satisfactorily. A small number of recent court decisions have created some uncertainty about how the law can control abuses by dominant firms. The legislative amendments announced in June 2004 will assist in addressing the uncertainties flowing from these decisions.

To offset rising ageing-related claims on resources, labour market participation should rise

International comparisons of structural unemployment, overall employment ratios and participation rates suggest that there is ample room for raising labour inputs in Australia. It is especially important to improve incentives to join the labour force in the first place and to remain in it when older. To help raise participation rates, policy initiatives, commencing with the introduction of the *Australians Working Together* (AWT) package in the 2001-02 Budget, have aimed to help people move from income support into work and reduce welfare dependency by introducing a series of "making work pay" measures. To contain the extensive flow of people into the Disability Pension Support programme, initiatives were taken to address the work capacity of people with disability, and tighten the rules governing access to disability pensions. The latter has so far encountered strong political opposition, although new assessment measures were introduced in 2002 as part of the AWT. *Low participation remains a problem, especially for older workers. Rebalancing obligations, services and assistance for those on income support would improve participation. In addition, more could be done to encourage employers to provide training and re-training facilities for workers before they reach their mid-50s, and encourage those workers themselves to enrol in such schemes.*

Welfare reforms should encourage participation

Welfare policy reforms have also aimed at reducing high effective marginal tax rates (EMTRs) faced by income support recipients when they move from welfare to work and have also granted "Working Credits" which enable welfare recipients to keep more of their income support payments when they take up work. Its impact, however, on high marginal effective tax rates is transitory, as the financial benefit depends on the level of working credits accrued by the person. With the May 2004 Budget also incorporating a reduction in the withdrawal rates of the Family Tax Benefits and increased family assistance, EMTRs for families on average earnings have now fallen to 51.5 per cent from 85.5 per cent in 1999. *Further welfare reforms should continue to provide firmer incentives for participation, with the fiscal costs of the prospective changes being closely monitored.*

Further reforms to labour market legislation would also encourage employment

To further encourage participation and favour employment, the industrial relations system also needs to be reformed so as to increase the flexibility of the labour market, reduce employment transactions costs and achieve a closer link between wages and productivity. *Regulatory requirements for collective and for individual agreements should be eased so that they can replace awards. A major step in this direction would be another reduction of the number of allowable award matters, and the tightening of their definitions and specifications. "Safety Net" award wage increases should be guided by the productivity and thus employability of low-skilled workers.* Further unfinished business includes harmonisation of federal and state industrial relations and the streamlining of regulations which minimise the incidence of unlawful industrial action. Finally, the cost of dismissal procedures, including for employees who have been with firms for only a short period, is often cited by small businesses as a disincentive to hiring. *The Government is now in a position to address these issues and should proceed as soon as practicable.*

Education levels have improved, but there are wide disparities in achievement and drop-out rates remain high

While the educational attainment in Australia has improved remarkably over the twenty five past years, there is still scope for catching up. For example, on the basis of the OECD PISA study around 12 per cent of 15 year old students have low reading literacy levels, while Australia exhibits above-average disparities in student reading performance. Also, despite an increase in the apparent retention rates in the past two decades or so, the share of 15-19 year olds enrolled in post-compulsory secondary education is lower than in many OECD countries. *Further improving the educational opportunities and outcomes in order to facilitate the school to work transition for young people should remain a policy priority*. Recent initiatives aiming at enhancing the foundation of skills learned in school, and strengthening career education and information systems, are steps in the right direction. *Efforts should also continue towards broadening the secondary school curriculum to meet students' aspirations and reduce the risk of early school leaving*. *The further integration of the vocational education and training sector with the broader education sectors would be advisable in this respect*. *Training and up-skilling persons already in work should be given higher policy priority*, and recent moves towards a coordinated strategy to adult learning represent a welcome step forward. Policy initiatives should be closely tailored to the needs of adult workers so that lifelong learning outcomes meet the underlying costs of tuition and production losses from being out of work. Finally, regarding higher education, the comprehensive reform package, announced in the May 2003 Budget is expected to improve the functioning of the sector by making funding arrangements more flexible, through a partial deregulation of university fees and an extension of income contingent loans to full-fee paying students. *Improvements in other areas, including that of governance, are also required in order to enhance the quality of the higher education system and ensure it remains internationally competitive*.

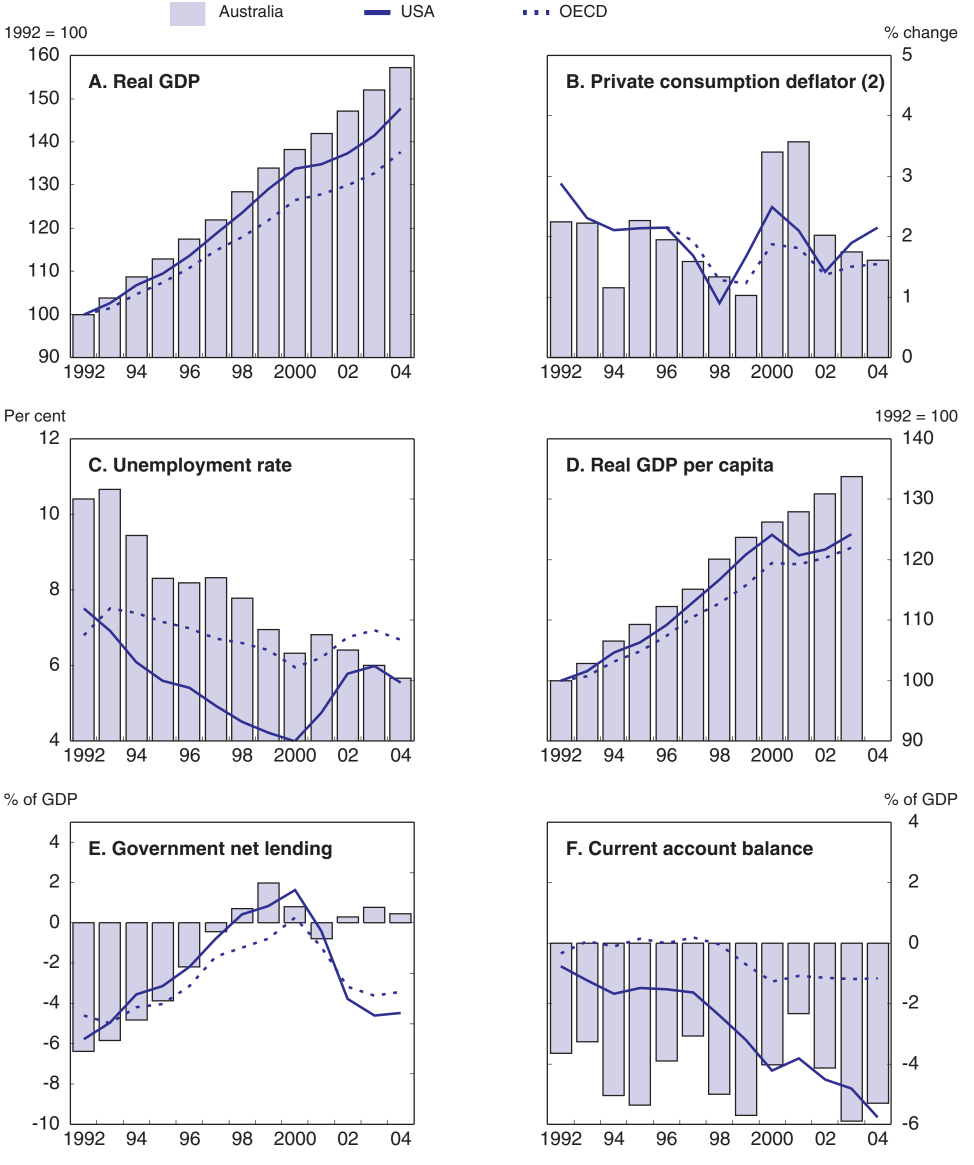
1. Economic performance and key challenges

Economic performance has been outstanding during the thirteen year long upswing

The Australian economy completed the thirteenth year of its expansion in the middle of 2004, marking the longest run of uninterrupted growth in Australia's post-war history. Over this period, the growth of output averaged 3.5 per cent and that of real per-capita income 2.4 per cent, which compares favourably with the performance of most other OECD countries (Figure 1.1). The long expansion was barely affected by the financial crisis in East Asia in the second half of the 1990s nor by the outbreak of the severe acute respiratory syndrome (SARS) there in 2003. Economic growth even remained relatively robust in the face of the global economic weakness in 2001-02 and the severe and prolonged drought in Australian regions in 2002-03, which alone subtracted about 1 percentage point from GDP growth[1] in fiscal year[2] (FY) 2003-04 (Table 1.1). And unlike in other OECD countries, Australia did not experience an asset price boom and bust cycle with a subsequent unwinding of the capital overhang. The vigorous growth of the Chinese economy has also helped the resources sector, contributing further to the improvement of the terms of trade,[3] which partly offset the drag on domestic activity from weak export volumes from the global slowdown. Very importantly, a careful mix of sound macroeconomic policies and broad structural reforms[4] has no doubt helped greatly to allow the economy to work closer to potential over time than in past episodes of disturbance as well as raising the underlying rate of growth of potential.

T*he long-lasting economic upturn has brought about solid aggregate employment gains*, in spite of the recent drought-induced loss of around 100 000 jobs in the farm sector. The unemployment rate decreased from a peak of nearly 11 per cent in late 1992 to a recent low of around 5½ per cent, which is close to the OECD estimate of structural unemployment. Notwithstanding increased labour utilisation, the long economic upswing was further accompanied by a marked improvement in the trend growth of labour and multifactor productivity (until the recent drought), which approached the high-productivity episodes in the late 1960s and early 1970s. The expansion also took place in an environment of much lower inflation

Figure 1.1. **Key indicators in international perspective**[1]



1. Figures for 2004 are OECD estimates.
2. OECD excludes high inflation countries. For Australia, inflation in 2000 and 2001 also includes the effect from the introduction of the goods and services tax.

Source: OECD, *Economic Outlook* 76.

Table 1.1. **Demand and output**[1]

Percentage changes

	From previous year			From previous period, at annual rate					
	Fiscal years[2]			2002	2003		2004	2004	
	2001/02	2002/03	2003/04	S2	S1	S2	S1	Q1	Q2
Consumption									
Private	3.4	3.8	5.5	3.6	3.5	6.3	5.9	5.9	5.2
Public	2.0	4.4	3.2	5.1	3.9	2.7	3.5	3.6	3.4
Gross fixed capital formation	9.6	13.3	7.3	15.1	7.0	7.5	7.2	7.4	5.1
Public sector	4.8	4.6	6.2	5.2	7.4	4.6	8.1	9.0	6.2
General government	3.9	5.5	5.7	6.1	12.9	2.6	5.1	5.6	7.0
Public enterprises	6.4	3.2	6.9	3.7	–1.3	8.1	12.9	14.6	3.3
Private sector	9.8	15.0	7.5	17.2	7.0	8.0	6.9	7.1	4.3
Dwellings[3]	16.1	16.1	7.4	17.5	3.9	7.2	11.3	12.1	7.9
Other building and structures	8.5	35.1	10.9	46.0	16.7	7.8	11.8	13.6	9.1
Machinery and equipment and intangible fixed assets	5.0	12.4	7.9	13.7	10.8	7.5	5.7	5.5	6.2
Machinery and equipment	5.9	14.0	8.5	14.8	12.0	8.7	4.8	4.5	4.6
Intangible fixes assets	1.3	5.6	4.9	8.9	5.7	2.0	10.1	10.7	14.2
Livestock and transfer costs	18.2	–3.2	1.2	–8.4	–0.1	9.7	–12.9	–14.9	–21.8
Livestock	1.0	–37.2	38.9	–56.0	–7.4	87.7	13.9	10.5	–6.6
Ownership transfer costs	21.7	2.5	–2.7	0.8	0.7	3.0	–16.3	–18.1	–24.0
Final domestic demand	4.3	6.1	5.5	6.5	4.3	6.0	5.7	5.7	4.7
Increase in stocks[4]	–0.3	0.1	0.5	–0.4	0.5	1.1	–0.1	0.3	–0.4
Total domestic demand	4.3	6.1	5.5	6.6	4.4	5.9	5.8	5.9	4.9
Exports of goods and services	0.7	–0.7	0.7	1.1	–4.9	–0.2	8.6	9.9	6.7
Imports of goods and services	2.3	13.0	13.7	13.6	10.7	13.1	17.8	18.8	15.4
Change in foreign balance[4]	–0.3	–2.7	–2.9	–2.6	–2.9	–3.1	–2.7	–2.8	–2.5
Statistical discrepancy[4]	–0.0	–0.1	0.3	0.1	–0.2	0.1	0.5	0.4	0.6

Table 1.1. **Demand and output**[1] (*cont.*)

Percentage changes

	From previous year			From previous period, at annual rate					
	Fiscal years[2]			2002	2003		2004	2004	
	2001/02	2002/03	2003/04	S2	S1	S2	S1	Q1	Q2
GDP	3.9	3.1	3.5	3.0	2.2	4.2	3.4	3.5	2.4
Farm	3.9	–24.7	26.8	–36.3	–21.1	64.2	21.9	34.2	–26.3
Non-farm	3.9	4.1	3.0	4.8	3.8	3.0	2.4	1.0	3.6

1. Chain volume measures, trend, at FY 2002/03 prices.
2. Fiscal years begin 1st July.
3. Including real estate transfer expenses.
4. Contributions to changes in real GDP (as a percentage on real GDP in the previous year).

Source: Australian Bureau of Statistics.

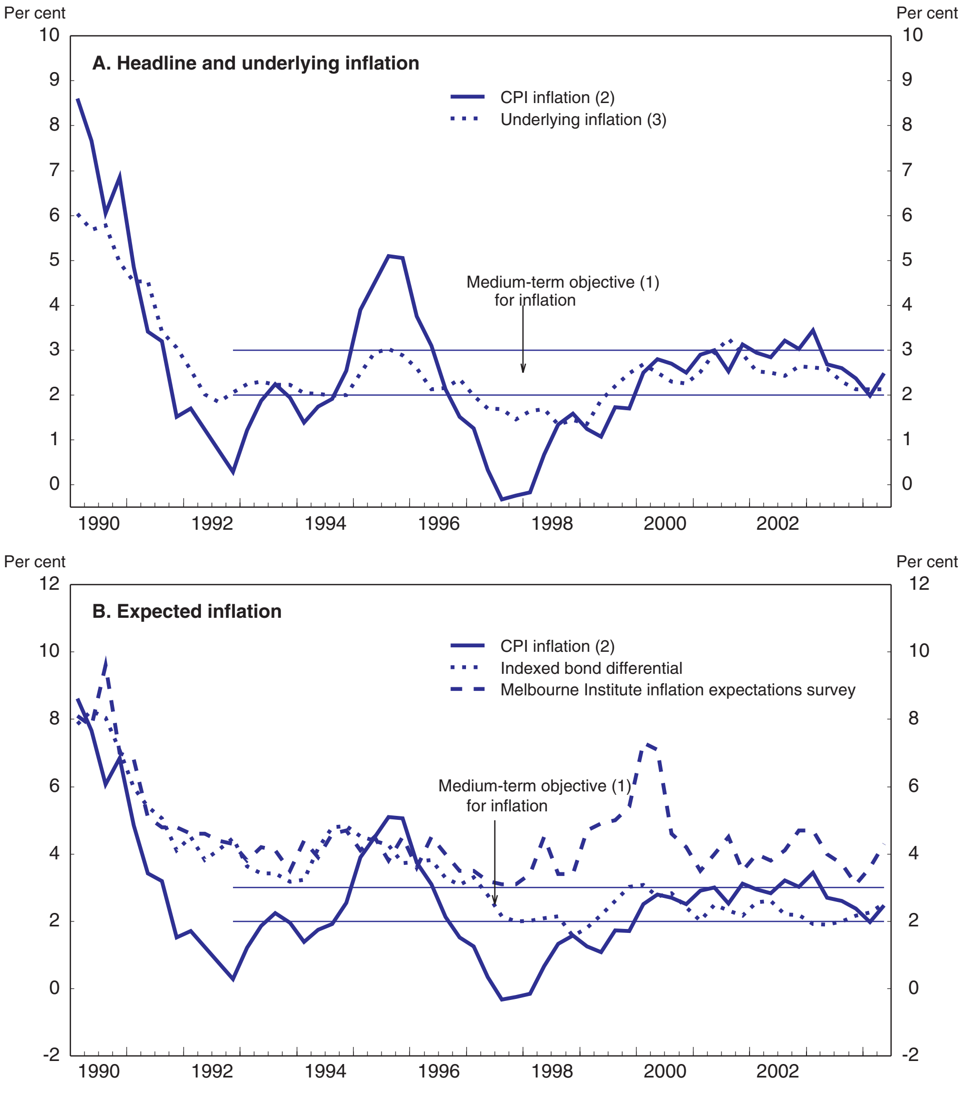
than in the 1970s and 1980s. Underlying consumer price inflation was consistent with the inflation target of 2 to 3 per cent over the course of the business cycle (Figure 1.2).

With the drought effects fading, there should be a rebalancing of growth

Economic growth firmed again in 2003-04, driven by domestic spending, while the external sector continued to act as a drag on activity. Farm output recovered from the drought and contributed ¾ percentage point to GDP growth in 2003-04, while labour productivity growth bounced back. A continuation of strong growth is expected over the next two years, at around 3¾ per cent per year, accompanied by inflation within the target band of 2-3 per cent (Table 1.2). Public finances are expected to remain healthy, but household indebtedness is expected to remain high. Further gains in employment are likely to encourage higher labour force participation, keeping unemployment broadly at its achieved low level. More details of recent developments and economic prospects are in Annex 1.A1. A summary of the main features of the projections and risks surrounding them is given below:

- *Private consumption* is expected to slow somewhat, along with the easing in house prices since late 2003.
- With business confidence very high, an improved environment for raising equity finance, indications of capacity constraints in the resources sector, in particular mining, large investment projects in the pipeline,[5] and faster world GDP growth, the prospects for *business investment* remain favourable.
- Indications of falling house prices during the first half of 2004, a steep fall of housing loan approvals to both owner-occupiers and investors from their peak in October 2003, and falling building approvals suggest that the *dwelling investment* boom is already cooling off.
- With the international economy picking up, the impact of the drought waning, and the housing cycle turning around, there should be less reliance on domestic demand and a smaller drag from *net exports*. Together with the expected further improvement in the terms of trade, the *current balance deficit* should thus narrow, from 5¾ per cent of GDP in mid-2004 to 4½ per cent by 2006.
- *Inflation* is likely to stay within the target band in the face of high capacity utilisation and low unemployment, as wage gains remain moderate, productivity gains are solid, and the cooling of the housing market dampens private consumption demand.
- The recovery of *farm production* and *exports* from the drought in 2002-03 could be interrupted if the disappointing rainfall in the first half of 2004 were to continue.

Figure 1.2. **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 acquisition 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 1.2. **Short-term prospects**

Percentage changes

	Percentage shares of GDP current prices 2001	2002	2003	2004	2005	2006
A. Demand and output at constant 2002-2003 prices						
Private consumption	59.4	4.0	4.1	5.4	3.6	3.3
Public consumption	17.9	3.8	3.8	3.2	3.1	3.2
Gross fixed capital formation	21.1	15.7	8.2	6.1	4.4	4.8
of which:						
Government	2.3	–0.8	10.1	5.6	5.6	3.5
Private[1]	18.8	17.7	8.0	6.1	4.3	4.9
Dwellings[2]	5.1	24.4	7.5	7.6	–0.9	–1.8
Other building and structures	2.7	25.8	19.4	7.5	5.5	7.9
Machinery and equipment and intangible fixed assets	7.8	11.4	8.5	7.5	8.1	82
Public enterprises	1.2	20.6	4.2	9.7	4.2	3.8
Final domestic demand	98.5	6.5	5.0	5.2	3.7	3.6
Increase in stocks[3]	0.1	–0.3	1.1	–0.2	0.1	0.1
Total domestic demand	98.6	6.2	6.1	4.9	3.8	3.7
Exports of goods and services	20.8	0.3	–2.6	6.4	8.3	9.8
Imports of goods and services	19.7	11.9	11.0	13.5	7.6	9.1
Change in foreign balance[3]	1.1	–2.3	–2.8	–1.9	–0.3	–0.4
Statistical discrepancy[3]	0.2	–0.2	–0.0	0.1	–0.6	–0.1
GDP	100.0	3.6	3.3	3.6	3.8	3.6
B. Other items						
Private consumption deflator	. .	2.0	1.7	1.6	2.6	2.7
Employment (LFS definition)	. .	2.0	2.3	1.6	1.8	1.9
Unemployment rate (per cent)	. .	6.4	6.0	5.6	5.5	5.5
General government financial balance (% GDP)	. .	0.3	0.8	0.7	0.4	0.5
Current balance (% GDP)	. .	–4.1	–5.9	–5.5	–4.9	–4.6

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

Source: OECD, *Economic Outlook* 76.

- Higher *oil prices* will reduce domestic spending power in the short term and may raise inflation, although in the medium term the overall effects are more ambiguous. On the one hand, Australia is a net exporter of energy, and hence the rise in world oil prices will lead to an increase in Australia's terms of trade. However, Australia's major trading partners are net importers of energy and hence the rise in world oil prices is likely to see slower economic growth than otherwise in these countries, with flow-on effects to Australia's export industries.
- While the strength of domestic demand and firming labour market conditions have not so far generated systemic inflationary pressures, there is a *risk of higher consumer price inflation* once the effect of the earlier currency appreciation diminishes.
- High levels of *household debt* and debt-interest payments have made households more sensitive to further increases in interest rates - incorporated in the projections - and more vulnerable to an abrupt fall in house prices as a possible response to excess supply in the property market, or in response to a deterioration in macroeconomic conditions.
- Although there is no fixed benchmark for *current account sustainability*, and a change in the total debt-to-GDP ratio in either direction is no reliable indicator on whether problems of current account financing might eventually emerge, the stubbornly large external deficit (currently around 6 per cent of GDP) and high foreign indebtedness (some 48 per cent of GDP) might give rise for concern, though this should not be a major one given that the counterpart to the deficit is foreign investment, rather than private consumption.

The challenge of maintaining high economic growth in the face of population ageing

Notwithstanding its excellent macroeconomic performance by international comparison since the early 1990s, Australia's per capita income and productivity levels are still exceeded by a number of OECD countries (Figure 1.3). Indeed, although Australia's per capita GDP relative to that of the United States improved by 6 percentage points from 1990 to 2002, to 76 per cent of the US per capita GDP, this only restored Australia's relative position held in the early 1970s and falls short of where it was in 1950. Australia's GDP per hour worked is also estimated to have moved closer to that of the United States, but remains even further below hourly productivity in a number of European countries.[6] While such comparisons are fraught with measurement problems and reflect in part fundamental differences in endowments and geography of the economies compared, they nevertheless suggest that there still is substantial scope for further gains in income and productivity levels of the Australian economy. Furthermore, participation rates for some groups of the working-age popula-

Figure 1.3. **International comparison of income and productivity levels**

United States = 100

Source: OECD, *Science, Technology and Industry: Scoreboard of Indicators* (2003).

tion are well below those recorded in some other OECD countries. Further convergence with international leaders could thus be achieved if Australia succeeded in maintaining, or even exceeding, its outstanding productivity performance of recent years, assisted by more and better labour inputs. This is the major challenge facing Australian policy makers.

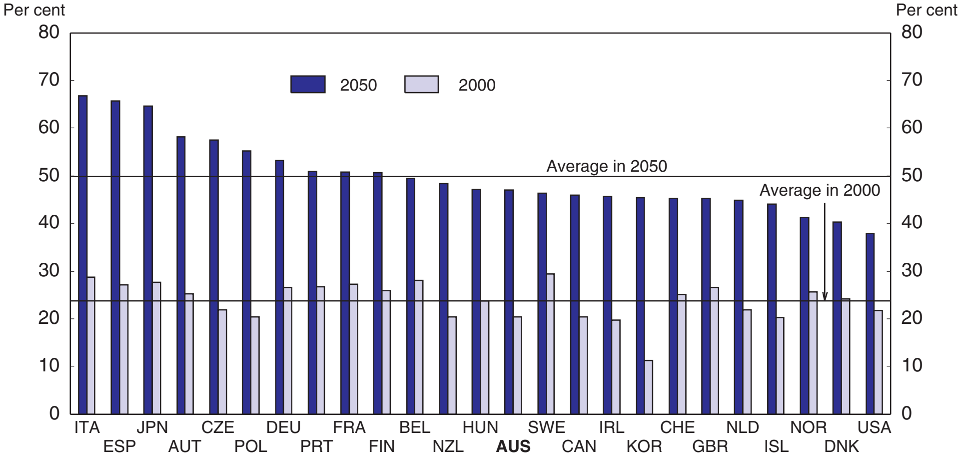
The consequences of population ageing and rising health costs on per capita incomes

Demographic developments and the labour force

There is no guarantee that Australian economic performance will continue to be as impressive as it has been over the past thirteen years even though the gains from the major reforms in labour and product markets implemented since the late 1980s may be felt for some years to come. On the contrary, without counteracting economic policies, the ongoing demographic change is set to lead to lower gains in material living standards over the medium to long term as the large "baby boomer" generation[7] progressively moves into older working-age brackets and then into retirement. The proportion of the population in the age group under 55 years, where labour force participation is normally highest, will decline sharply during the next twenty years. Projections of the Australian Government[8] are for a doubling of the population over 65 to around 25 per cent of the total over the next 40 years, while the old-age dependency ratio – which shows the number of people aged at least 65 relative to the working-age population (here defined as being between 20 and 64[9]) – is projected to slightly more than double over the next half-century (Figure 1.4). At the same time, the ratio of the very old (80 and above) within the older (65 and above) population will also increase rapidly (Table 1.3). Currently, people over the age of 80 make up less than a quarter of the older population in Australia. By 2050, this ratio is estimated to rise to more than a third. Excluding an unprecedented rise in fertility rates, the age structure of the population is likely to stabilise thereafter with a far higher proportion of older people above retirement age. Although migration will continue to support the labour force, increased migration can only slow but not stop population ageing, mainly because migrants will age along with the rest of the population.

The Australian labour force has expanded more than the OECD average during the last 25 years. Population increase has been the major driver, although a rise in the participation rate also played a role. During the 1990s, labour force growth was lower than in previous decades and relied entirely on demographics (including net immigration, as usual), with no further improvements in aggregate participation rates (Table 1.4). Given the expected unfavourable demographic trend, it is clear that future labour force growth will decline in the absence of further increases in participation. While Australia's total participation rate compares favourably with other OECD countries, participation rates for prime-aged males (Figure 1.5) and older workers are among the lowest in the OECD area. Increasing participation of

Figure 1.4. **Old age dependency ratio**[1]
2000-2050, per cent



1. Share of the population aged 65 and over in population aged 20 to 64.
Source: OECD, Office fédéral de la statistique de la Suisse and United Nations, "World Population Prospects" 1950- 2050.

women in the Australian labour market has been mainly responsible for the increase of the aggregate participation rate over the past decades. Specifically, women's entry into the workforce is estimated to have boosted the total participation rate by over 6½ percentage points between 1975 and 2000, while the evolution of male participation has knocked off almost 4 percentage points of the total over the same period (Burniaux *et al.*, 2004).

Burniaux *et al.* (2004) project labour supply developments over coming decades taking into account variables such as demographics (ageing), cohort effects (younger women replacing older men), unemployment, fertility rates and population. According to these calculations the Australian labour force would increase by 18 per cent between 2000 and 2025 and then remain constant the following quarter of a century. This is better than the projected OECD average labour force evolution of a mere 5 per cent increase in the first 25 years of this century, followed by a decline of close to 9 per cent between 2025 and 2050.

A weakness of this analysis is that labour supply should be measured in terms of hours worked rather than on a headcount basis. While the long run trend in hours worked remains upwards, there has been some fall off in recent years. Preliminary work by Banks (2004), who focuses on hours instead of workers, depicts a less positive outlook. Firstly, he projects aggregate participation (total hours worked relative to the working-age population) to fall by 10 percentage

Table 1.3. **The old-age dependency ratio and the share of the very old in the total elderly population**

Per cent and change in percentage points

	Old-age dependency ratio			Very-old persons ratio		
	2000	2005	*Change*	2000	2005	*Change*
Australia	**20.4**	**47.0**	**26.6**	**23.3**	**34.0**	**10.7**
Austria	25.2	58.2	33.0	22.7	42.7	20.0
Belgium	28.1	49.5	21.4	21.5	39.7	18.2
Canada	20.4	45.9	25.5	23.8	36.2	12.3
Czech Republic	21.9	57.5	35.6	17.0	29.0	12.0
Denmark	24.2	40.3	16.2	26.8	37.4	10.6
Finland	25.9	50.6	24.7	22.0	35.2	13.2
France	27.2	50.8	23.6	22.2	37.5	15.3
Germany	26.6	53.2	26.6	21.1	37.5	16.4
Hungary	23.7	47.2	23.5	16.9	26.6	9.7
Iceland	20.3	44.0	23.7	23.9	34.3	10.4
Ireland	19.7	45.7	26.1	23.1	27.1	4.0
Italy	28.8	66.8	38.0	21.0	37.1	16.1
Japan	27.7	64.6	36.9	21.9	42.2	20.3
Korea	11.3	45.4	34.2	13.7	33.2	19.6
Netherlands	21.9	44.9	23.0	23.3	37.3	14.0
New Zealand	20.4	48.3	27.9	23.6	36.3	12.7
Norway	25.6	41.2	15.7	29.0	34.7	5.7
Poland	20.4	55.2	34.8	16.2	26.6	10.4
Portugal	26.7	50.9	24.2	19.1	30.7	11.6
Spain	27.1	65.7	38.5	21.8	33.2	11.4
Sweden	29.4	46.3	16.9	28.0	35.7	7.7
Switzerland	25.1	45.3	20.3	26.5	40.4	13.9
United Kingdom	26.6	45.3	18.7	25.0	37.3	12.3
United States	21.7	37.9	16.2	26.5	36.1	9.6
Average	**23.8**	**49.9**	**26.1**	**22.4**	**35.1**	**12.7**

Note: Old-age dependency ratio is equal to (persons aged 65+)/(persons aged 20-64) and the very-old persons ratio is the equal to (persons aged 80+)/(persons aged 65+).

Source: *Eurostat*; National data for Norway, Switzerland, Canada and the United States, United Nations' "World Population Prospects 1950-2050 (The 2000 Revision)" – February 2001 for Iceland.

Table 1.4. **Trends in population and aggregate labour supply in OECD countries**
Average annual growth rate

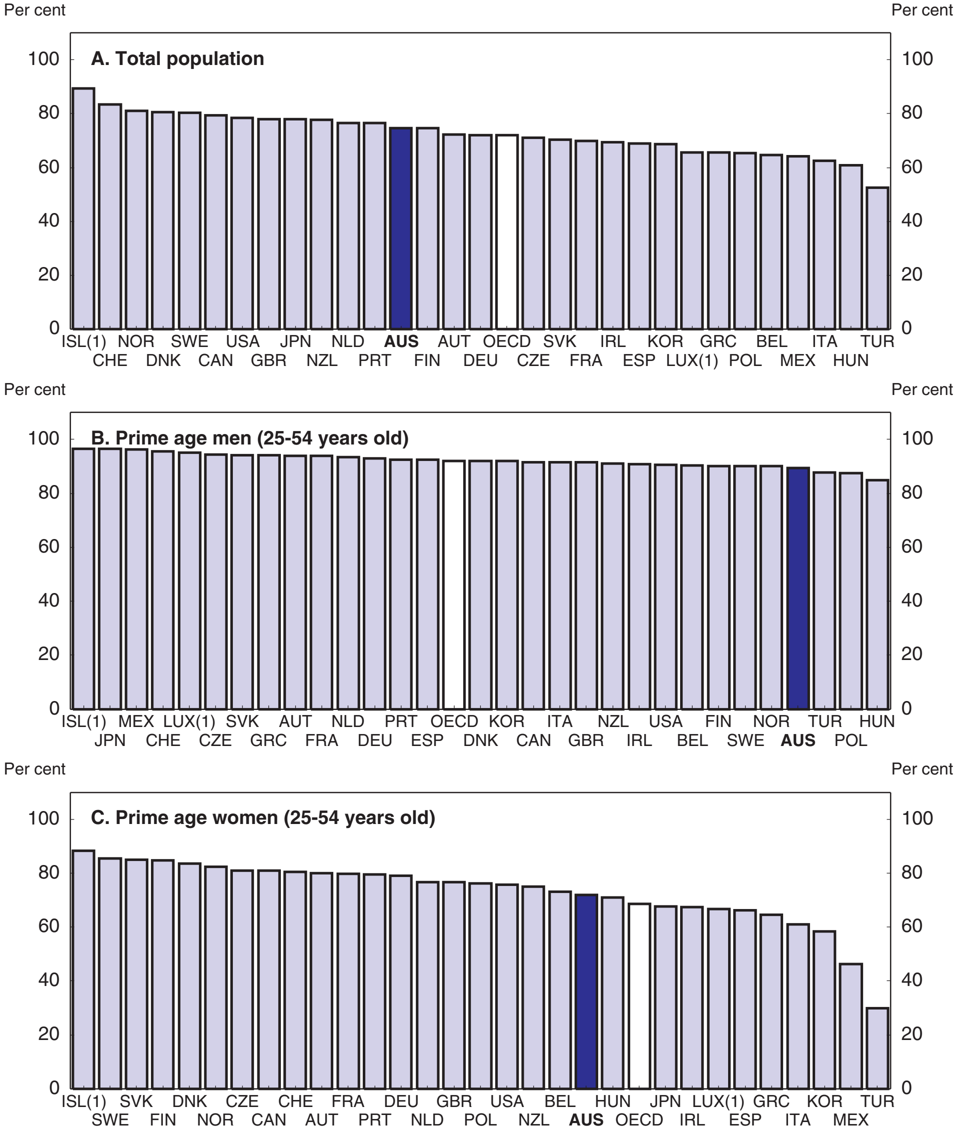
	Population		Participation rate[1]		Labour force	
	1975-1989	1990-2000[2]	1975-1989	1990-2000[2]	1975-1989	1990-2000[2]
Australia	**1.9**	**1.4**	0.2	**0.0**	**2.1**	**1.4**
Austria	0.6	0.6	0.4	0.5	1.0	1.1
Belgium	0.4	0.3	–0.1	0.2	0.4	0.5
Canada	1.7	1.3	0.7	–0.1	2.4	1.2
Czech Republic	0.2	0.5	. .	–0.2	. .	0.3
Denmark	0.6	0.2	0.5	–0.4	1.1	–0.2
Finland	0.6	0.5	0.3	–0.5	0.9	0.0
France	0.8	0.5	–0.1	0.1	0.7	0.7
Germany	. .	0.4	. .	–0.3	. .	0.1
Greece	1.2	0.9	0.2	0.1	1.4	1.0
Hungary	. .	0.0	. .	–1.2	. .	–1.2
Iceland	1.6	1.2	0.6	1.0	2.1	2.2
Ireland	1.0	1.5	–0.3	1.2	0.7	2.7
Italy	0.9	0.3	0.0	–0.6	1.0	–0.3
Japan	1.2	0.7	0.0	–0.1	1.2	0.6
Korea	2.6	1.5	0.2	0.2	2.8	1.7
Luxembourg	0.6	1.1	0.5	2.2	1.1	3.3
Mexico	. .	2.7	. .	2.1	. .	4.8
Netherlands	1.2	0.6	0.9	1.0	2.1	1.6
New Zealand	1.2	1.4	0.7	0.3	1.9	1.6
Norway	0.8	0.4	0.6	0.5	1.4	0.9
Poland	0.7	0.9	. .	–1.0	. .	–0.1
Portugal	1.0	0.5	0.1	–0.2	1.1	0.3
Slovak Republic	0.8	0.9	. .	0.1	..7	1.1
Spain	1.2	0.9	0.2	0.5	1.0	1.3
Sweden	0.5	0.3	0.1	–0.6	0.6	–0.3
Switzerland	0.8	0.7	0.5	–0.2	1.3	0.5
Turkey	2.8	2.7	–1.1	–1.8	1.7	0.9
United Kingdom	0.6	0.4	0.2	–0.2	0.8	0.2
United States	1.3	1.0	0.6	0.2	2.0	1.2
OECD average[3]	1.3	0.9	0.2	–0.1	1.5	0.9
European Union[4]	0.8	0.5	0.1	0.0	0.9	0.5

1. Data refer to total labour force and population aged 15 and over.
2. 1991-2000 for Germany, 1992-2000 for Hungary and Poland, 1994-2000 for Slovak Republic.
3. Weighted average. Not included Czech Republic, Germany, Hungary, Mexico, Poland and Slovak Republic.
4. Weighted average. Not included Germany.

Source: OECD, *Labour Force Statistics* (Part II).

points by 2050.[10] Hours worked are declining both because the incidence of part-time work is generally rising and because older workers have a much higher tendency to work part-time. This is only partly offset by lower unemployment rates of older workers, and the fact that educational attainment is rising over time, and better educated persons tend to have higher participation rates. Overall, aggregate participation could fall by 9 percentage points. Of course, insofar as falling hours worked represents a rational trade-off between work effort and demand for

Figure 1.5. **Participation rates by age and gender groups in OECD countries**
2003



1. Data refer to 2002.
Source: OECD, Employment Outlook database.

leisure, welfare could rise even if the growth of production of material goods and services is slower. But this also assumes that access to retirement benefits and the structure of the personal tax system, especially high marginal tax rates does not distort the work/leisure trade-off (see Chapter 2).

A *lowering of the aggregate participation rate by 9 percentage points would reduce the growth in real GDP and real GDP per capita* to, respectively, about 2 per cent and 1½ per cent from the 2020s onwards, under the assumption of labour productivity growth of 1¾ per cent[11] (the average of the last 30 years). This compares with growth of real GDP of nearly 3½ per cent and growth of real GDP per capita of 2¼ per cent in the 1990s.[12] Even if the good labour productivity performance of the 1990s (on average 2 per cent per year) could be sustained indefinitely, then long-term annual growth rates would be only ¼ percentage point higher, which still would fall markedly short of the income gains experienced in recent years. Hence, even on an optimistic assessment of "business as usual", material living standards are unlikely to rise as quickly in the next few decades as they have in the past decade. The impact of ageing on productivity is not clear cut. With fewer workers, fewer capital goods would be needed to equip them. But with labour scarcer, firms may opt for more capital-intensive modes of production.

More recent work by Banks (2004) calculates the impact on GDP for different productivity growth scenarios. With an annual productivity growth rate of 2 per cent (the high productivity performance of the 1990s), Australians would be better off in cumulative GDP terms by around A$ 5 700 billion by 2050-51 relative to the assumed base-case growth rate of 1¾ per cent. This equates to an average productivity dividend of around a one quarter of a million dollars per person over this period. If Australia were to record only the average productivity growth rate that prevailed in the two decades prior to the "miracle" years, the outcome is far less satisfactory. In that case, by 2050-51 Australia would be cumulatively worse off relative to the base case by around A$ 2 300 billion (Table 1.5). Evidently, the pursuit of higher productivity is essential for continuing significant increases in material living standards.

The consequences on government finances

In a "business as usual" scenario, not only would the economy grow more slowly than currently, but mounting age-related public expenditures would raise budget pressures. The purely fiscal implications of public pensions are not particularly preoccupying by international comparison in part because Australia's demographic structure is less unfavourable than elsewhere,[13] but mainly because the flat rate, means-tested pay-as-you-go public Age Pension element is small relative to average wages, guaranteeing a pension of 25 per cent of male total average weekly earnings.[14]

Retirement income comprises three main components in Australia. The targeted *age pension* provides a safety net and is financed out of general taxation.

Table 1.5. **The GDP effects of different productivity growth scenarios**

	Productivity growth scenarios, per annual rate after 2002/03		
	2.05 %	1.75 %	1.62 %
Average growth in GDP *per capita*[1]			
1990s	2.15	2.15	2.15
2000s	2.06	1.85	1.76
2010s	1.79	1.49	1.36
2020s	1.57	1.27	1.14
2030s	1.73	1.43	1.30
2040s	1.87	1.57	1.44
	In Australian dollars		
Real GDP			
Per capita in 2050/51	88 073	76 467	71 915
Increase in 2003/04	50 899	39 293	34 741
Additional from 2003/04 to 2050/51 (billion)	5 651	. .	–2 279

1. GDP is in 2001/02 prices.
Source: Preliminary Productivity Commission calculations.

The second is distributions from pension funds (called superannuation funds in Australia) financed by compulsory employment related contributions mandated by the *Superannuation Guarantee Act* and paid by employers. And the third is *voluntary savings*, which include sums voluntarily placed in superannuation funds by employees, the purchase of owner-occupied housing and other private savings. The latest estimate shows that 98 per cent of employees with leave entitlements and 72 per cent of all employees are covered by superannuation (Australian Bureau of Statistics, 2001). Insofar as voluntary saving is concerned, around 27 per cent of employees already receive employer contributions (including salary sacrifice) greater than the Superannuation Guarantee level, while 20 per cent of all employees make voluntary post-tax contributions (Bingham, 2003). The fact that private saving amounts for an increasing part of total retirement income suggests that the Australian government will avoid the fiscal burden associated with old-age pensions that almost all other countries have to deal with. Old-age pension expenses are projected to increase from 3 per cent of GDP in 2000 to 4.6 per cent of GDP in 2050 (Casey *et al.*, 2003). Although this represents a significant increase, Australia is well placed with other OECD-countries in relation to meeting its age-pension obligations (Table 1.6). Still, the ageing of the population may have other impacts on expenditure such as health and aged care services, discussed in the next section.

The biggest pressure on public finances is expected to come from public health and long-term care spending. Across Australian health services, average annual expenditures per person on those aged 65 and over are around four times more than on those

Table 1.6. **Projections of age-related spending, 2000-2050**[1]

Levels in per cent of GDP, changes in percentage points

	Total age-related spending		Old-age pensions		"Early retirement" programmes		Health care and long-term care		Child/Family benefits and education	
	Level 2000 (1)	Change 2000-50 (2)	Level 2000 (3)	Change 2000-50 (4)	Level 2000 (5)	Change 2000-50 (6)	Level 2000 (7)	Change 2000-50[2] (8)	Level 2000 (9)	Change 2000-50 (10)
Australia	**16.7**	**5.6**	**3.0**	**1.6**	**0.9**	**0.2**	**6.8**	**6.2**	**6.1**	**-2.3**
Austria[2]	[10.4]	[2.3]	9.5	2.2	. .	. .	[5.1]	[3.1]	. .	. .
Belgium	22.1	5.2	8.8	3.3	1.1	0.1	6.2	3.0	6.0	-1.3
Canada	17.9	8.7	5.1	5.8	. .	. .	6.3	4.2	6.4	-1.3
Czech Republic	23.1	6.9	7.8	6.8	1.8	-0.7	7.5	2.0	6.0	-1.2
Denmark[3]	29.3	5.7	6.1	2.7	4.0	0.2	6.6	2.7	6.3	0.0
Finland	19.4	8.5	8.1	4.8	3.1	-0.1	8.1	3.8	. .	. .
France[4]	[18.0]	[6.4]	12.1	3.9	. .	. .	[6.9]	[2.5]	. .	. .
Germany	[17.5]	[8.1]	11.8	5.0	. .	. .	[5.7]	[3.1]	. .	. .
Hungary[5]	7.1	1.6	6.0	1.2	1.2	0.3	. .	. .	. .	. .
Italy	[19.7]	[1.9]	14.2	-0.3	. .	. .	[5.5]	[2.1]	. .	. .
Japan	13.7	3.0	7.9	0.6	. .	. .	5.8	2.4	. .	. .
Korea	3.1	8.5	2.1	8.0	0.3	0.0	0.7	0.5	. .	. .
Netherlands[6]	19.1	9.9	5.2	4.8	1.2	0.4	7.2	4.8	5.4	0.0
New Zealand	18.7	8.4	4.8	5.7	. .	. .	6.7	4.0	7.2	-1.3
Norway	17.9	13.4	4.9	8.0	2.4	1.6	5.2	3.2	5.5	0.5
Poland[5]	12.2	–2.6	10.8	–2.5	1.4	–0.1	. .	. .	. .	. .
Spain	[15.6]	[10.5]	9.4	8.0	. .	. .	[6.3]	[2.5]	. .	. .
Sweden	29.0	3.2	9.2	1.6	1.9	–0.4	8.1	3.2	9.8	-1.2
United Kingdom	15.6	0.2	4.3	–0.7	. .	. .	5.6	1.7	5.7	-0.9
United States	11.2	5.5	4.4	1.8	0.2	0.3	2.6	4.4	3.9	-1.0

Table 1.6. **Projections of age-related spending, 2000-2050**[1] (*cont.*)

Levels in per cent of GDP, changes in percentage points

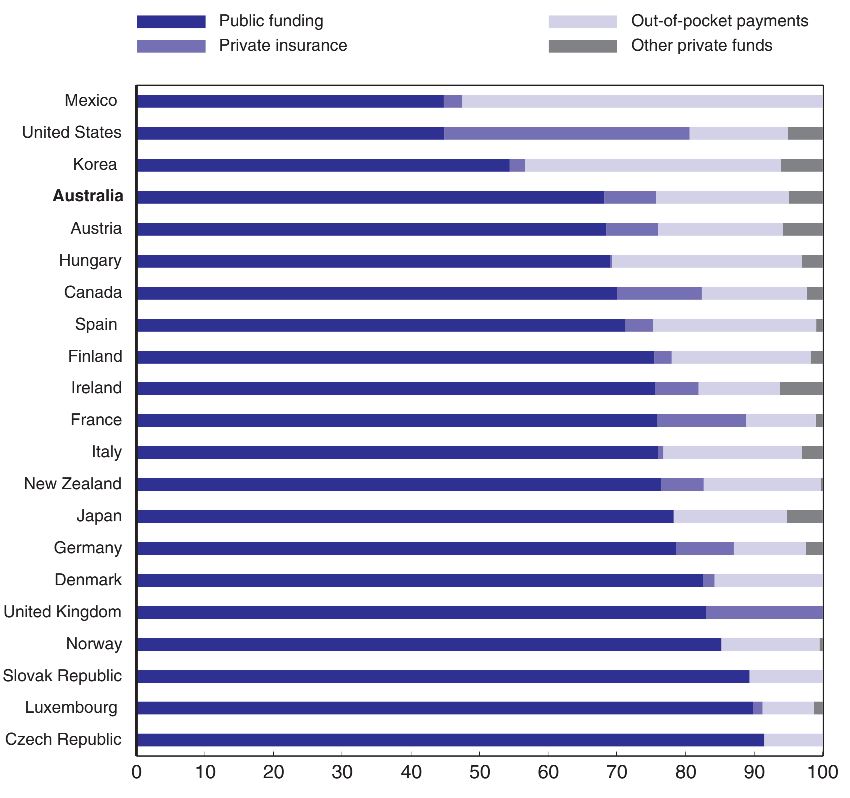
	Total age-related spending		Old-age pensions		"Early retirement" programmes		Health care and long-term care		Child/Family benefits and education	
	Level 2000 (1)	Change 2000-50 (2)	Level 2000 (3)	Change 2000-50 (4)	Level 2000 (5)	Change 2000-50 (6)	Level 2000 (7)	Change 2000-50[2] (8)	Level 2000 (9)	Change 2000-50 (10)
Average of countries above[7]	21.2	5.8	7.4	3.4	1.6	0.2	5.9	3.1	6.2	-0.9
Portugal[8]	15.6	4.3	8.0	4.5	2.5	-0.4	..	..	..	..

1. Data for health care shown in parenthesis are drawn from EPC (2001). They are the result of an EC exercise using a common methodology for all countries. The projections are based on the same macroeconomic assumptions as in OECD (2001) Table 1.8. These health and long-term care projections assume that costs per capital rise in line with productivity/wages. They do not allow for technological change or other non-age-related factors.
2. Total pension spending for Austria includes other age-related spending which does not fall within the definitions in columns 3-10. This represents 0.9 per cent of GDP in 2000 and rises by 0.1 percentage point in the period to 2050.
3. Total for Denmark includes other age-related spending not classifiable under the other headings. This represents 6.3 per cent of GDP in 2000 and increases by 0.2 percentage points from 2000 to 2050.
4. For France, the latest available year is 2040.
5. Total includes old-age pension spending and "early retirement" programmes only.
6. "Early retirement" programmes only include spending on persons 55+.
7. Sum of column averages. OECD average excludes countries where information is not available and Portugal where the data are less comparable than for other countries.
8. Portugal provided an estimate for total age-related spending but did not provide expenditure for all of the spending components.

Source: OECD and EPC (2001).

under 65, and rise to between six to nine times more for the oldest groups (Banks 2004). In addition, and possibly even more importantly, there will be growing demand for health services induced by the emergence and diffusion of new medical technologies, which interact with the ageing effect and is compounded by the high income elasticity of demand for health care.[15] Although some of the new technologies may lower the cost of health services, long-term trends indicate that this is by far outweighed by the overall expansion of treatment and rising unit costs of some technologies, notably pharmaceuticals.[16] Spending more is not necessarily a problem, if additional benefits are perceived to outweigh the extra costs. But since 70 per cent of Australian health spending comes from the public purse, the government has an interest in ensuring efficient service delivery, and in promoting productivity gains (Figure 1.6).

Figure 1.6. **Distribution of health financing**
Shares of total health expenditure, 2001



Source: OECD (2004), Health Database.

To a large extent because of the rapidly increasing number of older people, health and aged care spending is set to increase substantially and is projected by the Government[17] to rise by as much as 5 to 6 percentage points of GDP by the middle of the century. There are four major categories of health expenditure in Australia; hospital, medical services (Medicare), pharmaceutical and other expenditure, and the effects of population ageing vary across these different components of health care. They are profound in hospitals and pharmaceuticals, because these services have cost profiles that rise most steeply with age. Average costs per person for a male aged 65-74 in the Pharmaceutical Benefits Scheme (PBS) are more than 18 times those for a male aged 15-24. Hospital costs follow a similarly steep age-profile, while Medicare costs also rise with age, though less steeply (Banks, 2004). With rapidly increasing numbers of the old, the upward-sloping age profile of health expenditure suggests that ageing will increase health spending significantly. As a result, the *Intergenerational Report* projects that the federal Government's budget balance would deteriorate from small surpluses currently to a deficit of 5 per cent of GDP in the early 2040s on unchanged policies.

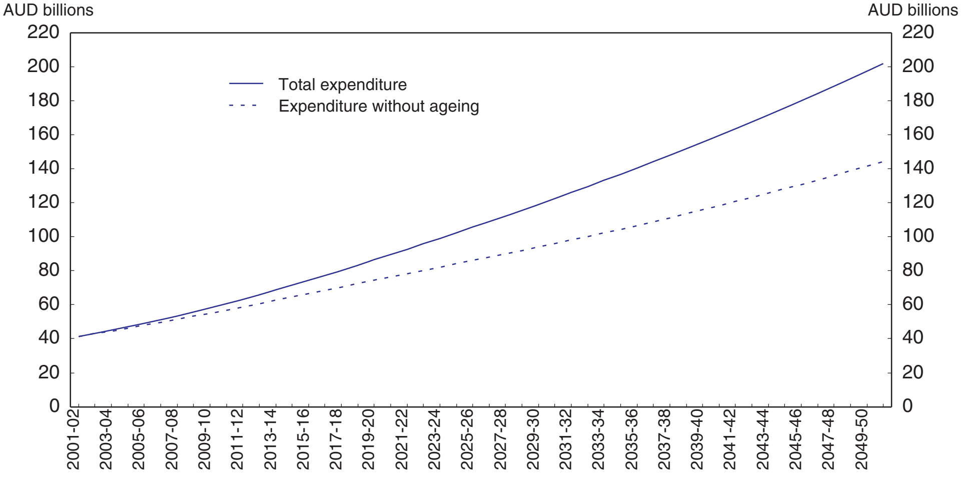
These estimates are significantly higher than those reported by other OECD countries that have official projections. One of the pressures highlighted by the *Intergenerational Report* is the continuing high rates of growth in the PBS, reflecting the increased availability of new and more expensive drugs, which increase the total volume of prescriptions and cost to the government per prescription. The share in GDP of PBS spending is projected to rise by as much as 3 percentage points[18] by 2041-42, to around 3½ per cent of GDP.

Indeed, in the past, non-demographic factors,[19] rather than population growth or changes in the age structure of the population, have been the key driver of real health spending over the past decade. Between 1989-90 and 2000-01, the non-demographic part of health spending grew by 3.2 per cent in real terms, whereas health spending attributable to population and age structure grew by "only" 1.2 per cent and 0.5 per cent, respectively. Technological advances account for a significant proportion of non-demographic growth in health spending per person (Commonwealth, 2002). According to the *Intergenerational Report*, Commonwealth (as opposed to state, territory and private) spending on health is projected to increase to 4.3 per cent of GDP by 2011-12 and to 8.1 per cent of GDP by 2041-42. In this scenario, real non-demographic Commonwealth health spending is set to rise by 2.6 per cent per year over the next four decades, *i.e.* by an annual 0.6 percentage points less than the last decade. Clearly, the projections are very sensitive to the non-demographic growth rate used. Assuming the annual underlying growth (real per person age-adjusted) in health spending to be 3 per cent increases the endpoint in 2040-41 from 8.1 per cent of GDP to 9.7 per cent of GDP. Such growth rates of underlying health costs are not only high in themselves, but also appear to be higher than those assumed by other countries in their long-term projections. Nevertheless, they do reflect a continuation of long-established trends that show no signs of slowing. In the health area, at least, technological progress does not seem to result in lower costs.

Recently, Banks (2004), reporting on preliminary projections from the Productivity Commission, estimates that overall health care spending by all Australian governments (excluding aged care and capital consumption) will increase from 5.8 per cent of GDP in 2000-01 to 11.1 per cent by 2050-51. The "ageing-effect" results in health costs being one-third higher in 2050-51 than in a scenario where the age structure from 2001 is preserved. Over the entire period to 2050-51, ageing of the population accounts for an additional A$ 1.2 trillion in government-funded spending (Figure 1.7). As in the *Intergenerational Report*, spending on hospitals and pharmaceuticals will experience the biggest increase (Table 1.7). Reflecting the magnitude of its contribution through the PBS and funding for public hospitals, the Australian government is estimated to account for over 3.9 percentage points of the 5.3 percentage points increase in health costs as a share of GDP over this period. These projections of health spending are significantly higher than those reported by other OECD countries that have official projections. However, other countries do not typically assume increases in real unit costs of delivering health care: they generally project only the purely age-related factors.

Another budgetary impact of population ageing is the prospective increases in aged care expenditure. The government plays the leading role in planning and funding residential aged care and a range of community care services. The Commonwealth

Figure 1.7. **How big is the ageing effect for health care costs**
Australian dollars billions



Source: Productivity Commission.

Table 1.7. **Where are the biggest cost pressures in health**
Per cent

Area of health	Share of GDP		Increase to 2050/51 due to ageing
	2001/02	2050/51	
Hospital	2.71	5.00	45.3
Medicare	1.27	1.93	19.7
Pharmaceutical benefits scheme	0.68	2.52	52.1
Other expenditure	1.14	1.67	15.4
Total	5.79	11.12	36.4

Source: Preliminary Productivity Commission calculations.

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.

To prevent public financing from going into chronic deficit in the longer term, public services would need to be cut or taxes be raised by 5 per cent of GDP to finance in the 2040s the same level of access to publically funded services as those provided today. Neither "solution" enjoys popular support. An alternative would be to implement economic policies which raise productivity growth, including in health service delivery and participation rates for the population of working age to compensate for falling aggregate participation rates. Such policies should be assisted by reforms which aim at greater efficiency in the provision of health and aged care services. Appropriate policies are discussed in the following chapters.

Enhancing productivity and participation

If past experience is anything to go by, measures to enhance labour productivity appear particularly promising to maintain growing output and incomes (Figure 1.8). Furthermore, productivity measures consistently show that output per person-hour in Australia is well below that in leading countries (US and some European countries). This suggests there is further scope for catch-up. Policies most prominent in this respect encompass those which foster competition in product markets (discussed in Chapter 3 below) and thus promote the growth of multifactor productivity and the wider use of new technologies. Another avenue to higher economic growth is rising employment. International comparisons of structural unemployment, overall employment ratios and participation rates suggest that there is ample room for raising labour inputs in Australia. Hence, labour market and welfare system reforms are needed which reduce structural unemployment, and encourage continued attachment to the labour force later in life (see Chapter 4). Improved incentives to join the labour force in the first place and stay in it through better job

Figure 1.8. **Decomposition of per capita income**

Percentage point differences in PPP-based GDP per capita relative to USA, 2002

1. Productivity is measured on a per-employee basis.

Source: OECD, Productivity Database (September 2004).

prospects for discouraged workers in general and the provision of jobs which match with the aspirations of older workers would also help.[20]

The effects of higher labour force participation on output and government finances

Higher output

Rising participation rates would have a powerful impact on GDP in future. Gruen and Garbutt (2003) examine the output implications of a *sustained* rise in Australian labour force participation over the next forty years, using the Government's IGR as the baseline projection. The projection assumes (the mechanism is not spelled out) that for each age- and gender cohort, Australian participation rates would rise gradually over the next twenty years to reach the 80th percentile of the distribution of current participation rates across the OECD[21] and would remain at these higher values thereafter. In the early 2040s, the aggregate participation rate would be 5 to 6 percentage points higher than in the IGR projections. This rather ambitious and optimistic participation scenario would imply that aggregate Australian participation rates instead of falling consequent upon population ageing, would rise gradually for most of the next twenty years, but decline somewhat thereafter. As a result of these projections, the *level* of real GDP would be about 9 per cent higher than projected by the IGR in about twenty years' time, and would remain roughly 9 per cent higher for the following twenty years. About one-third of the higher output would be the result of higher labour force participation of 45 to 64 old male workers, and between one-sixth to one quarter would ensue from higher participation of people aged 65 and over.

A lower fiscal gap

An important policy aspect of faster economic growth generated through greater labour inputs rather than through higher productivity growth is the latter's lower positive impact on the government budget balance. This is so because economy-wide productivity increases are highly likely to generate corresponding general real wage increases in the entire economy, including in the public sector. If productivity growth is higher in all sectors of the economy, including the government-funded service sectors, then higher wages paid in the public sector will be matched by higher productivity and will result in a (small) reduction in the projected fiscal deterioration. The projections of Gruen and Garbutt (2004) result in a narrowing of the fiscal gap relative to GDP by a ½ percentage point by 2040 for labour productivity growing ½ percentage point faster than in the IGR baseline case (hence 2¼ per cent instead of 1¾ per cent). If, however, productivity growth is higher only in sectors other than government-funded services, then there will be no productivity offset for higher real government wages. As a consequence, the decline in the fiscal gap relative to the IGR over the next forty years or so may only be of the order of

¼ per cent of GDP. Measuring productivity gains in the government-funded service sector is notoriously difficult, but most observers find that they are low.

Conversely, additional output growth from higher labour inputs raises tax revenues without creating higher government expenditures. Higher labour force participation also implies that fewer people will draw on age and disability support pensions. Accordingly, projections of the fiscal implications of higher participation rates result in a much more favourable budget balance than those based on plausible additional productivity gains.[22] While the IGR projects a fiscal gap induced by population ageing of 5 per cent of GDP in about forty years from now, age-and-gender cohort participation rates equivalent to the top one-fifth of the current OECD distribution would more than eliminate the component of the fiscal gap arising from demographic change. However, most of the fiscal gap associated with the IGR projection – between three-fifth and four fifths of it depending on assumptions – arises from growth in health spending not related to population ageing. Nevertheless, with income levels significantly higher as a result of a policy-induced increase in labour force participation relative to the baseline scenario (and possibly higher labour productivity growth), higher costs for health and aged care services would be more easily affordable.

The challenge of sustainable water supply

Another challenge is the management of water in a sustainable way, as Australia is a relatively dry continent, in which water scarcity is exacerbated by climate variability, including periodic drought. The drought that began in 2002 proved to be one of the worst and longest-lasting on record. Even by late 2004, rainfall in the worst affected areas had not returned to normal. The drought has resulted in a very large drop in agricultural production, and severe water restrictions for householders in several Australian cities. Water is a state property in Australia, and entitlements to use water were traditionally tied to land. Around three-quarters of the water used goes to irrigation in agriculture, with rapid growth of population and activity in urban areas also increasing the level of water use.

In the past, water supply was heavily subsidised, encouraging excessive use and inefficient allocation, in spite of its scarcity. Mounting competition for water resources is putting pressures on the environment, as flow levels in rivers are reduced and irrigation-induced soil salinity mounts. However, growing scarcity has engendered substantial water policy reforms since the 1980s, especially the introduction of a *National Agenda for Water Reform* in 1994-95, whereby all jurisdictions committed themselves to implementing a range of market-based measures. Chapter 3 discusses recent policy developments in this area.

Water reform aims at increasing efficiency in water allocation and use, while at the same time striking a better balance between consumption and environmental needs in stressed rivers. It is thus an attempt to integrate microeconomic policy reforms with environmental ones. Accordingly, prices are required to reflect the full economic cost of resources, cross-subsidies are to be removed and other subsidies are to be made transparent. Trading in water entitlements seeks to improve allocative efficiency. The agenda also includes the specific provision of water for the environment, making water services providers operate on a commercial basis and separating regulatory functions from provision, as well as limiting new investment in rural water supply to economically viable and ecologically sustainable projects.

Progress in implementing water reform has been uneven across water-use categories and between states. Pricing reform in urban areas is generally well-advanced, but has been proceeding much more slowly in rural areas, in particular for irrigation pricing. Full cost recovery is also a stated objective for rural water, but has been interpreted in a narrow sense, as it excludes the costs of existing infrastructure. Considerable progress has been made in establishing the basic requirements for markets in water rights. Indeed, limited water trading occurs in most States as standardised contracts are not available yet and many states have restrictions on trading outside the irrigation district where the water is currently used. These constitute barriers to effective trading and to moving water to its most productive use. Reforms in this area, as in several others, raise issues of ensuring level playing fields between the States and Territories – and indeed achieving agreement on what constitutes a level playing field. The challenges here are more political than economic.

Notes

1. See Lu and Hedley (2004). During the three years from 2001 to 2003, the slump in net exports is estimated to have subtracted (cumulatively) up to 6 percentage points from economic growth.
2. Fiscal years begin 1 July.
3. The current period of improving terms of trade began in 1999. They are now at their highest level in 28 years.
4. See the introduction of Chapter 3 below.
5. Public infrastructure projects will be undertaken in the areas of transportation, electricity, water, schools, hospitals and public housing, although the bulk of them only after FY 2004-05. Many of these projects will be undertaken and operated by the private sector under Public-Private-Partnerships.
6. When comparing productivity levels, it has to be taken into account that in a number of European countries in particular high productivity levels partly reflect the fact that low-skilled jobs have been priced out of the market, due to a combination of tax and benefit systems, employment protection and collective bargaining arrangements, with a corresponding chronic lack of employment opportunities for low-skilled workers.
7. This cohort includes Australian residents born during Australia's "*baby boom*", generally considered to have started in 1946 and ended some time between 1961 and 1965.
8. Commonwealth of Australia (2002), *Intergenerational Report* 2002-03.
9. The "conventional" working-age group is 16 to 64. In the age group 16-19, many people are in school (in particular in western societies where schooling is compulsory until 18). Then, when measuring the dependency ratio (those withdrawing resources at retirement with respect to those paying in) it could be argued that a better measure of the pressures is to use in the denominator those aged 20 to 64.
10. These projections largely corroborate the findings in the Commonwealth Government's *Intergenerational Report* (2002).
11. Report 2002-03.
12. While assuming the same long-term labour productivity growth, the latest growth scenario of the Productivity Commission (Banks 2004) is a little more pessimistic, arriving at 1¼ per cent per capita GDP growth as from the 2020s.
13. See the Chapter 4 of the 2003 OECD *Economic Survey of Australia*.
14. To encourage voluntary contributions to the superannuation system to top up retirement incomes, a co-contribution of the government was enacted in 2003 for low and middle income earners. Under this measure, the Government provides a matching co-

contribution of up to A$ 1 000 per year towards the superannuation savings of eligible people who make personal contributions to superannuation.

15. However, when examining health care costs, it should not be forgotten that increased consumption of health services provide benefits such as higher life expectancy and quality of life.
16. There is the view that improved medical treatments and better medication may reduce disability rates, which would lower medical costs, thus offsetting part of the ageing-induced health cost increase. See for example Richardson and Robertson (1999). However, most researchers appear to expect only minor cost reductions from such effect.
17. The Intergenerational Report presents detailed projections of government expenditures in the broad areas of health and aged care, social safety net payments to individuals, education and government superannuation spending. For other areas of government spending, the IGR assumes that expenditure remains a constant 8.3 per cent share of GDP over the projection period.
18. The IGR projections of health spending assume that measures in the 2002-03 Budget to slow the growing costs of the Pharmaceutical Benefits Scheme would be in place over the projection period. After initially being blocked by the Senate, the co-payment proposition was passed in 2004, to take effect from 1 January 2005.
19. Real per person age-adjusted growth.
20. See Encel (2003).
21. The participation benchmark excludes a number of OECD countries (Korea, Mexico, Turkey and Slovak Republic) with very low shares of social expenditures in GDP as workers in these countries face much stronger incentives to stay in work later in life than in Australia. Hungary is excluded because of data problems and Luxembourg because of its participation measure of more than 100 per cent, reflecting large numbers of workers who commute daily to Luxembourg from neighbouring countries.
22. See Gruen and Garbutt (2004).

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Annex 1.A1

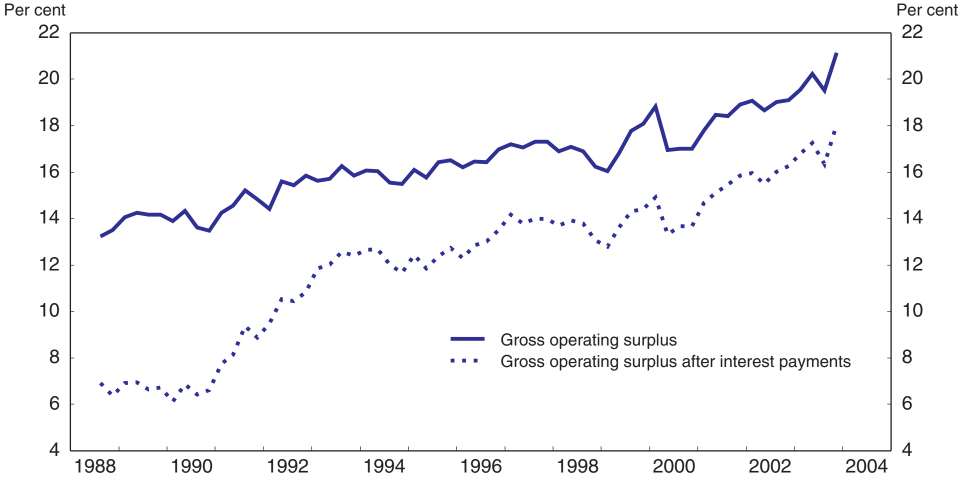
Recent trends, outlook, risks and vulnerabilities

Recent trends and economic prospects

The main features of recent developments and economic prospects are the following:

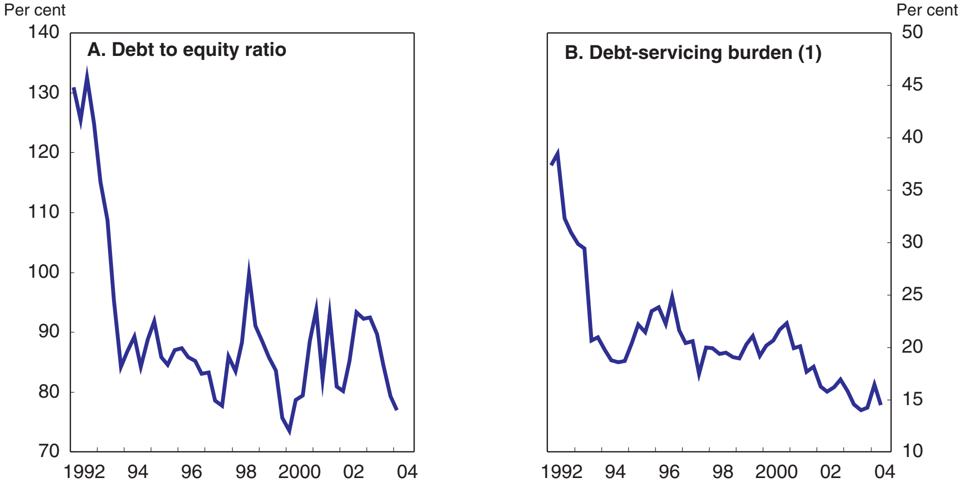
- *Private consumption* was boosted by solid growth in disposable incomes from substantial real wage and employment gains. Household spending power was further supported by rising household wealth from higher house prices since the late 1990s,[1] which allowed additional consumption financing *via* mortgage equity withdrawals,[2] whereby households use the increased value of their property as collateral to borrow at rates of interest that are substantially lower than those of unsecured loans. In consequence, the growth of consumption outpaced that of incomes, leading to a negative household saving ratio[3] as from 2002. Despite consumer confidence at a record-high and the 2004-05 Commonwealth budget providing additional social benefit payments and income tax cuts (see Chapter 2), household consumption is expected to slow somewhat, along with the easing in house prices since late 2003. It nevertheless is likely to remain a major driver of domestic demand, in spite of the easing in house prices since late 2003.
- *Private non-residential investment* grew briskly as corporate profitability is at record levels Figure 1.A1.1), while both low corporate gearing and debt-serving costs are very low Figure 1.A1.2). With business confidence very high, an improved environment for raising equity finance, indications of capacity constraints in the resources sector, in particular mining, and large investment projects in the pipeline,[4] the prospects for business investment remain favourable. This is confirmed by the positive investment outlook from the ABS Capital Expenditure Survey, which reports upward revisions in investment intentions, especially in the mining sector.
- *Dwelling investment* activity remained strong in 2003-04, having contributed heavily to riding out the recent adverse external shocks and the drought. It was supported not only by the factors which have stimulated private consumption such as robust disposable incomes and low credit interest rates (mortgage interest rates have approximately halved since the second half of the 1980s), but also by easier access to housing finance from new financial instruments, expectations of capital gains on housing assets and the subdued performance of the equity market. This was amplified by the subsidisation of first-time home buyers[5] and the possibility of "negative gearing"[6] by property investors. Indications of falling house prices during the first half of 2004, a steep fall of housing loan approvals to both owner-occupiers and investors from their peak in October 2003, and fall-

Figure 1.A1.1. **Corporate profitability**
As a percentage of GDP



Source: Australian Bureau of Statistics.

Figure 1.A1.2. **Corporate gearing**



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

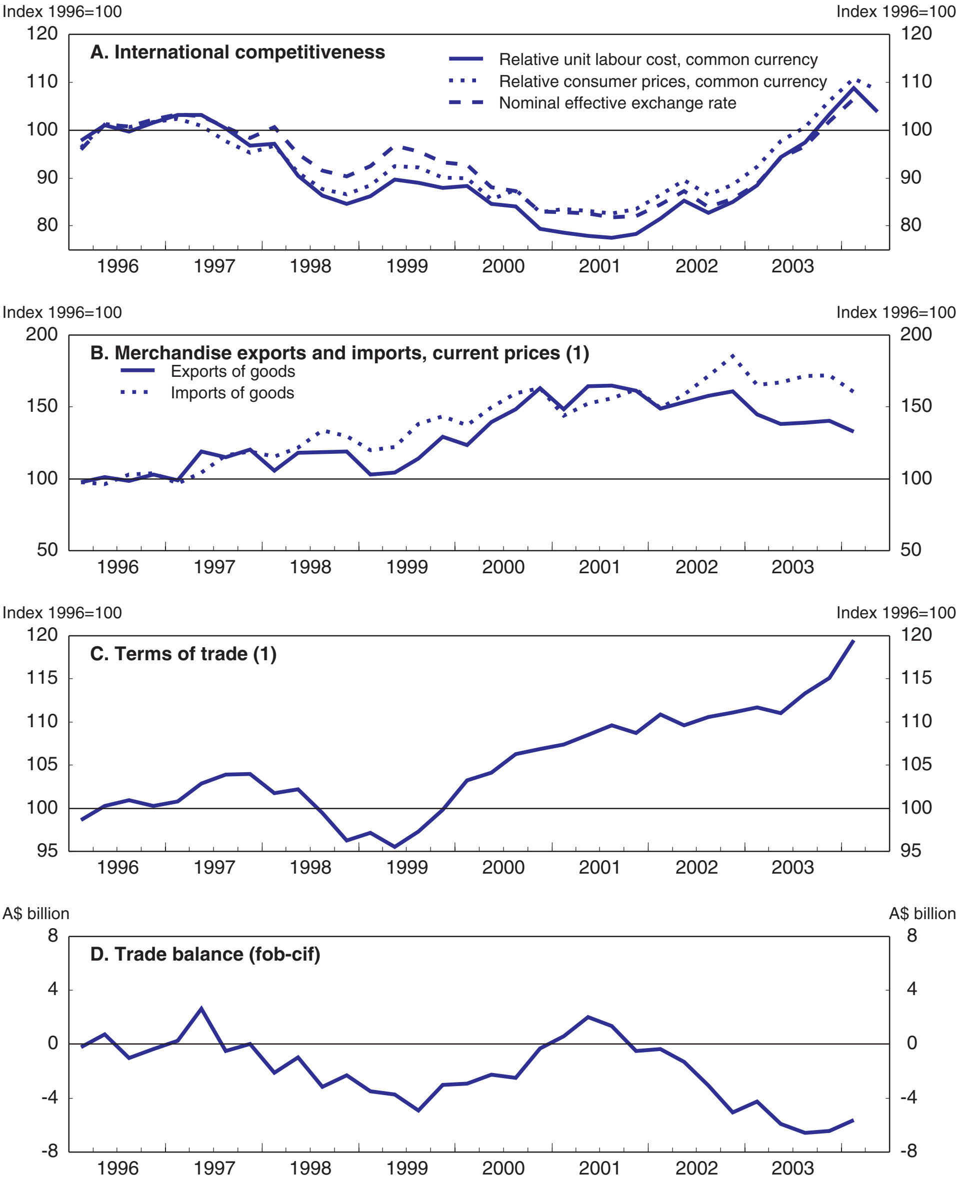
ing building approvals suggest that dwelling investment is already about to cool off. With the RBA's two cash rate hikes in late 2003 expected to be followed by further, albeit mild policy interest rate increases in the direction of a cyclically neutral cash rate, dwelling investment is expected to fall, but not steeply in 2005-06.

- *Exports* (measured at current prices) continued to be sluggish for the third year in a row, initially reflecting weak export markets, but later on also the drought-induced slump in farm exports and the marked effective exchange rate appreciation (Figure 1.A1.3). At the same time, *imports* of goods and services soared during the past two years, driven by buoyant domestic demand and the strong Australian dollar. Accordingly, and notwithstanding the sizeable terms-of-trade gains, the current external deficit widened to around 6 per cent of GDP in 2003. With the international economy picking up, the impact of the drought waning, and the housing cycle turning around, there should be less reliance on domestic demand and a smaller drag from net exports. Together with the expected further improvement in the terms of trade, the current balance deficit should thus narrow, from 5¾ per cent of GDP in mid-2004 to 4½ per cent by 2006.

- *Inflation* in late 2002 and early 2003 was temporarily above 3 per cent, largely reflecting higher oil and drought-induced food prices, but also higher house-purchase costs. However, both headline and underlying inflation are now running at around 2¼ per cent, fully consistent with the objective of keeping inflation between 2 and 3 per cent, on average, over the cycle. In spite of high capacity utilisation and around 25-year record-low unemployment, wage moderation, improved labour productivity and the effect of previous currency appreciation should keep inflation at bay. The housing slowdown will take a lot of steam out of that source of price pressures. In addition, there will also be a dampening of price increases from the reduction in tariffs on clothing and motor vehicles as from beginning 2005. All this is in line with medium-term inflation expectations of financial market participants, as implicit in the interest differential between indexed and non-indexed bonds.

- *Monetary policy* actions have been directed at guarding against any upward creep in inflation. The conditions for price stability were improved further by the RBA's increase in the *cash rate* in two moves from 4¾ to 5¼ per cent in November and December 2003, on the grounds that there was a need to reduce the degree of monetary stimulus imparted on the economy (Table 1.A1.1). The cash rate is now 100 basis points above its trough of 4¼ per cent during the December 2001 to May 2002 period, hence still below its average of the past decade. In view of the continued strength in lending to both households and businesses (Table 1.A1.2), monetary policy still appears mildly accommodative. A further gradual tightening of monetary policy is projected for 2005, which should bring the cash rate back to a "neutral" level, estimated to be in the 5½ to 6 per cent range.[7] Given the high leverage of households (the debt-to-assets ratio), the impact of monetary policy on the behaviour of borrowers should be bigger than in the past, especially as most of the household debt is at floating rates. This should contribute to a further moderation in household credit growth which was at an annualised rate of 16.4 per cent over the first half of 2004, down from the 21.3 per cent growth in the preceding half-year. Such a high pace of credit growth appears unsustainable in the longer run in view of households' capacity to service debt.

Figure 1.A1.3. **Foreign trade indicators**



1. Seasonally adjusted balance of payments basis.

Source: Australian Bureau of Statistics and OECD.

Table 1.A1.1. **Changes in official interest rates**
1994-2204

	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
5 November 2003	+0.25	5.00
3 December 2003	+0.25	5.25

Source: Reserve Bank of Australia, *Bulletin*.

- *Fiscal policy* decisions announced in the 2004-05 *Commonwealth Budget* include personal income tax cuts, additional payments to families, and increased spending directed at aged care and retirement savings, while keeping the government finances in a small surplus over the projection period (see Chapter 2). With state budgets expected to be mildly expansionary, fiscal policy in general is projected to be supportive of activity over the projection period.

Risks and vulnerabilities

Risks to the outlook

- There are risks to the otherwise bright economic outlook. The recovery of farm production and exports from the drought in 2002-03 could be interrupted if the disappointing rainfall in the first half of 2004 were to continue. Moreover, higher

Table 1.A1.2. **Financial aggregates**
Per cent

	Twelve months to:			Three months[1] to:		
	December 2003	June 2004	September 2004	March 2004	June 2004	September 2004
Total credit	15.1	14.9	13.8	10.3	15.1	12.1
Personal	15.5	14.0	12.8	13.9	11.2	13.0
Housing	20.8	19.8	17.7	17.7	16.7	13.0
Business	7.7	8.5	8.7	-0.3	14.0	10.7
M3	13.6	11.6	9.7	9.6	7.2	7.6
Broad money	13.2	11.1	9.1	8.4	7.2	6.7
Memorandum item:						
GDP	7.3	8.2	. .	5.7	7.9	. .

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

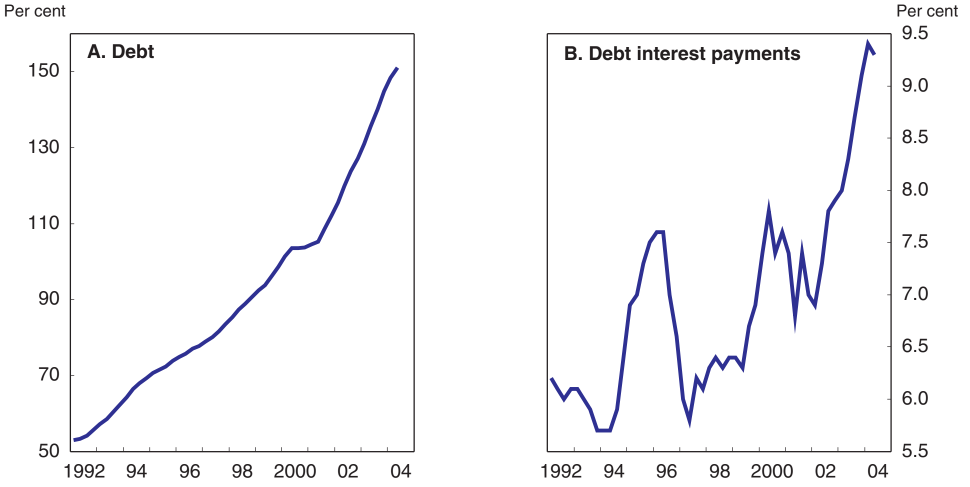
oil prices may raise inflation and thus depress real incomes worldwide, with a downside risk for exports and GDP. However, the direct effect of higher oil prices on the terms of trade would be relatively small as Australia is a (small) net importer of oil, but a net energy exporter because of large gas and coal exports. The price of gas is linked by contracts to that of oil, and there is a medium-term tendency of coal prices to follow general energy price trends. Hence a sustained rise in oil prices sets in train a net transfer of income from international consumers of gas (and with a lag, of coal) to Australian producers.[8] And given the strength of domestic demand and firming labour market conditions, there is a risk of higher consumer price inflation once the effect of the earlier currency appreciation diminishes.

Household indebtedness

A key risk to the Australian outlook arises from the households' high use of mortgage equity withdrawals and other borrowing for consumption and investment purposes. This has led to a household debt-to-disposable-income ratio of more than 150 per cent and a sharp rise in the debt-servicing ratio to 9½ per cent, exceeding its previous peak of the late 1980s (Table 1.A1.4). The high levels of debt and debt-interest payments have made households more sensitive to further increases in interest rates – incorporated in the projection – and vulnerable to an abrupt fall in house prices as a possible response to excess supply in the property market or if house prices have risen significantly above fundamental economic drivers. Both events could lead to a sharp restructuring of household finances towards higher savings and lower consumption, which if resulting in – or aggravating – a sharp slowdown in activity, could lead to a substantial increase in mortgage arrears and repossessions.

However, at the current juncture the occurrence of such events seems rather unlikely. As already indicated, the RBA's cash rate increases in late 2003 have already taken some momentum out of the housing market, contributing to a (modest) fall in house prices so far in 2004. The magnitude of further interest rate hikes needed to take unnecessary monetary stimulus off the economy is rather minor, of the order of ½ percentage point. Moreover, sharp

Figure 1.A1.4. **Household debt and debt-service burden**
Per cent of household disposable income



Source: Reserve Bank of Australia.

downward corrections in house prices have been quite rare in the past. On the last two events (1982-83 and 1990-91), they were triggered by sharp increases in lending interest rates and unemployment, which are the two most important determinants of the households' capacity to incur and service debt. Given the current excellent macroeconomic conditions and the favourable outlook, a debt-induced crash seems extremely unlikely. This view is further supported by benign indicators of financial stress for households, such as loan arrears, personal bankruptcies and repossessions, which continue to suggest that the debt-service burden is not affecting household behaviour at present. It is also important in this context to note that a recent analysis of financial constraints on households concludes that most of the household debt rests with middle and higher income earners who also have the greatest ability to service this debt.[9] It is thus conceivable that households continue to boost aggregate activity by taking on and servicing even more debt. Nevertheless, the prevailing macroeconomic conditions are much in favour of a "soft landing" of housing and consumption spending.

There might also be concern about financial system stability in the, perhaps unlikely, case of a housing price "collapse". However, recent work by the Australian Prudential Regulation Authority (APRA) indicates that even if house prices fell by 30 per cent and mortgage default rates increased dramatically, more than 90 per cent of authorised deposit-taking institutions would continue to meet minimum regulatory capital requirements.[10] For the small number of institutions that fell below the minimum, the breach is estimated to be small. Of more concern would be the wider economic consequences of a housing downturn associated with a pullback in household spending. But even in such an unlikely event, prompt monetary easing could potentially contain macroeconomic instability.

The current account deficit and external debt

The desynchronisation of the Australian and global economic cycles, effective exchange rate appreciation and the drought-effect on rural exports led to a substantial widening of the current external deficit during the past three years. The deficit was 5¾ per cent of GDP in FY 2003-04, up from a cyclical trough of 2¾ per cent in FY 2000-01, when economic activity had temporarily slowed. The widening current external deficit is reflected in the banks' greater reliance on offshore funds to meet the increase in domestic demand for credit. As a consequence, net foreign-debt and net foreign liabilities as a percentage of GDP rose to 48½ and 62 per cent of GDP, respectively, in mid-2004. Although there is no fixed benchmark for current account sustainability, and a change in the total debt-to-GDP ratio in either direction is no reliable indicator on whether problems of current account financing might eventually emerge, the large external deficit and high foreign indebtedness might give rise for concern.

However, there are no good reasons for alarm as in countries with floating exchange rates, current account deficits which are deemed unsustainable by market participants tend to be self-correcting: if foreign investors become unwilling to fund the increasing shortfall between total saving and investment, there is a downward pressure on the exchange rate. Moreover, when assessing the Australian situation, it has to be kept in mind that, with general government finances in surplus for seven years in a row, Australia's current account reflects private saving and investment decisions. And with structural reform having stripped out many 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.

It could be argued that the increased reliance on foreign funds to finance the shortfall of domestic savings relative to investment could increase Australia's vulnerability to an external shock and a loss of confidence by foreign investors. However, the risks should not be exaggerated. Although about two-thirds of external debt is denominated in foreign currencies, a large part of it is offset by off-balance-sheet derivatives positions. When taking on-balance sheet and off-balance sheet exposures together, Australian banks' foreign currency exposure remains at low levels.[11] The remaining amounts of foreign currency debt outstanding are more than offset by holdings of foreign currency assets. Accordingly, the Australian economy as a whole, as well as individual sectors, do not seem to have important foreign exchange exposure.

In addition, the banking system, which accounts for about 80 per cent of Australia's net foreign debt, is in good shape. This is reflected in Australia's Aaa and AAA foreign currency ratings, respectively, by the Moody's and Standard & Poor's rating agencies. The financial positions of firms and households are also sound. The general government's share in net external debt is only about 5 per cent. Australian Government total net debt is very low, around 3 per cent of GDP in 2003-04, which is one of the lowest levels of general government net debt in the OECD. This places Australia in a comparatively better position than most other countries to respond to future economic shocks. To preserve this favourable position, the authorities should continue to ensure that the government does not add to aggregate external financing requirements.

Notes

1. Aggregate house prices have roughly doubled since 1998. According to estimates of Eaqub (2004) a 5 per cent rise in real housing wealth adds about ½ percentage point to real consumption growth within up to 1½ years. Hence, if real housing wealth had not changed instead of actually increasing by 18 per cent in 2003, household consumption might have been 2 per cent lower and real GDP 1½ per cent lower than the actual outcomes.
2. Mortgage equity withdrawal is borrowing that is secured on the housing stock but not invested in it, so it represents additional funds available to finance consumption or investment or to consolidate other debt.
3. However, the ongoing trend towards incorporation of previously unincorporated businesses also contributed to low household saving measures, as it moves savings out of the National Accounts' household sector into the business sector. Household saving may have been reduced further by higher corporate saving as households are the ultimate owners of corporations and should internalise corporate saving decisions. On the other hand, compulsory contributions to superannuation funds are estimated to have had an overall positive effect on household saving, in spite of lowering voluntary household saving to some extent (Connolly and Kohler 2004).
4. Public infrastructure projects will be undertaken in the areas of transportation, electricity, water, schools, hospitals and public housing, although the bulk of them only after FY 2004-05. Many of these projects will be undertaken and operated by the private sector under Private-Public Partnerships.
5. 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. In view of the decline in dwelling investment in the second half of 2000, induced by the advancement of housing expenditures to avoid their taxation under the new goods and services tax, 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.
6. "Negative gearing" occurs when expenses in excess of income on an investment are deducted against other sources of income. The use of negative gearing arrangements is likely to be encouraged by high marginal tax rates (*Reserve Bank Bulletin*, May 2004). Proposals to remove negative gearing arrangements in order to reduce the volatility in residential construction activity were rejected by the government as it wished to maintain consistent tax treatment of housing and other assets.
7. For a way to estimate the neutral cash rate see the *Reserve Bank of Australia Bulletin* (2002), "Statement on Monetary Policy", August.

8. A detailed discussion of this link can be found in the *Reserve Bank of Australia Bulletin* (2000), "Statement on Monetary Policy", November, Box A. Hay (2004) estimates a loss of 0.3 per cent of GDP as direct effect of a crude oil price increase by $10 per barrel, excluding the negative impact on exports and second round domestic feedbacks via the labour market.
9. See La Cava and Simon (2003) and Kohler, Connolly and Smith (2004).
10. Reserve Bank of Australia (2004).
11. See the section on Financial System Stability in Reserve Bank of Australia (2003).

2. Fiscal policy: short-term issues and long-term challenges

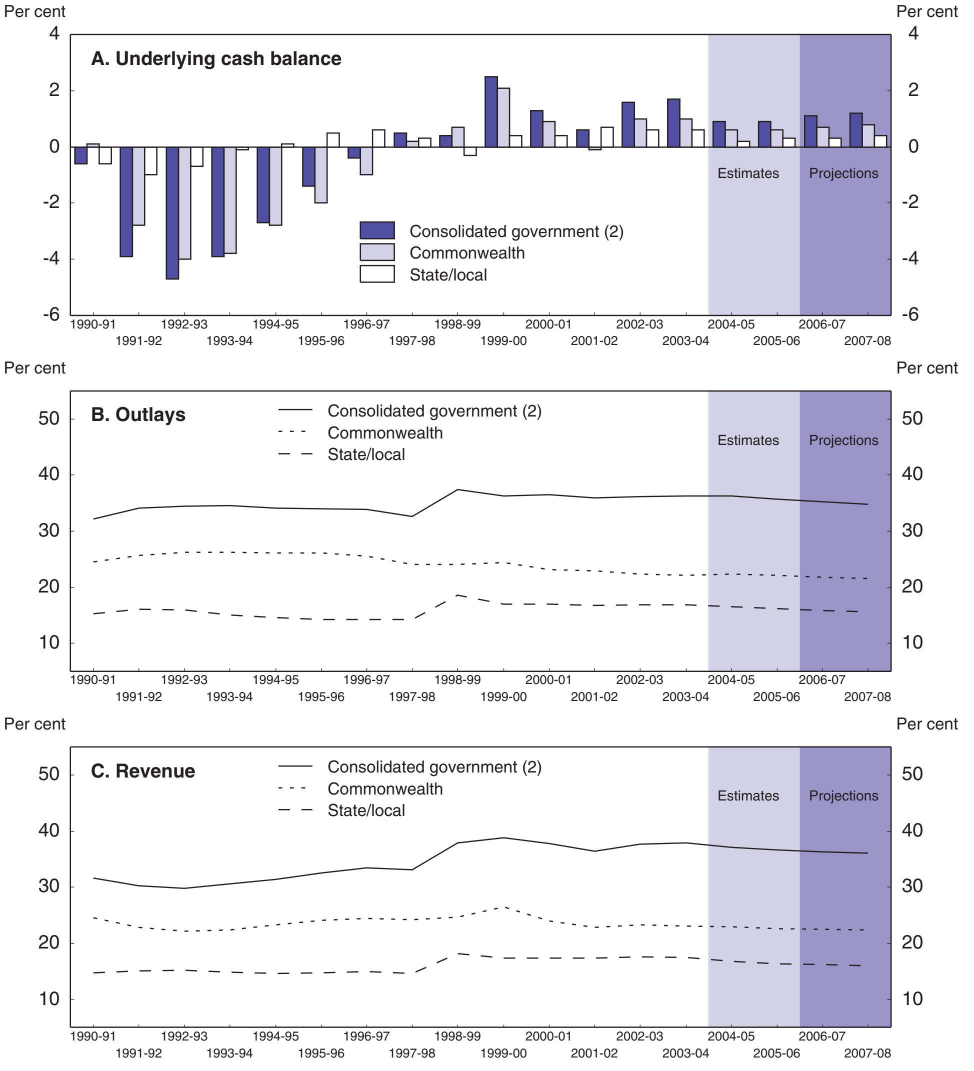
Fiscal policy

Managing the budget

Consolidation was the primary objective of fiscal policy during the second half of the 1990s. The actual and structural net lending positions of the general government improved by 8.4 and 6.3 per cent of GDP respectively over the period 1992-1999 – well above the OECD average.[1] In particular, the general government financial balance swung to a surplus of 2 per cent of GDP in 1999 from a deficit of 6.4 per cent in 1992.[2] Fiscal developments for general government largely reflected those of the Australian Government (formerly referred to as the Commonwealth Government). The underlying cash balance at the Australian Government level moved to a surplus in 1997-98,[3] from deficits of around 3 to 4 per cent of GDP in the early 1990s (Figure 2.1). At the same time the tax burden has not increased from its 1996-97 level, while the ratio of public expenditure to GDP has fallen. In addition, fiscal policy delivered on the ambitious target of halving the Australian Government net debt to GDP ratio by the turn of the century, from its 1995-96 level of 19.1 per cent of GDP. Underlying these outcomes was the successful implementation of reforms in fiscal institutions which commenced with the *Charter of Budget Honesty Act* 1998.[4] The Charter requires the government to lay out its medium-term fiscal strategy in each budget, together with its shorter-term fiscal objectives and targets, consistent with the principles of sound fiscal management laid down in the Charter. The establishment of a medium-term fiscal framework reduces the risk of slippage, ensuring the sustainability of fiscal policies over the longer run. Transparency has been further improved by the requirement of a *Pre-Election Economic and Fiscal Outlook*, and the introduction of accrual budgeting, enabling a more comprehensive view of the total activity of the government and its long-term effects. The presentation of both cash flow and accrual fiscal measures in each budget provides for a richer framework for policy analysis and assessment.

The medium-term strategy of running a balanced budget on average over the cycle (Box 2.1) provides the government with the flexibility to react to

Figure 2.1. **Developments in 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: Australian Treasury.

Box 2.1. **The medium term fiscal strategy of the Australian Government**

The central element of the Australian Government's medium-term fiscal policy is to maintain budget balance, on average, over the economic cycle. The supplementary objectives of the strategy are:

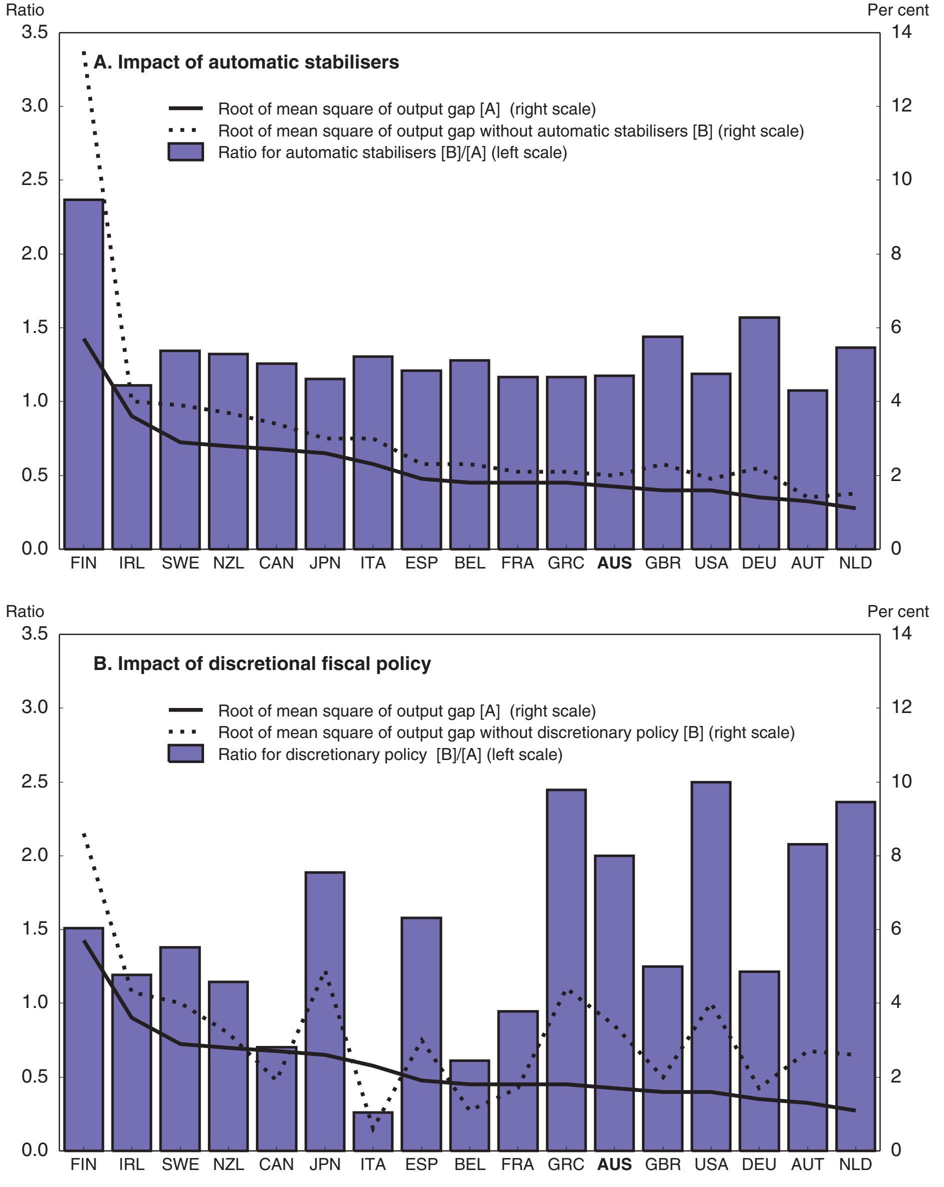
- to maintain fiscal surpluses over the projection period, while economic growth prospects remain sound;
- to increase in the overall tax-burden from its 1996-97 level; and
- to improve the Australian Government's net worth position over the medium to longer-term.*

The primary fiscal objective of a balanced budget over the economic cycle helps ensure the sustainability of fiscal policies over the longer run. It further facilitates the achievement of other crucial goals, including macroeconomic stability, encouraging private investment in a low interest rate environment, establishing low public debt, and ensuring that, over time, the current account reflects private saving and investment decisions. The supplementary objective (introduced in the 1999-2000 Budget) of an improvement in the net worth position over the longer term, emphasises the government's view that fiscal strategy should be sustainable and equitable in an intergenerational sense. Moreover, the objective of ensuring that there is no increase in the overall tax-burden implies that the government obtains balance over the cycle through a disciplined and targeted approach to spending.

* Net worth consists of total assets less total liabilities.
Source: Australian Government (2004a) and OECD (2003b).

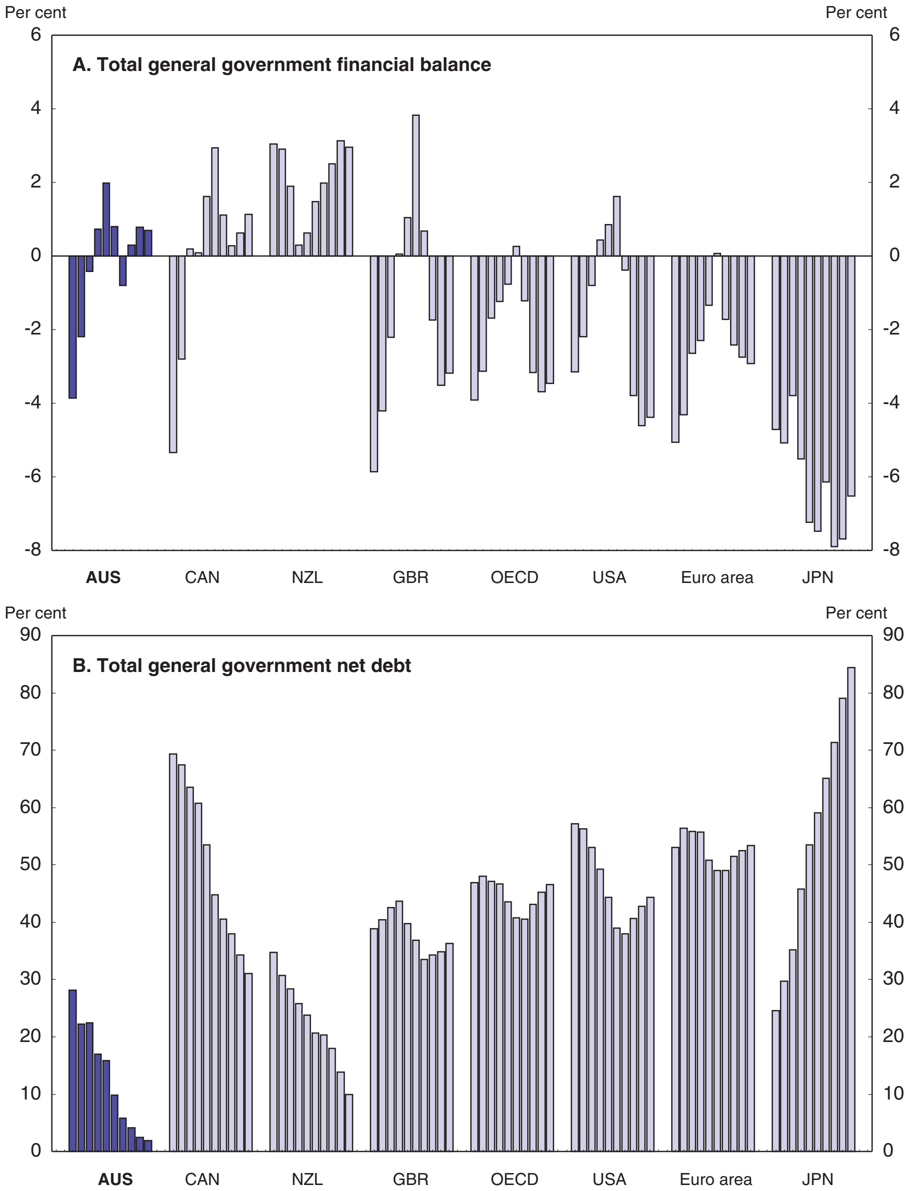
short-term economic fluctuations. OECD simulations suggest that the automatic stabilisers themselves in Australia have worked to reduce output volatility by only about a fifth over the 1990s, somewhat below the area-average (Figure 2.2). This largely reflects the limited size of the general government sector in Australia, and the relatively low sensitivity of the budget to the state of the economy.[5] Discretionary policy, on the other hand, had a much larger impact, resulting *ceteris paribus* in a halving of the output volatility in the 1990s. While the small size of automatic stabilisers, a sound fiscal position and low net debt (Figure 2.3), provide ample scope for the use of discretionary action, it needs to be used with prudence – reinforcing rather than neutralising the impact of automatic stabilisers. It is very important that discretionary fiscal policy be conducted symmetrically over the cycle, as its impact can be difficult to reverse. The need for cautious discretionary policy is further underlined by the difficulty at times in distinguishing between permanent and temporary factors

Figure 2.2. **The role of fiscal policy in smoothing cyclical fluctuations**



Source: van den Noord (2002), "Automatic Stabilisers in the 1990s and Beyond", in *The Behaviour of Fiscal Authorities: Stabilisation, Growth and Institutions*, edited by Buti, M., von Hagen, J., and C. Martinez-Mongay, European Communities.

Figure 2.3. **International comparison of financial balance and net debt position**
As a percentage of GDP from 1995 to 2004



Source: OECD, *Economic Outlook* 76 Database.

influencing government spending and revenues, and the inherent uncertainty of the growth assumption underlying the budget projections. In addition, contrary to automatic stabilisers, discretionary policy measures may not operate in a timely fashion.[6] Finally, discretionary action may be mitigated through offsetting changes in private savings. Empirical evidence by Comley *et al.* (2002) suggest that, private sector savings responses in Australia imply that the size of any fiscal stimulus would need to be correspondingly larger to have the same effect on aggregate demand.[7]

Recent developments of the Australian Government finances

Reflecting the expected strengthening of the economy, the May 2002 Budget intended to remove some of the fiscal impulse provided over the previous two fiscal years,[8] projecting a return of the underlying cash balance to a small surplus of 0.3 per cent of GDP in 2002-03 (Figure 2.4). In the event, the Australian Government budget recorded a significantly higher underlying cash surplus, of 1 per cent of GDP, in spite of slightly weaker growth than had been anticipated.[9] The bulk of the improvement came from an overshooting in company tax receipts; also lower-than-expected expenses contributed.[10] The budget over-performance continued in 2003-04, despite the introduction of tax cuts and spending initiatives, with robust tax revenues boosting the underlying cash surplus to 1 per cent of GDP – three times the original estimates, and unchanged from the previous fiscal year (Box 2.2).

The 2004-05 Budget and medium-term fiscal outlook

The 2004-05 Budget is mildly expansionary, estimated by the government to inject a stimulus to the economy of around one-half of a percentage point of GDP for the fiscal year[11] (Box 2.3). Nevertheless, it adheres to the objectives of the government's medium term fiscal strategy, as it maintains an underlying cash surplus of around 0.3 per cent of GDP in 2004-05 and additional small surpluses in the forward years, after the delivery of the new measures. The current fiscal stance, in particular, is considered by the government to be consistent with its "balance-over-the-cycle" objective, as well as that of maintaining budget surpluses while economic prospects remain favourable (Box 2.1). The *Pre-Election Economic and Fiscal Outlook* (PEFO) 2004,[12] issued in advance of the October 2004 elections, revised upwards the fiscal outlook, forecasting an underlying cash surplus of 0.6 per cent for 2004-05, increasing gradually to 0.8 per cent by 2007-08. The significant improvement, compared to the May 2004 Budget estimates, largely reflects favourable developments in tax and non-tax revenues, which offset the trimming impact of new policy initiatives, and parameters and other variations.

Box 2.2. The 2003-04 budget and outcome

The May 2003 Budget included cuts in personal income taxes of around 0.3 per cent of GDP[1] in 2003-04 (and a total of approximately 1.3 per cent over four year period 2003-04 to 2006-07), and expenditure increases in a number of priority areas, which worsened the starting position relative to the 2002-03 *Mid-Year Economic and Fiscal Outlook* (MYEFO) estimates of November 2002.[2] The tax initiatives raised the thresholds for the three top marginal personal income tax rates, and provided additional assistance for low income earners, through an increase in the low income tax offset and the income threshold at which the offset starts to phase out. In addition, the budget provided funding for the simplification of Australia's international income arrangements and an overhaul of energy taxation. On the expenditure side, initiatives focused on spending more on defence and domestic security, and on reforms of health and higher education system at a cost of around 0.2 per of GDP in 2003-04. In all, the new measures led to a halving of the underlying cash surplus target for the fiscal year, to 0.3 per cent of GDP (A$ 2.2 billion), compared with the mid-year estimates of November 2002.[3] However, the budget continued to project underlying cash surpluses for 2003-04 and each of the forward fiscal years.

In the event, the budget outcome outperformed expectations, with the Australian Government sector recording an underlying cash balance of 1 per cent of GDP in 2003-04 – according to the *Final Budget Outcome* of September 2004 – well up on the previous estimates. This outturn reflects favourable parameter and other variations – mainly stronger than expected tax revenues – which offset the effect of new policy decisions taken since the budget.

1. On the basis of the latest GDP estimates for 2003-04.
2. The budget forecast a growth of 3¼ in 2003-04, a little below the trend. This represented a downward revision from a forecast of 4 per cent at the time of MYEFO of November 2002, mainly because of the developments in the global economy.
3. The November 2002 MYEFO forecast a cash underlying surplus of 0.6 per cent of GDP (A$ 4.9 billion). The 2003-04 Budget also revised downward the budget surplus in accrual terms to 0.1 per cent of GDP, compared to previous estimates of 0.4 per cent. Forward years were also revised down, in both cash and accrual terms.

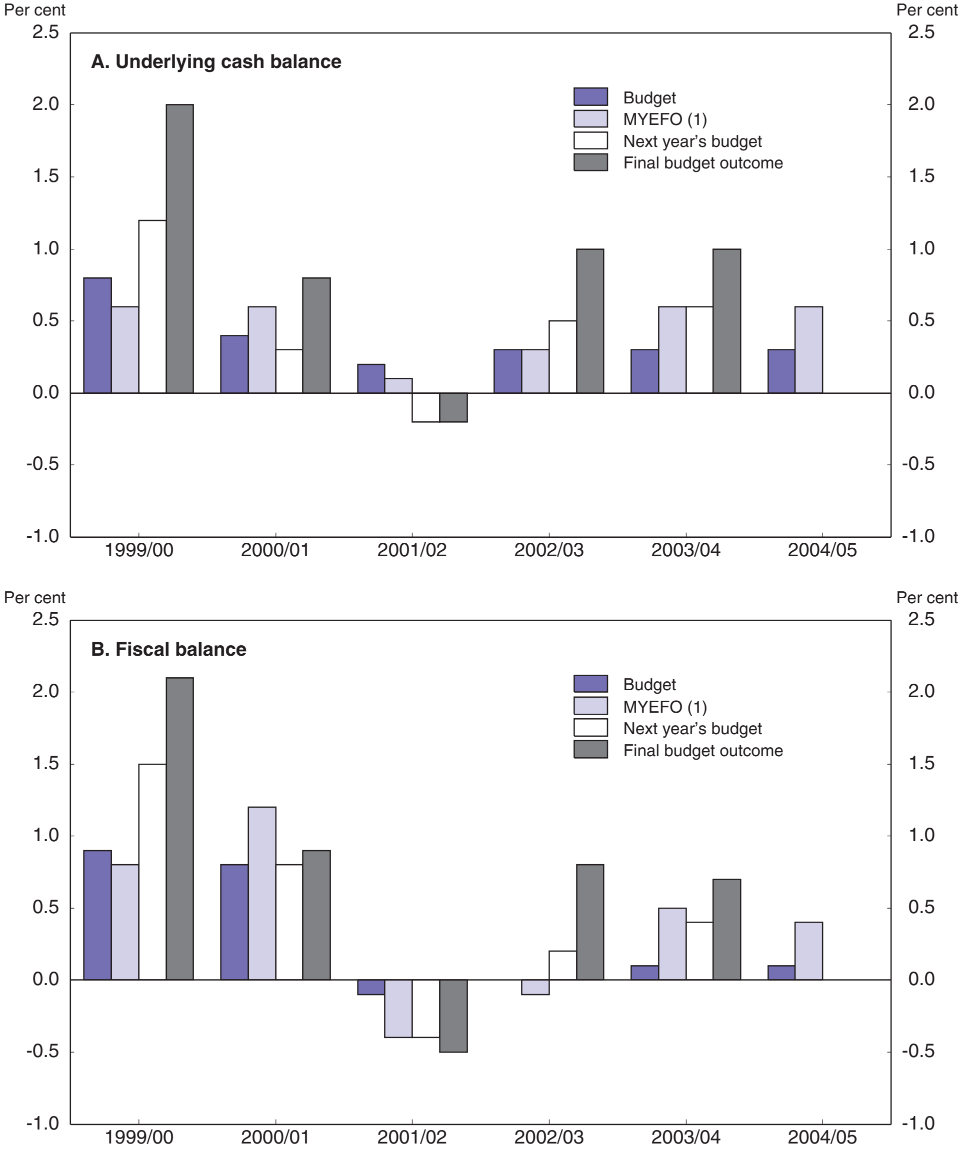
Source: Australian Government (2003a, 2004c).

Recent developments and prospects for States/local government and general government finances

The State/local general government sector has maintained cash surpluses since the mid-1990s, with the exception of 1998-99, reflecting initiatives by the governments of New South Wales and Victoria to fund unfunded superannuation liabilities (Figure 2.1). On the basis of official estimates, the state/local sector is

Figure 2.4. **Budget estimates and outcomes**

As a percentage of GDP



1. *Mid-Year Economic and Fiscal Outlook* estimates. *Pre-Election Economic and Fiscal Outlook* 2004 estimates for 2004/05.

Source: Australian Treasury.

Box 2.3. **The 2004-05 Budget: main features**

The May 2004 Budget contained further income tax cuts and introduced significant targeted spending, with families and low income earners the main beneficiaries.[1] The centrepiece of the budget is the *More Help for Families* package, with an estimated cost of around 4.3 per cent of GDP (A$ 37 billion) over five years. The package increases assistance to families by raising the rate of Family Tax Benefits and reducing withdrawal rates. It also introduces, from July 2004, a new lump-sum maternity payment granted to all families (see Chapter 4).[2] On the revenue side, the family package raises the thresholds for the two top marginal tax rates (with an expected revenue loss in 2004-05 of around 0.2 of GDP). The new initiatives improve rewards to work through lower effective marginal tax rates (EMTRs) and cuts in income taxes, encouraging labour force participation and boosting productivity. Moreover, the budget package provides incentives to save for retirement, through an increase in the government superannuation contribution and a cut in the maximum surcharge rates. As such, the new measures have the potential of enhancing growth and addressing the impact of ageing of populations on per capita income growth – as intended by the budget.

1. The budget forecasts an average growth of 3½ per cent for the 2004-05, slightly below a rate of 3¾ in the previous fiscal year.
2. Others areas of spending include MedicarePlus, aged care, and defence and security.

Source: Australian Government (2004a,d).

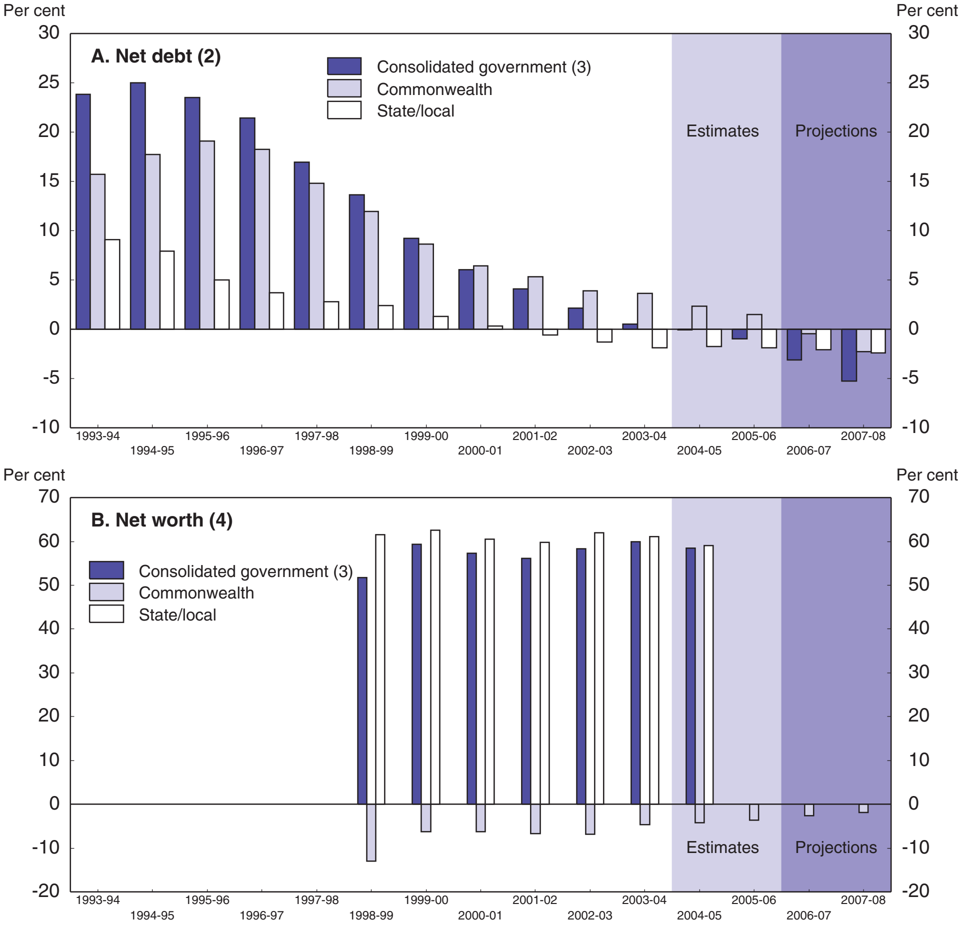
forecast to record a cash surplus of 0.2 per cent of GDP in 2004-05, lower than those of previous years, reflecting a higher estimated spending and lower tax revenue from real-estate transactions, after the strong growth in recent years. The cash surplus is projected to grow gradually to 0.4 per cent of GDP in 2007-08. Taking all levels of government together, the underlying cash surplus of the general government is forecast to decline to around 0.9 per cent of GDP in 2004-05, from 1.7 per cent of GDP in the previous fiscal year, with slightly larger surpluses envisaged in the outer years.

Debt developments and debt management strategy

Australian Government net debt has fallen sharply to around 3 per cent of GDP in 2003-04, from a peak of 19.1 per cent in 1995-96 (Figure 2.5). The reduction has been achieved through the use of proceeds from the sale of assets to retire debt, coupled with budget surpluses. The decline in net debt is expected to continue over the projection period – helped by underlying fiscal surpluses in prospect and further sales of the Australian Government's shareholding in the

Figure 2.5. **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 minus shares and other contributed capital. 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: Australian Treasury.

telecommunications company Telstra – and the September 2004 PEFO forecasts its elimination by 2006-07. The net worth position of the Australian Government is also expected to improve over the projection period, mainly as a result of the cumulative surpluses in the forward estimates.[13] The net debt of the state/local government has also fallen significantly over the 1990s, declining from a high of 10.3 per cent of GDP in 1992-93 to a negative asset position of 0.6 per cent in 2001-02, with official expectations of a further rise in net assets to 2.4 per cent of GDP in 2007-08. In line with these developments, the general government net debt has fallen sharply, as a share of GDP, from a peak of 25 per cent in 1994-95 to an estimated 0.5 per cent of GDP in 2003-04, swinging towards a net asset position thereafter.

The Australian Government debt management

The decline in the Australian Government net debt since the mid-1990s has been accompanied by reductions in gross debt outstanding, reflected primarily in declining Commonwealth Government Securities (CGS) on issue. Specifically, Treasury bonds on issue have fallen from around 15 per cent of GDP in 1995-96 to around 7 per cent of GDP in 2003-04.

The significant decline of the net debt, along with the prospect of its elimination in a few years time, has raised concerns among key market participants about the future viability of the CGS market and the likely impact on the broader financial markets and the functioning of the overall economy. In response, the Australian Government undertook a public review of the CGS market in 2002 to determine whether there was a case – on the basis of financial market efficiency or other policy objectives – for continuing to issue debt in spite of a strong fiscal position.[14]

The review of the CGS market concluded that the issuance of Treasury bonds should continue, independently of the government's net funding requirement, to support efficient interest rate risk management in the economy. The review assessed that the closing of the CGS market would result in slightly higher interest rates, given the current state of development of Australian financial markets and the lack of effective alternatives to CGS. Moreover, the elimination of the CGS market may lead to less diversity in the financial markets and increased vulnerability during periods of instability. Following the review, the government announced in the May 2003 Budget its decision to maintain sufficient CGS on issue to support the Treasury bond futures market.[15] The outcome of the review has implications for the Australian Government debt issuance and portfolio management, as discussed in Box 2.4.

Given the government's medium-term fiscal strategy of ensuring that the budget is balanced, on average, over the economic cycle, the maintenance of the CGS market will result in surplus funds which will require management. Government ownership of private financial assets raised concern among market participants over

Box 2.4. The implications of the CGS market review for debt issuance and portfolio management[1]

The decline in net debt since the mid-1990s has been managed while maintaining depth and liquidity in the CGS market. To this end, surplus budget proceeds not applied to the redemption of CGS have been held as financial assets. Mechanisms used by the government to support CGS liquidity include: maintaining a modest gross debt issuance programme; undertaking bond conversion tenders to ensure that CGS outstanding is concentrated in liquid maturities; and holding some surplus funds as deposits with the Reserve Bank of Australia, rather than repurchasing outstanding CGS.

Until 2003-04, debt issuance had been targeted at the long end of the yield curve to assist with maintaining the length and efficiency of the CGS market. CGS issuance will now be targeted at both the long end and the middle of the yield curve. The issuance of CGS will be structured to ensure liquidity for the 3-year and 10-year Treasury bond futures contracts, which are used extensively (along with interest rate swaps) by the private sector to hedge interest rate risk. Each Treasury bond future contract is based on a basket of three bonds. The review of the CGS market concluded that, at the long end of the yield curve, spacing of up to 2 years between each bond issuances would be consistent with efficient futures contract operations as market participants expressed the opinion that the average maturity of the basket of bonds underlying the 10-year bond futures contract could range from 9 to 11 years. Hence, issuance of long-dated bonds every second year will continue to support the 10-year futures contract, and maintaining this profile will involve issuance of a new 13-year bond every two years. However, market participants indicated that the average maturity of the 3-year contract should vary in a narrower range: preferably around 2.5 and 3.5 years. To this end, a new medium maturity Treasury bond will be issued with a term to maturity of around five years in alternate years (which will reduce the intervals between the benchmark lines to around 12 months for bonds with less than five years to maturity). With eight or nine lines of debt needed to provide the appropriate coverage of maturities, this implies an overall Treasury Bond market of around A$ 40 to A$ 45 billion which will be maintained with around $5 billion of issuance each year. Given the focus on the issuance of Treasury bonds, the issuance of Treasury Index bonds (the only other type of long-dated debt used by the Australian government in recent years) has been suspended in order to limit the government's exposure to financial risks.

The reduction in net debt since mid-1990s has resulted in both indexed debt and within-year financing flows becoming a higher proportion of the portfolio. This has implications for portfolio management, leading to the adoption of a new benchmark aiming at better balancing debt service costs and risk. The objective of the new benchmark is to maintain the same broad approach as its predecessor; namely, to use interest rate swaps to shorten the duration of the net debt portfolio so as to reduce average debt service costs. Nevertheless, the new benchmark enhances the previous approach by establishing separate cash management and long-term debt portfolios, and by introducing specific measures that take account of the different risk properties of inflation-linked and fixed coupon bonds, and on the proportion of the portfolio subject to immediate repricing (by expressing the

Box 2.4. **The implications of the CGS market review for debt issuance and portfolio management**[1] (*cont.*)

new benchmark in terms of both modified duration and short-dated exposure). The Government has also clarified and enhanced the governance arrangements of the Australian Office of Financial Management (AOFM) and the Department of the Treasury, both in the long-term and in the transition towards the new benchmark. A three-year period will be required for the transition to the parameters of the new benchmark, with interest rate swaps being an integral part of the transition period and afterwards.

1. The Box draws on Comley and Turvey (2004). See also, Australian Office of Financial Management (2003); Australian Government (2003a); and OECD (2003a).

the potential distortions it may cause on financial asset prices, the impact on the operations of the firms the government invests in, and the potential for asset liquidation to be used in the general government expenditure, among others. Taking these considerations into account, the Australian Government intended to place the proceeds of Treasury bond issuances and budget surpluses on term deposit with the Reserve Bank of Australia (RBA). These would continue to be used to assist with financing short term (within-year) mismatches between revenues and expenditures.[16] The 2003-04 Budget stated that, in the event that deposits at the RBA exceed A$ 25 billion on a sustained basis, the Government would consider allocating some funds to other liabilities, possibly unfunded superannuation liabilities.

Consistent with this strategy, the Australian Government announced in September 2004 its intention to set up a 'Future Fund', financed with future budget surpluses. These funds could be used to meet superannuation liabilities for its employees which are being incurred today by the government but do not have to be paid for some time. This implies that future surpluses will be set aside in an asset fund – that would have outside managers and be invested in a diversified portfolio – to offset the government's largest liability, its unfunded superannuation liability for public servants, estimated at around 10.5 cent of GDP in 2004-05 (A$ 89.9 billion at end-June 2005).[17] The establishment of the Fund is of major importance, given the looming costs of an ageing population. Based on the baseline projections of the first official *Intergenerational Report* (IGR), incorporated in the 2002-03 Budget, Commonwealth "demographic" spending is expected to exceed revenue in about 15 years, under unchanged policies, with the gap growing to around 5 per cent of GDP by 2041-42. Moreover, the channelling of future surpluses into the fund will reduce the call on the budget over the coming years, allowing the allocation of revenues to areas of high priority, such as health and education. With the establishment of the Future Fund the government further aims to increase national savings and maximise its net worth.

Assessment

Fiscal consolidation that began in the mid-1990s allowed policy to become more expansionary at the turn of the century, in the wake of weaker growth, leaving the Australian Government budget balance with smaller surpluses over recent years. The May 2004 Budget forecasts an underlying cash surpluses of 0.3 per cent of GDP in 2004-05 and additional small surpluses in the forward years, after delivering further tax cuts and increased family assistance under the *More Help for Families* package. However, as in the previous two years, revenue windfalls have led to an upward revision of the estimates for the current fiscal year and forward estimates at the time of the *Pre-Election Economic and Fiscal Outlook* 2004. Australia's sound fiscal position affords the scope for injecting some stimulus to the economy, if needed, without threatening the medium term objective of a balanced budget over the course of the economic cycle. It is important that this objective be maintained so that the public sector does not become a drain on national savings. In addition, fiscal prudence is critical in order to provide reserves for periods of future downturns, as discretionary policy is difficult to unwind. The need for continued discipline is reinforced by the imminent pressures of the ageing population and the government's intention to fund future unfunded superannuation liabilities for public servants by channelling future surpluses into an asset fund.

While the main medium term objective of fiscal policy is that of a balanced budget over the economic cycle, the Australian Government also aims for surpluses when economic growth is strong. This is a prudent policy at the current stage, provided that it is accompanied by further reforms in the tax system.

The significant reduction in the Australian Government's net debt since the mid-1990s, raised the question of whether to maintain the government bond market and how to allocate the improving net position. In response to the outcome of a public review, the government announced in May 2003 its decision to keep the CGS market because of the important role that the market plays in the efficient management of interest-rate risk. In addition, as a positive step towards meeting imminent fiscal pressures of an ageing population, the government announced its intention to channel future surpluses into a Future Fund to ensure the funding of future unfunded superannuation liabilities, estimated at around 10.5 per cent of GDP in 2004-05. There are precedents of governments establishing asset funds to offset future liabilities. An important benefit of such a strategy is that it reduces the burden on future taxpayers.[18] The decision to purchase assets, however, raises many different issues about their regulation and administration, with cross-country experience providing only limited guidance.[19] For example, allowing government funds to invest their funds in domestic and foreign equity markets may cause large shifts in capital flows, to the extent that investments are made abroad, and domestic assets would need to be purchased with care so as not to distort either relative prices or to influence corporate governance.

Progress in implementing tax reform

Recent years have seen a comprehensive reform of the Australian tax system, the main features of which are: *i*) the introduction of A N*ew* T*ax* S*ystem* (ANTS) in July 2000, encompassing changes in consumption taxes, personal income taxes, as well as a simplification of tax administration; *ii*) the implementation of the business tax reform in response to the recommendations of the Ralph Committee;[20] and, *iii*) a review of international tax arrangements (Annex 2.A1).

A N*ew* T*ax* S*ystem*

ANTS set the ground for a more robust indirect tax system, through the replacement of former narrowly-based indirect taxes (wholesale sales tax and a range of inefficient State taxes) with a broadly based Goods and Services Tax (GST), imposed on a value added basis at the single rate of 10 per cent. State governments have now agreed to abolish the bank account debit tax (which is levied on withdrawals from a bank account that has a cheque drawing facility) by 1 July 2005. Moreover, the Ministerial Council[21] will review by 2005 the need to retain certain stamp duties (such as on leases, mortgages, cheques and others).[22] The rapid abolition of these distorting State taxes (on selected business input and final consumption transactions) would yield additional benefits to the Australian indirect tax system, as would the reform of the payroll tax (also under the jurisdiction of the States).[23] Payroll tax is narrowly-based and exemption-ridden, with different States levying different rates. The exemptions restrict the taxable base and introduce distortions in the system, implying that such tax is not an efficient origin-principle based GST (Warren, 2004).

In addition to serving as a catalyst for major indirect tax reform, ANTS further introduced personal income tax cuts (Table 2.1), to compensate for the introduction of the GST, and measures to reduce high effective marginal tax rates (EMTRs), to improve work incentives (see Chapter 4). The cuts in the personal income tax took the form of an increase in the tax thresholds and reductions in marginal tax rates. A key feature of the new personal income tax schedule was the replacement of the 34 per cent and 43 per cent tax rates with a 30 per cent rate, implying that 80 per cent of taxpayers faced a top bracket of no more than 30 per cent. However, the changes were concentrated on low and middle incomes, with no reduction in the highest personal tax rate. Recent years saw further cuts in personal taxes, as part of the May 2003 and May 2004 Budgets, with the combined effect of the three stages of reform delivering significant tax reductions for all Australians.[24] The 2004-05 Budget, in particular, announced increased thresholds for the two top tax brackets (delivered in two stages – from 1 July 2004 and 1 July 2005), which will

Table 2.1. **Personal income tax cuts**

Tax thresholds to 1 July 2000	Tax rate	Tax thresholds from 1 July 2000[1]	Tax rate[1]	Tax thresholds from 1 July 2003[2]	Tax rate	Tax thresholds from 1 July 2004[3]	Tax thresholds from 1 July 2005[3]	Tax rate
Income range (A$)	%	Income range (A$)	%	Income range (A$)	%	Income range (A$)	Income range (A$)	%
0-5.400	0	0-6.000	0	0-6.000	0	0-6.000	0-6.000	0
5.401-20.700	20	6.001-20.000	17	6.001-21.600	17	6.001-21.600	6.001-21.600	17
20.701-38.000	34	20.001-50.000	30	21.601-52.000	30	21.601-58.000	21.601-63.000	30
38.001-50.000	43	50.001-60.000	42	52.001-62.500	42	58.001-70.000	63.001-80.000	42
50.001+	47	60.001+	47	62.501+	47	70.001+	80.001+	47

1. Changes under A *New Tax System*.
2. Changes under the 2003-04 Budget (May 2003).
3. Changes under the 2004-05 Budget (May 2004).

Source: Australian Government.

ensure that taxpayers on average (adult full-time weekly) earnings will remain inside the 30 per cent tax bracket over the next four years, even in the face of robust wages growth (Australian Government, 2004).[25] The budget also improved rewards from work by lowering to 51.5 per cent the EMTRs for families on average earnings in 2004, from 61.5 per cent in 2000, and 85.5 per cent in the pre-reform year. Nevertheless, as with the July 2000 reforms, the new arrangements did not bring down the top marginal tax rate (effectively 48.5 per cent including the Medicare Levy), which comes into effect at a relatively low income level (Table 2.2). Concern has been expressed that increasing numbers of qualified young people (especially in the financial and business services) appear to be attracted to job opportunities in the major Asian capitals, where significantly lower rates can apply (Smith, 2003). Further improving rewards from work for people at higher income levels would enhance incentives for work, skill acquisition, and savings, with potential positive effects on output growth. The increases in the top thresholds provided in the 2004-05 Budget go some way towards motivating skilled people to stay and work in Australia, in addition to making the personal tax system more internationally competitive.

Business tax reform

Significant headway has also been made towards implementing the business tax reform. Largely offsetting the revenue loss from a phased reduction of the company tax rate and the halving of the capital gains tax for individuals, was the removal (except for small business) of accelerated depreciation arrangements and the adoption of an effective life system.[26] The business tax reform agenda also encompassed other major measures, including the introduction of a simplified tax system to ease the burden of compliance for small firms, and "consolidation" provisions, whereby groups of companies with common ownership can be treated as a single entity for tax purposes.[27] These provisions are expected to reduce the tax administration and compliance costs incurred by corporate groups, and facilitate choices about business structures and restructures (Smith, 2003). Other recently implemented reforms include the introduction, in 2002, of a new venture capital regime, and the introduction of foreign resident withholding arrangements for collecting income tax from certain payments to foreign residents, while the redesign of taxation of financial arrangements, aiming at providing a comprehensive and coherent framework, is still under development with commencement dates yet to be determined. Gains would be even greater, if two major reform proposals – namely, the introduction of the "tax value method" (TVM) for determining taxable income,[28] and of "entity taxation" regime, aiming at taxing trusts like companies[29] – had borne fruit. The government has announced the development, by July 2005, of a systematic legislative treatment of so called "black hole" expenditure (business expenditure which currently does not qualify for deduction over an appropriate period of time). As for the entity taxation legislation, which was intended to achieve greater consistency in the taxation of entities and to combat on income

Table 2.2. **Top marginal personal income tax rates for employees**[1]

	Top marginal rates		Threshold (multiple APW)[2]	Threshold in $ (using PPP)
	Combined	All-in		
Australia	48.5%	48.5%	1.2	45 505
Austria	42.9%	42.9%	2.9	74 074
Belgium	45.1%	59.3%	1.2	40 319
Canada	46.4%	46.4%	2.6	85 991
Czech Republic	28.0%	40.5%	2.2	28 409
Denmark	54.3%	62.3%	1.0	37 548
Finland	51.1%	57.4%	2.0	58 424
France	37.9%	48.1%	3.5	85 779
Germany	51.2%	64.2%	1.7	59 214
Greece	33.6%	49.6%	2.3	39 051
Hungary	55.9%	68.4%	1.2	10 865
Iceland	42.0%	42.0%	1.5	42 832
Ireland	42.0%	48.0%	1.0	27 786
Italy	46.1%	46.1%	3.6	93 769
Japan	47.1%	47.8%	5.3	159 730
Korea	38.6%	41.1%	4.1	136 158
Luxembourg	33.9%	47.8%	1.3	41 057
Mexico	29.3%	31.7%	3.8	34 404
Netherlands	52.0%	52.0%	1.6	53 242
New Zealand	39.0%	39.0%	1.4	41 354
Norway	47.5%	55.3%	2.8	91 996
Poland	26.2%	44.9%	3.4	49 912
Portugal	35.6%	46.6%	6.8	85 889
Slovak Republic	33.1%	45.9%	4.6	40 133
Spain	45.0%	45.0%	3.1	67 583
Sweden	56.2%	56.2%	1.8	46 152
Switzerland	37.6%	48.2%	4.0	137 578
Turkey	40.6%	40.6%	10.2	164 017
United Kingdom	40.0%	41.0%	1.7	55 081
United States	41.4%	42.9%	9.6	319 749

Key to abbreviations:
Combined = the combined central government and sub-central government (top marginal) rate, calculated as the additional central and sub-central government personal income tax resulting from a unit increase in gross wage earnings.
All-in = the all-in (top marginal) tax rate, calculated as the additional central and sub-central government personal income tax, plus employee social security contribution, resulting from a unit increase in gross wage earnings.
APW = average production wage (in national currency), meaning the average annual gross wage earnings of adult, full-time workers in the manufacturing sector.
Threshold = the multiple of the APW at which the reported combined top marginal rate is first observed.
1. This table reports for each country the marginal combined personal income tax rate on gross wage income (derived according to the OECD Taxing Wages framework) for a single person without dependants based on the earnings level where the top statutory rate first applies.
2. This column reports the level of gross wage earnings (expressed as a multiple of APW) at which the top marginal combined personal income tax rate is reached.

Source: OECD Tax Database.

tax avoidance, efforts are now targeted on specific actions – in line with the recommendations by the Board of Taxation – addressing the issue of tax minimisation through trusts[30] (Warren, 2004).

Review of international tax arrangements

Another major area of reform where progress has been made is that of international tax arrangements. Following public consultations conducted by the Board of Taxation,[31] the Australian Government announced in the 2003 Budget a package of reforms aimed at improving the offshore efficiency and competitiveness of Australian businesses, and increasing Australia's attractiveness as a regional headquarters for foreign groups.[32] The reforms further sought to improve the competitiveness and reduce the compliance costs of Australian managed funds. Main initiatives to meet these objectives include: a reduction in the costs of complying with the controlled foreign company (CFC) rules; a reduction in tax on certain forms of foreign investment income and gains; a revision of Australia's tax treaty practice; and a better targeting of the foreign investment fund (FIF) rules. These reforms go in the right direction in reducing the complexity of the Australian international tax system. Most of the major measures have now been implemented (Annex 2.A1) or relevant legislation has been submitted to Parliament, with a number of other changes in international arrangements in the pipeline. An important reform to be completed regards the withholding tax relief paid on dividend from foreign income. With the creation of a 'foreign income account' existing tax relief for foreign dividend will be extended to include branch profits, tax-exempt gains from the sale of an offshore subsidiary with an underlying active business, and other foreign income passing through Australia. This will provide additional tax relief on foreign income currently paid *via* an Australian company to non-resident shareholders, eliminating the anti-globalisation bias currently imposed by the tax system in Australia, and enhancing Australia's attractiveness as a regional headquarters for foreign groups.

Assessment

The tax reforms since 2000 go a long way in removing inefficiencies in the previous system – including excessive reliance on a range of inefficient indirect taxes and tax bases in long-term decline, complex and inefficient financial arrangements among different levels of governments, and inconsistent treatment for tax purposes of business entities and their investment operations.[33] This has led to a more robust and efficient, as well as more internationally competitive tax system with long-term benefits for both consumers and businesses. However, concern has been voiced by small businesses about the cost of complying with the GST.[34] In recognition the government introduced, in April 2001, significant changes to streamline the GST payment and reporting arrangements for small business. Nevertheless, the compliance requirements of the new tax system should be considered in the light of the entire reform package, which has several positive implications for businesses.

Despite progress achieved in reforming the tax system, two important issues are still pending. These regard the large gap between the top personal marginal income tax rate and the company tax rate (48.5 per cent – including Medicare Levy – compared with a corporate rate of 30 per cent); and the fact that the top marginal income tax rate of close to 50 per cent comes into effect at a relatively low income level. When marginal tax rates on labour income are markedly higher than on corporate profits, this may encourage tax deferral, and avoidance, *via* the redefinition of personal income as company income. Recent measures to address tax avoidance opportunities, including the introduction of alienation of personal services income provisions,[35] and rules governing trustees,[36] go in the right direction. In addition, the top marginal income tax rate, along with the relatively low income level at which it comes into effect, raise concerns about incentives to work and skill acquisition. Recent increases in the threshold level are a welcome development, but the benefits from changing the personal tax schedule would be greater if these were accompanied by a reduction of the top marginal tax rate. More comprehensive reforms to the personal tax rate schedule may be also necessary to maintain the Australian tax system's international competitiveness, so as to deter professionally qualified young people from going overseas, enhancing the economy's growth potential.

An additional important income tax related issue is that of effective marginal tax rates (EMRTs), arising from the interaction of the tax and income support system – which remain high for many low income earners (see Chapter 4). Recent reforms reducing to some extent both the personal tax rates and the withdrawal rate for income support payments are expected to provide better incentives for participation, but efforts towards lowering the EMTRs should continue, with the prospective changes being accompanied by a closer monitoring of the fiscal costs.[37]

Ageing and public expenditures

Ageing has lately been an intensely debated topic in Australia as in most other OECD countries. The "baby-boom" in the few decades after the Second World War and the subsequent fall in fertility rates are dramatically changing the age structure of the OECD economies. Increased life expectancy reinforces this tendency towards more elderly populations, and a widespread tendency for workers to retire earlier has meant that the retired population is growing even more rapidly. Although the fact that people live longer and healthier lives is very welcome, rising dependency ratios do present challenges. Firstly, per capita GDP growth will slow since the proportion of people actually working will fall, *ceteris pari-*

bus. Secondly, spending on public pensions will rise when the baby-boom cohort starts drawing on their old age pensions. Thirdly, spending on health care is expected to rise above and beyond that associated with rising unit costs in real terms for medical products and services, as older people consume relatively more health services than do working-age citizens. Importantly, in the case of Australia, the authorities envisage spending on health to be the biggest challenge of them all (see Chapter 1).

Policy implications

Health care services in Australia are delivered by a variety of government and non-government providers in a range of service settings. It is a public-integrated model supplemented by private insurance. 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.[38] Nevertheless, public spending on health is climbing fast and is projected to continue to do so. Appreciating that increased health spending may increase the quality and length of life of the beneficiaries, this development nevertheless poses a major risk to government finances. Specifically, the key challenge is to arrest the two major drivers behind the rising public health spending – spending on public hospitals and the Pharmaceutical Benefits Scheme (PBS), while maintaining universal access to high quality health care. The government-initiated measures below seek to move more of the financial burden to private stakeholders.

As regards the former challenge, two major initiatives have been launched; 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, which changes the way private insurance operates. This scheme encourages people to join a health fund early by differentiating premium prices across age. Hence, participation in private health insurance has increased, with the aim of taking pressure off public hospitals. On PBS, the May 2002-03 Budget announced proposals to increase the patient co-payments for prescriptions, with budgeted expenditure savings of A$ 1.1 billion over four years, but this was blocked by Senate.

The government has introduced some changes to private health insurance regulation since Lifetime Health Cover, designed to ease cost pressures and thereby improve the sustainability of private health insurance. These include *inter alia* reducing the coverage of ancillaries and ongoing modifications to second tier default benefit arrangements. After initially being blocked by the Senate, the co-payment proposition was passed this year. The need for strict prescribing controls is a consideration for new listings on the PBS. As well, the Pharmaceutical Benefits Advisory Committee is currently conducting a review of the existing eligibility criteria and utilization of lipid-lowering drugs, to ensure they remain cost-effective, given that they account for around one-sixth of PBS expenditure.[39]

Much of the debate over the Australia-US Free Trade Agreement (AUSFTA) has centered on whether and how it will affect the PBS. One of the concerns expressed about the agreement is that proposed changes to the PBS could lead to higher drug prices in Australia – a cost that would further strain public budgets. However, what the Australian Government agreed under the AUSFTA was to implement improvements in the transparency of the existing processes for the listing of drugs on the PBS. These include establishing an independent review mechanism for negative recommendations of the Pharmaceutical Benefits Advisory Committee (PBAC), the expert committee responsible for recommending to the Australian Government which drugs should be subsidised on the PBS. The independent review will not have the authority to overturn a recommendation of the PBAC, but will re-examine specific issues identified by an applicant in circumstances where PBAC has declined to recommend the listing of a drug on the PBS formulary. The findings of the review will be reported back to the PBAC who will then reconsider the application – but may only make a recommendation to list a drug on the PBS if it believes it to be acceptably efficacious and cost-effective. The Minister for Health and Ageing cannot list a drug on the PBS in the absence of a positive recommendation to do so from the PBAC. Accordingly, there is no reason to believe that the prices of drugs will rise as a result of the Agreement.

Using general taxation revenues to finance the bulk of the expansion of health-care provision increases the burden on tax payers or detracts from other publicly financed services and programmes. In order to relieve future public financing pressure, individuals may be called upon to play a larger role in financing their own health care, as now incrementally introduced in Australia. Complementary private health insurance can help to ensure access to care where cost-sharing requirements are large. But it can drive up consumer demand and overall costs at the same time. Private health insurance can offset some of the costs that would otherwise be borne publicly. However, as depicted above, subsidies have been used to encourage purchase of insurance and other interventions may be needed to promote the use of privately financed services by those with publicly financed coverage who are also privately insured. In Australia, as in most OECD countries, private health insurance represent a relatively low share of total health spending, as it often concentrates on minor risks, rather than more costly cases and treatments (OECD, 2004b). Major savings from user fees are also unlikely, particularly as vulnerable populations must be exempted to avoid restrictions on access that could be costly in the long run. Such exemptions impose administrative costs, but are important to ensure that policy goals are met. Apart from this, consumers are likely to skimp on preventive care and appropriate treatments unless they are given incentive to do otherwise.

The measures so far are mainly designed to curtail public health spending by transferring disbursements to the private sector. Just as important is to make the health system more efficient, *i.e.* help more people at a lower cost, in human as well as financial terms. Increased efficiency in the provision of health care services can help budgetary pressures and/or release resources to improve services elsewhere. A public-integrated model, like the Australian health system, has inherently weak incentives to improve efficiency or maintain quality and responsiveness to patient needs. Addressing such weakness could involve modifying financing arrangements to better align the incentives of health care providers and, in some cases, of patients, with efficient production and use of health services. In other countries with public-integrated systems, efficiency related reforms have included *inter alia* better alignment of incentives with objectives through contracts, decentralized decision making and greater competition among providers (Docteur and Oxley, 2003).

Experiments with competition among providers has been less successful and reforms have been reversed in those countries where they where introduced. Failures partly reflected tight supply conditions and monopoly positions of providers in local health care markets and lack of sufficiently skilled purchasers (Docteur and Oxley, 2003). New payment systems, however, can enhance productivity if introduced carefully. There are countries that have managed to slow cost growth using a combination of budgetary and administrative controls over payments, prices and supply of services. Although sophisticated payment systems can be technically difficult to employ, there are numerous examples of successful systems – such as discharge-based payment systems for hospitals – that can promote productivity without harming outcomes. On the other hand, systems that keep health sector wages and prices artificially low are likely to run into quality-of-care problems, difficulty with recruitment and retention of health-care practitioners, or shortfalls in the supply of services and innovative medical products (OECD, 2004b).

At the end of the day it may prove difficult to increase efficiency of health care provision while maintaining tight central budgetary control. While the view has often been expressed that increases in efficiency can help moderate increasing cost pressure, the introduction of greater management independence of providers plus output-based contracting methods means, lifting many of the top-down controls that have been put in place and introducing provider incentives to respond to patient demands. Where such controls had served as real constraints on spending growth, this may lead to increased supply and also increased costs in the short term, at least (Docteur and Oxley, 2003).

Notes

1. The actual and structural net lending position of the general government for the OECD area improved, respectively, by 5.3 and 3.5 per cent of GDP over the period 1993-2000 (based on OECD *Economic Outlook* 76 (2004)).
2. On a calendar year basis. The cyclically-adjusted general government balance moved from a deficit of 4.7 per cent of potential GDP in 1992 to a surplus of 1.6 per cent in 1999 (based on OECD *Economic Outlook* 76 (2004)).
3. The Australian budget year runs from 1 July to 30 June. The move of the budget balance into a surplus was achieved one year ahead of the official target.
4. For a detailed discussion of the reforms see previous OECD Economic Surveys of Australia.
5. OECD analysis shows that, the cyclical sensitivity of the budget 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 to 0.5 per cent for the OECD average (van den Noord 2000, 2002).
6. For a discussion see de Lima *et al.* (2003); Simes (2003); and OECD (2003b).
7. The authors conclude that automatic stabilisers (which are inherently changes in cyclical government savings) are likely to be a more effective policy option for managing aggregate demand than discretionary policy actions (which are inherently changes in structural government savings). They point out, however, that the derived 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. In addition to private savings offsets, the empirical findings also reveal that significant interest rate offset may also limit the effectiveness of fiscal policy as a demand management tool (Comley *et al.* 2002).
8. The easing in 2000-01 mainly reflected the introduction of income tax cuts under A 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. Based on estimates included in the Australian Government's 2002-03 Budget, these resulted in an estimated stimulus of about 1 per cent of GDP in both 2000-01 and 200-02.
9. Original growth estimates of 3¾ per cent were revised downward to 3 per cent at the time of mid-year fiscal update, due to the anticipated impact of the drought.
10. Further to an over-performance in company tax receipts, the higher-than-expected underlying cash surplus reflected lower than anticipated expenditure on family and community services and education programmes, as well as delays in some contracted health expenditure (Australian Government, 2003b).

11. This indicative estimation was derived by looking at the underlying cash balances between 2003-04 and 2004-05 and making some broad assumptions about saving and leakages into imports.
12. The PEFO was published in September 2004.
13. The PEFO 2004 provides for lower net-debt estimates in 2004-05 and an improved net worth position, relative to the May 2004 Budget estimates, reflecting the over-performance of the 2003-04 Budget and the upward revision to the projected surplus for 2004-05. The improvement in net worth position largely reflects the higher than anticipated net operating surplus for 2004-05 and the higher than projected opening net worth due to the outperformance of the 2003-04 Budget (Australian Government, 2004d).
14. The discussion paper released by the Australian Government – in acknowledgement of these concerns –assessed the costs and benefits of maintaining the CGS market, identifying three possible alternatives available to the government: *i*) winding down the CGS market; *ii*) consolidating the CGS market with the state government markets; and *iii*) maintaining the CGS market and fund the Commonwealth's unfunded superannuation liabilities to its employees. See OECD (2003a), and Comley and Turvey (2004).
15. See Australian Government (2003a), and Comley and Turvey (2004).
16. The Australian Government has held limited financial assets with RBA, in the form of term deposits, since 1998, used to assist the government's short-term funding requirements. These assets were the result of the strategy of maintaining liquidity in the CGS market (Comley and Turvey (2004); and Australian Government (2003a)).
17. The government aims to be in a position to fully fund superannuation liabilities by 2020. The government has already taken steps to deal with the growth in its unfunded superannuation liabilities. These include closing the existing Public Service Superannuation Scheme and paying out A$ 4.6 billion to fully offset the liabilities relating to the Telstra and Australian Post superannuation schemes (Statement by the Treasurer on Investing for the Future (*www.liberal.org.au/default.cfm?action=*2004 *policy*).
18. For a discussion see, The Allen Group (2002).
19. See Mylonas *et al.* (2000).
20. 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, 2000 and 2001).
21. The Council comprises the Australian Government, States and Territory Treasurers.
22. Under the Intergovernmental Agreement of the Reform of Commonwealth-State Financial Relations (IGA), which provides for the transfer of all GST revenue to the States, accommodation taxes were abolished on 1 July 2000, and Financial Institutions Duty and stamp duty on quoted marketable securities were abolished on 1 July 2001.
23. An important case is that of "small firm exemption" the thresholds of which ranges significantly across the states (States and Territories). In recent years, the States have introduced adjustments to the base, thresholds and rates on which payroll tax is applied.
24. As a result of the introduction of tax cuts since July 2000, taxpayers around average earnings (A$ 50 000 per year) saw a reduction of approximately 21 per cent in personal

income tax, with the decline for those on a lower income (A$ 20 000) standing at 23 per cent. By July 2005, high income earners (A$ 90 000) will see a reduction of around 18 per cent (Australian Government 2004a).

25. The tax cuts will also ensure, according to the government, that more than 80 per cent of the taxpayers will be in the 30 per cent tax bracket or lower over the forward estimates, that is, to 2006-07 (Australian Government, 2004b).
26. The effective life of an asset is the estimated period it can be used by any entity for income producing-purposes. The accelerated deprecation rates, under the previous system, provided for the cost of an item to be claimed well before the end of its effective life (Australian Government, 2000).
27. The pre-existing arrangements resulted in a range of problems for the taxation of companies with wholly-owned groups of companies, such as tax impediments to business re-organisation, high compliance costs, tax-avoidance through intra-group dealings, value shifting, double deductions and double taxation.
28. The government announced its in principle support to the development of the TVM and associated high level rules – proposed by the Ralph Review of Business Taxation – subject to an extensive consultation process with representatives of the business community. The outcome of the review indicated that the benefits of TVM could not be reliably determined (OECD 2003a, 2001).
29. The government has decided, following the Advice of the Board of Taxation considerations of submissions received, not to proceed with the draft legislation on entity taxation legislation – a key recommendation of the Ralph reform (OECD 2003, 2001).
30. For a discussion of the issues see the Board of Taxation (2002) (*www.taxboard.gov.au/content/trusts/index.asp*).
31. The public consultation was based upon *Review of International Taxation Arrangements: Consultation Paper*, released in August 2002 (available at *www.taxboard.gov.au/content/int_tax_index.asp*).
32. See Australian Government (2003a), and Commonwealth Treasurer Press Release No 032 (2003) *Review of International Taxation Arrangements*.
33. The main problems of the previous tax system in Australia and the government's 1998 tax package, along with the modifications to the original package to get the Senate's approval, were discussed in detail in the 1999 and 2000 OECD *Economic Surveys of Australia*.
34. For a discussion see Dirkis and Bondfield (2004).
35. This integrity measure was introduced in 2000 to prevent individuals avoiding tax by diverting income gained from their personal efforts or skills to an entity such as a company, partnership, or trust. Such provisions restrict the ability of an individual to retain personal services income in an entity and deductions which can be claimed.
36. These rules aim at ensuring that a trustee cannot shelter trust income at the prevailing company tax rate by creating a present entitlement to a private company without paying, and then distributing the underlying cash to a shareholder of that company. The new arrangements replace the former section 109UB of the Income Tax Assessment Act 1936 which has a more restricted application (Australian Taxation Office (2004), Amendments to the Taxation of Discretionary Trusts (*www.ato.gov.au/businesses/*).
37. Saunders and Maley (2004) argue that while a positive step, the reduction in the taper rate on the Family Tax Benefit (FTB) in the 2004-05 Budget essentially implies an extension of the FTB coverage higher up in the income level, thereby extending the problem

across a broader range of people. As such, the budget measure has alleviated the problem of work disincentives, without however eliminating it. Instead, the authors argue in favour of raising the tax-free threshold to above the welfare floor (so as to provide workers with substance income before start paying tax) and to replace the means-tested family payments with a flat-rate child tax-credit.

38. See the 1999 and 2003 OECD *Economic Surveys of Australia*.
39. Data provided by Australian authorities.

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Annex 2.A1

The main features and implementation progress of tax reform

I. A *New Tax System*

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

- The introduction of a 10 per cent goods and services tax (GST) to replace the Wholesale Sales Tax (WST) 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 accrues 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.[2] The GST revenue is distributed between the States according to horizontal fiscal equalisation principles recommended by the Commonwealth Grants Commission.[3]

- The introduction of an income tax 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.

- Simplification of the number and administration of benefits available to families.

- Simplification of 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;[4] *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.[5] PAYG is a comprehensive system for reporting and paying withholding amounts and tax on business and investment income. Under the system 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 GST input credits), or to claim one net refund, quarterly, and abolish provisional tax and the uplift factor. The government made significant changes in 2001 to streamline the GST and payment and reporting arrangements for small business, aiming at easing compliance costs.[6]

II. Business tax reform

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 of 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 has reduced compliance costs by simplifying the many amortisation regimes previously in the law. Certain capital allowance "black hole" expenses are now recognised in the law.
- 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 entities to be treated as single entity for income tax purposes.
- 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.
- Taxation relief for demergers, to improve flexibility in business structures.
- Simplified imputation arrangements, to streamline the operation of the existing imputation system.

Recent reform measures completed, introduced or announced since the last update

- A new venture capital regime was introduced in 2002. Under the regime, certain tax exempt and other eligible foreign investors are exempt from income tax on profits or gains on certain eligible equity investments made by a venture capital limited partnership or similar eligible entity.

- Leasing, the first stage of reforms dealing with tax preferred entities have been released as an exposure draft, and industry consultations have commenced. The legislation is expected to be finalised in 2004, and will apply from Royal Assent.
- Losses, a package of measures designed to substantially simplify the company loss recoupment rules was announced by the Government on 7 April 2004, legislation is currently being developed. The tracing for the continuity of ownership test will be simplified for some companies, and the same business test will be removed for large companies and consolidated groups.
- The Government has announced that a systematic legislative treatment for black holes and rights will be developed by July 2005, in the intervening period specific examples will continue to be dealt with on a case-by-case basis.
- Foreign currency gains and losses: the Government has passed legislation to reform the taxation laws in this area. These provisions generally commenced from 1 July 2003.
- New measures removing the taxing point on conversion or exchange of certain financial instruments also commenced on 1 July 2003.
- Introduction of a Foreign Resident Withholding Tax regime. The legislation generally commenced from 1 July 2003. The rules apply to payments prescribed in regulations made from 1 July 2004. The three initial groups of payments were announced in the 2004-05 Budget.

Measures with commencement dates yet to be determined

- More general taxation of financial arrangements (TOFA) reform measures are still being developed with commencement dates yet to be determined. The reforms will provide a comprehensive and coherent framework for taxing financial arrangements
- The issue of 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.
- 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 proposal for the exemption from tax of temporary residents on their foreign source income is not proceeding in light of Senate opposition.

Source: Australian Government submission.

III. International tax reform package

Main measure	Legislative status	Announced commencement date
Reforms to better target the Foreign Investment Fund rules Reforms to better target the Foreign Investment Fund rules	Legislated	1 July 2003
New double tax treaty with the United Kingdom	Legislated	Generally 1 July 2004
Capital gains tax (CGT) concession on sale of active foreign company	Legislated	1 April 2004
Extended company tax exemption for foreign non-portfolio dividends and branch profits	Legislated	1 July 2004
Controlled Foreign Companies rules – modified tainted services income rules	Legislated	1 July 2004
Controlled Foreign Companies rules – reduced application to comparable tax countries	Regulations gazetted	1 July 2004
Reforms to tax treatment of non-residents investing in Australian managed funds (unit trusts)	Legislation introduced to Parliament, but expired due to calling of Federal election	When legislation passes
CGT concession for non-residents on sale of Australian company with foreign assets	Subject to consultation	Not announced
Foreign income account (dividend withholding tax relief)	Being drafted	Not announced

Source: Australian Government submission.

Notes

1. Financial Institutions and Duty (FID) and stamp duties on marketable securities have been abolished in July 2001. As discussed earlier, the time limit for abolishing the debit tax (on bank accounts) has been postponed to 1 July 2005, while the need for retaining a range of other business stamp duties will be reviewed by the Ministerial Council in 2005.
2. The States have been guaranteed by the Commonwealth government 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.
3. These principles take into account differences in State revenue mobilisation capacity and their expenditure needs based on national standards of service delivery.
4. PAYG replaces 11 existing systems, including Pay as You Earn (PAYE), prescribed payment system (PPS), reportable payments system (RPS), provisional tax and company instalments (Australian Government, 2000). It has no connection with the traditional pay-as-you-go public pension systems.
5. 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 that 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.
6. See Commonwealth Treasurer Press Release No. 007 (2001) at *www.treasurer.gov.au*. Moreover, a modification to PAYG has been announced in the 2004-05 Budget according to which taxpayers who become ineligible to pay annual PAYG instalment during an income year will not be required to start paying quarterly PAYG instalments until the first quarter of the following year. Moreover, the May 2004 Budget included measures aiming to enhance, for certain taxpayers, choice and flexibility in discharging their GST payment and reporting obligations and reducing the number of reports required to be lodged each year. These changes are subject to the states' agreement.

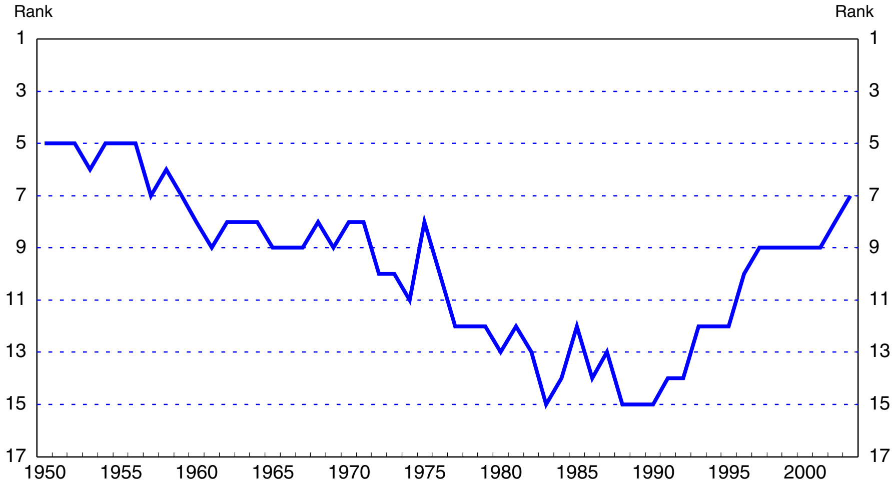
3. Product market competition and economic performance

Background of competition policy and other reforms

The OECD *Growth Study*[1] and other empirical work have shown that the strength of competition in product markets plays an important role in the economic growth process as well as contributing to a more efficient allocation of resources in a static sense. More intense competition is likely to encourage stronger efforts of managers to improve efficiency and induce higher innovative activity, leading to higher multi-factor productivity (MFP). Insufficient competition in the domestic economy is held to have accounted for much of the slippage in the growth in Australia's productivity and living standards in the 1970s and the first half of the 1980s, following the "Golden Age" of rapid economic growth after World War II.[2] A large part of the economic slowing was attributable to the poor productivity record in infrastructure industries: for example, in 1990, productivity levels were less than one-half of those of Australia's trading partners in ports, railroads and electricity generation, and productivity in Australia's telecommunications industry was the lowest in nine countries examined by the OECD.[3] Hence, Australia, which was near the top of 22 selected OECD countries in terms of per capita GDP in the 1950s, had fallen into the bottom third by 1990[4] (Figure 3.1).

Australia's falling behind other economies led to a wide-ranging series of reviews of existing policy strategies.[5] A recurring theme in many such reviews was that prices frequently did not reflect the cost of supply, and that excessive government intervention was a factor underlying poor performance. As a result of these analyses, economic reforms were introduced progressively, which dominated Australia's political life through the 1980s and 1990s. These reforms included further marked reductions in barriers to trade[6] and foreign direct investment; floating of the currency; deregulation of access to finance; commercialisation and privatisation of government business enterprises; changing institutional arrangements to allow greater labour market flexibility; promotion of education, training and innovation; and a general strengthening of competition. To achieve the latter, the National Competition Policy (NCP) was established as a centrepiece of structural reforms in 1995; it is discussed below. Microeconomic reforms were comple-

Figure 3.1. **Australia's per capita GDP ranking**
Selected OECD countries, purchasing power parity 1999 US$



Source: University of Groningen, GGDC Total Economy Database, *www.eco.rug.nl*.

mented in the 1990s with stability-oriented fiscal and monetary policies which are set in a medium-term framework.[7] Collectively, these reforms aimed at improving the allocation of resources and raising overall productivity by encouraging flexibility, technical efficiency and innovation in the economy on a broad basis, and fostering a more outward-oriented business culture.

The chapter continues with a short review of Australia's growth performance since the early 1990s and its possible link to strengthened competitive pressures and their interaction with other economic reforms. Attention is then turned to indicators of product market competition to gauge the strength of competitive pressures. This is followed by an assessment of the general competition policy framework and its role in promoting competition. The next section presents the framework of the National Competition Policy and reviews the completeness of the reform programme and the areas requiring further action. The chapter then examines a number of sectors where regulatory policies can be expected to have particularly large impacts. The implications of trade liberalisation on Australia's economic performance and the scope for further improvements are also discussed in some detail. The chapter concludes with a set of policy recommendations.

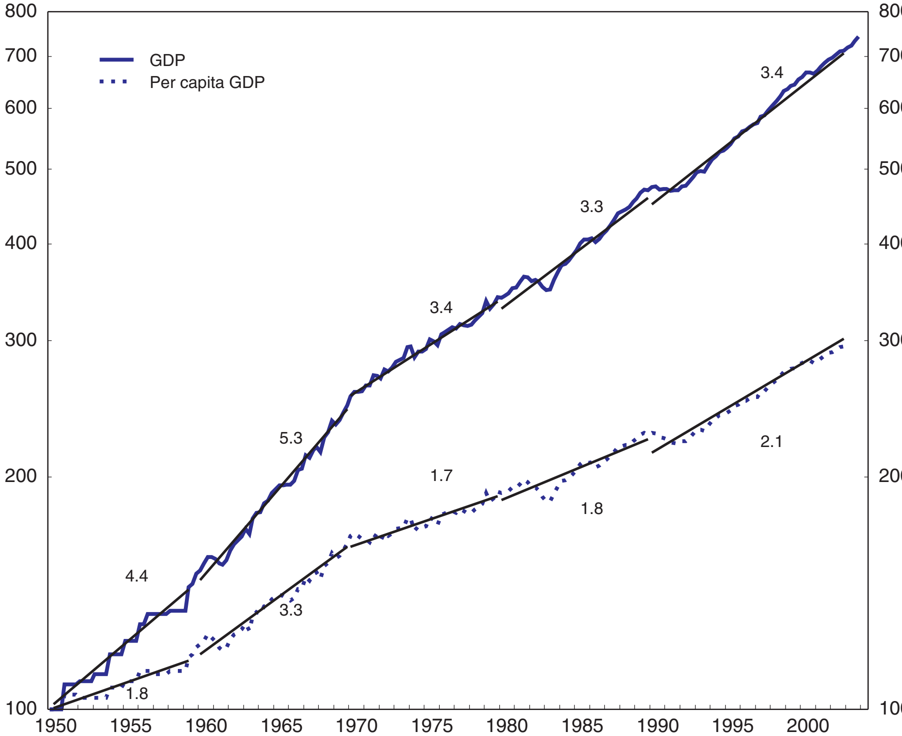
Macroeconomic performance and indicators of competition

The economic performance since the early 1990s

The economic reforms launched since the mid-1980s were followed by an economic recovery which began in 1992 and which turned out to be the longest economic expansion since the 1960s. During this long upswing, Australia's real GDP per capita increased faster than in the preceding two decades (Figure 3.2). Moreover, Australia's growth performance between 1990 and 2003 was substantially above the OECD and European Union averages, and is still on a rising trend (Figure 3.3). Growth of GDP per capita has also exceeded that of most individual OECD countries.[8] As a result, Australia's international ranking in per capita GDP – at purchasing power parity[9] (PPP) exchange rates – has rebounded from its low point of 15th in 1990

Figure 3.2. **Real GDP since 1950**[1]

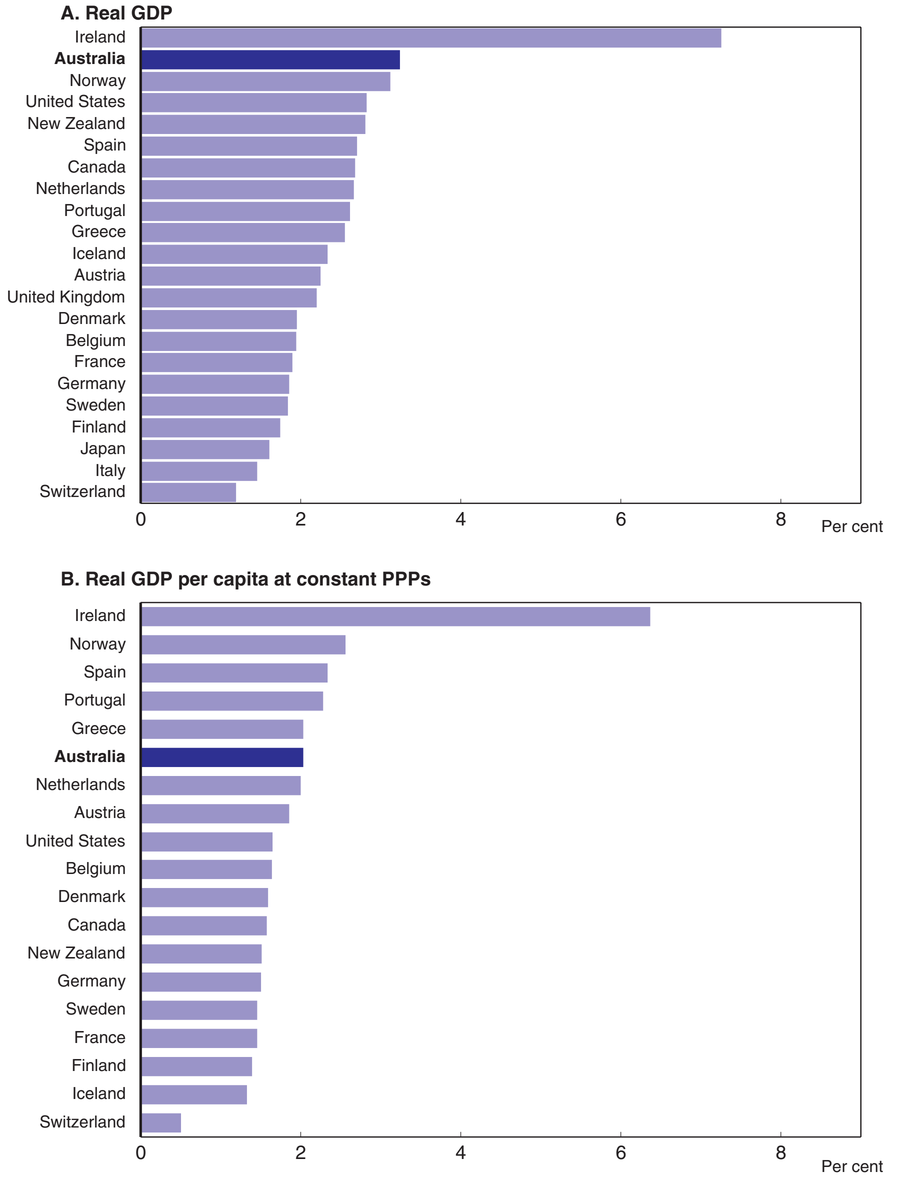
1950 = 100, log scale



1. The figures in the diagram are the average growth rates during the periods defined by the straight lines.

Source: Australian Bureau of Statistics.

Figure 3.3. **Growth performance: an international comparison**
Annual average percentage changes over 1990-2003[1]

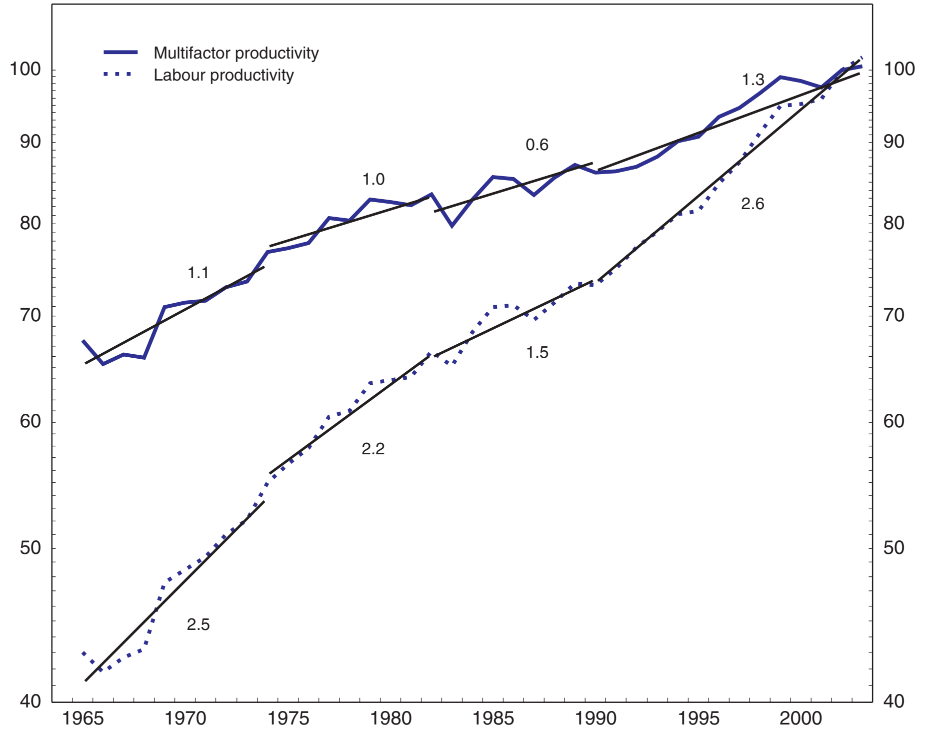


1. Or latest year available.
Source: OECD, Annual National Accounts Database.

to 7th in 2003. Nevertheless, Australia's per capita income was between 75 and 80 per cent of the US level in 2003, around the level achieved already in 1950.

Economic growth in the 1990s owes more to gains in labour productivity than to higher employment rates (Table 3.1). Indeed, higher labour productivity growth accounts for more than 90 per cent in the acceleration in per capita income in the 1990s. Although productivity can be boosted by an increased use of capital equipment per unit of labour ("capital deepening"), the growth decomposition shown in Figure 3.4 reveals that there was no acceleration in capital deepening from the 1988-89 to 1993-94 productivity cycle to the 1993-94 to 1998-99 period. Accordingly, the *additional* labour productivity growth of more than one percentage point between the two latest productivity cycles was entirely driven by higher

Figure 3.4. **Productivity in the market sector**[1]
2002/2003 = 100, log scale



1. The figures in the diagram are the average growth rates during the periods defined by the straight lines.
Source: Australian Bureau of Statistics.

Table 3.1. **Output, employment and productivity**

1990-2003

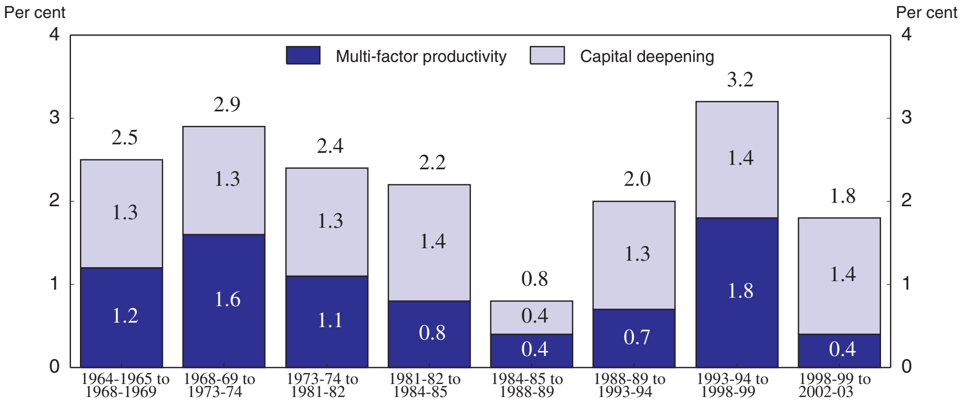
	Australia	New Zealand	United States	Japan	Canada	Germany[1]	France	Italy	United Kingdom
A. Growth decomposition, 1990-2003									
Average GDP growth	3.2	2.8	2.9	1.6	2.6	2.5	1.8	1.5	2.2
of which:									
Productivity	1.7	1.1	1.7	1.4	1.2	0.6	1.1	1.1	1.8
Employment	1.5	1.7	1.2	0.2	1.4	1.9	0.7	0.4	0.4
of which:									
Unemployment[2]	–0.0	0.2	–0.1	–0.2	–0.0	–0.3	–0.0	0.1	0.1
Labour force	1.5	1.5	1.2	0.4	1.4	2.2	0.7	0.2	0.3
B. Growth decomposition per capita, 1990-2003[3]									
Average GDP per capita	2.1	1.7	1.7	1.3	1.5	0.7	1.7	1.4	2.2
Productivity	1.7	1.1	1.7	1.4	1.2	0.7	1.3	1.1	1.7
Employment rate	0.4	0.6	–0.0	–0.0	0.3	–0.0	0.4	0.3	0.5
C. Labour productivity growth, 1993-2001									
Agriculture and forestry[4]	2.7	5.3	2.7	0.1	3.7	4.8	3.4	4.2	2.6
Mining and quarring	5.3	4.5	1.5	1.7	–0.8	–5.0	n.a.	0.3	2.7
Total manufacturing	2.2	1.4	4.0	3.6	2.7	2.4	4.0	2.3	2.2
Electricity, gas and water	5.6	7.7	1.3	3.2	1.7	6.3	2.5	5.7	7.8
Construction	0.4	0.2	–0.0	–2.6	1.7	0.2	-0.7	0.5	1.7
Wholesale and retail trade repairs[5]	3.1	1.3	4.5	1.8	2.9	0.1	0.9	1.7	4.9
Hotels and restaurants	0.9	–2.0	0.3	. .	1.2	–4.3	–0.8	-0.4	. .
Transports and storage[6]	2.9	0.6	1.0	0.4	2.0	4.4	1.8	1.0	2.0
Communication	4.7	. .	3.8	. .	3.4	14.6	3.9	9.4	. .
Other services	1.0	–0.4	0.9	0.9	1.1	0.5	–0.2	0.3	1.4

1. Data concerning Germany start in 1991.
2. A positive sign indicates that unemployment has declined and contributed to boost output growth.
3. 2002 for Australia, Germany and France, 2001 for United Kingdom.
4. Including hunting and fishing.
5. Including hotels and restaurants for Japan and United Kingdom.
6. Including communications for Japan, New Zealand and United Kingdom.

Source: OECD, STAN Database.

Figure 3.5. **Growth in labour productivity over productivity cycles, 1964-65 to 2002-03**[1]

Percentage changes at annual rates



1. Productivity cycles are the intervals between productivity peaks, as identified by the Australian Bureau of Statistics. 1998-99 to 2002-03 is an incomplete productivity cycle.

Source: Productivity Commission and Australian Bureau of Statistics.

growth of multi-factor productivity[10] (MFP) in the market sector,[11] hence by the more efficient use of resource inputs (Figure 3.5). But with real GDP per hour worked at between 75 and 85 per cent of the hourly productivity in the United States, there is still considerable scope for catching up.

During the four years ending in the financial year 2002-03, capital deepening maintained its trend, but market sector MFP growth slowed down to an average rate of 0.5 per cent. This could indicate the end of its strong trend increase in the 1990s. However, productivity outcomes over recent years have been influenced by a series of major shocks. These were: the introduction of the goods and services tax (GST), which induced a pre-GST-implementation housing boom, followed by slump; the global economic weakness in 2001-02; and the drought in 2002-03. These shocks appear to have caused strong fluctuations in MFP growth estimates. The estimated decline in MFP in agriculture by about 20 per cent in 2002-03 alone accounts for a decline in total market sector MFP by a full percentage point. Conversely, the current recovery in the farm sector is set to boost its MFP in the near future. Finally, it is important to note that the latest productivity growth cycle is incomplete and comparisons with earlier complete cycles may be misleading.

Increased competitive pressures have contributed to good economic performance

Although the causal connections between structural reforms and economic performance are difficult to establish beyond doubt, there is broad agreement among researchers that competition policy and other microeconomic reforms have played a central role in Australia's productivity surge.[12] They conclude that the reforms, with their focus on openness to foreign trade and investment and enhanced domestic competition, have been drivers and enablers of Australia's recent productivity growth (Productivity Commission, 2002a). The improved economic performance is also in broad accordance with *ex ante* estimates of the gains from microeconomic reform such as those of Filmer and Dao (1994) who predicted an acceleration of GDP growth by 1 percentage point in the first half of the 1990s and by 1½ percentage points in the second half, leading to a decline in the unemployment rate to a little above 5 per cent by 2001. Previous model-based projects by the Industry Commission (1995) suggested that the major elements of the National Competition Policy could potentially generate a net benefit equivalent to 5½ per cent of GDP. More selective analysis, undertaken for the current Productivity Commission inquiry into the future of NCP, indicates that the observed productivity and price changes in key infrastructure sectors in the 1990s – to which NCP and related reforms have directly contributed – have served to increase Australia's GDP by 2.5 per cent or $20 billion (Productivity Commission 2004c). Although alternative explanations have been proposed for the acceleration in productivity growth during the 1990s, these have either been dismissed, or when credible, could only account for a comparatively small quantitative contribution to the productivity advance (Box 3.1).

A look at sectoral multifactor productivity estimates may offer additional insight into the link between competition policy reforms and productivity performance (Table 3.2). The estimates show, for example, that the electricity, gas and water sector, which was previously dominated by uncompetitive public sector monopolies, substantially stepped up its multifactor productivity growth from the mid-1970s to the late 1990s, with the acceleration coinciding with the growing exposure of these industries to competitive pressures (Figure 3.6). The resulting productivity gains in infrastructure service industries have led to substantial cuts in infrastructure prices such as electricity, gas, water, sewage, urban transport, ports, railways and telecommunications (Productivity Commission 2002a). For example, during the 1990s, electricity prices for businesses fell between 30 and 60 per cent in real terms; port authority charges fell in real terms by between 50 and 60 per cent in Sydney and Melbourne; coal rail freight rates in the Hunter Valley fell by 60 per cent in real terms; and the real price of telecommunication services fell by more than 20 per cent.[13] It also seems that these price reductions were not at the expense of service quality and that their magnitude was broadly similar in city and country areas. The Productivity Commission (2004c) notes that structural reforms are likely to have been the principal contributors to the improvements in productivity growth for the five year period to 1998-99 which provided the equivalent of an additional A$ 7 000 to the "average" household. It also estimated that if Australia could increase its productivity further, to levels equivalent to the United States, Australian household income would rise by some A$ 22 000 per year.

Box 3.1. Factors apparently not contributing to the 1990's multifactor productivity surge

***External factors*:** Unlike the 1960s and 1970s, there was no worldwide productivity boom which could have stimulated Australia's performance in the 1990s.

***Cyclical forces*:** The 1990s productivity acceleration was too protracted to be explained as a purely cyclical phenomenon. Moreover, the ABS' measures of peak-to-peak productivity cycles adjust for much of the cyclical influences on trend productivity estimates.

***Higher unmeasured labour inputs*:** Although there was a trend to longer working hours in Australia over the past two decades, this is already adjusted for in the ABS main labour productivity measure (output per hours worked). There is no evidence of any increase in unrecorded hours worked. Claims that industrial relations reforms have eroded working time standards (Quiggin 2000, 2001) were examined by Wooden (2003) and could not be confirmed. However, more effective use of labour during working hours is a genuine source of productivity gains.

***Higher R&D spending*:** Although since the mid-1980s total R&D expenditure has increased from 1.12 to 1.53 per cent of GDP, and business R&D from 0.53 to 1.11 per cent of business value added, these indicators remain below the OECD average and are unlikely to have induced any significant technological leap forward in the 1990s.

***Higher infrastructure spending*:** Australian public investment has been declining rather than increasing since the mid-1980s.

***Effect of skills*:** Higher skill levels could have pushed up productivity levels but the accumulation of skills seems to have decelerated between the 1980s and 1990s (Parham, 2004). A small contribution from skills to MFP growth – about 0.2 percentage point – from the mid-1980s to the late 1990s was reported by Barnes and Kennard (2002).

***ICT effects*:** Rapid advances in the *production* of information and communication technology (ICT) are no credible explanation either because of the smallness of the sector in Australia (see the 2001 OECD *Economic Survey of Australia*). However, various studies (*e.g.* Bean 2000, Parham *et al.* 2001, Gretton *et al.* 2003) identified a productivity-enhancing effect from the increased *use* of ICT. Of the annual 1.1 percentage point acceleration in MFP growth that occurred in the 1990s – around 0.2 percentage points were attributed to the use of ICT between the 1990s growth cycles. This estimate is not uncontroversial, being based on growth accounting methods and an equilibrium assumption which may understate dynamic impacts. It also assumes that the timing of the acceleration has been correctly identified. It is not surprising then that a comparatively large part of the productivity acceleration remains unexplained. While the exact effect of ICT may be higher, it is certainly true that 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 growth. This suggests that other factors were important in this increase in the rate of growth. It also leaves open the question why Australia moved from a technological laggard in the 1970s and 1980s to a frontrunner in the 1990s, if it were not increased competitive pressures.

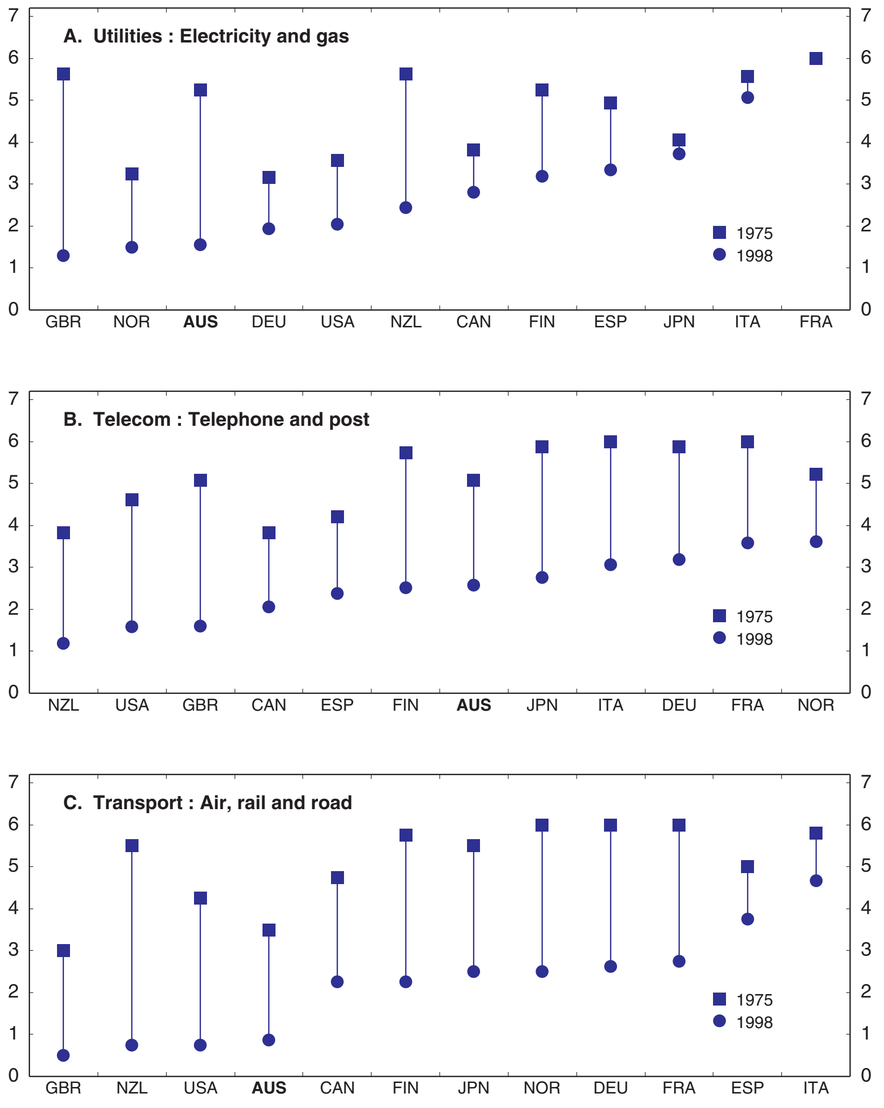
Table 3.2. **Growth in multifactor productivity by industry over aggregate productivity cycles**
Per cent, per year

Industry	1974-1975[1] to 1981-1982	1981-1982 to 1984-1985	1984-1985 to 1988-1989	1988-1989 to 1993-1994	1993-1994 to 1998-1999	1998-1999 to 2002-2003
Agriculture	2.7	3.0	–1.6	4.2	4.2	–2.1
Mining	–3.8	5.7	2.4	2.3	0.1	0.6
Manufacturing	2.3	2.0	1.5	2.0	0.5	1.2
Electricity, gas and water	2.2	1.2	5.1	4.0	1.8	–2.0
Construction	2.7	–0.7	–0.3	–0.5	2.2	1.3
Wholesale trade	0.5	–2.5	1.8	–2.2	5.8	1.9
Retail trade	0.9	2.6	–2.6	0.7	1.4	0.5
Accommodation, cafés and restaurants	–0.5	–2.9	–1.4	–1.9	0.8	0.1
Transport and storage	3.4	1.9	1.4	1.3	2.3	3.4
Communication services	6.1	3.2	3.6	6.1	5.1	–1.0.
Finance and insurance	–2.9	–1.2	1.5	0.0	1.6	–0.8
Cultural and recreational services	–0.5	–1.8	–4.6	–2.4	–4.0	–2.7
Total market sector	**1.1**	**0.8**	**0.4**	**0.7**	**1.8**	**0.4**

1. Because of lack of industry data for 1973-74, the 1970 cycle in this table begins in 1974-75.
Source: Productivity Commission and ABS.

A similar story can be told for a number of services industries during the 1990s, although these sectors were not direct targets of microeconomic reforms. In particular wholesale trade and finance and insurance, but also retail trade, construction and transport and storage became the new engines of the economy-wide strong overall productivity performance in the 1990s. Industry specific analyses, such as that of Johnston *et al.* (2000) for the wholesale sector[14] provide evidence that general economic polices which have strengthened competition and sharpened incentives to be more productive have encouraged the introduction of new production processes and firm organisation and stimulated the rapid uptake of ICT in Australia. The rapid adoption of productivity-enhancing technologies was further helped by more flexible industrial relations arrangements which have improved work incentives by bringing remuneration closer into line with productivity. The more flexible industrial relations allowed the reduction of demarcations and the application of new organisational approaches, such as the introduction of multi-skilling, just-in-time delivery, split shifts, total quality control, team-based responsibility and quality circles. In addition, financial markets reforms had facilitated the access to and reduced the cost of funding for capital accumulation and for the diffusion of new technologies. And the removal of many (but not all) impediments to foreign direct investment (FDI) has encouraged FDI into Australia, and the resulting transfer of technology may also have helped to raise productivity. These findings at the sectoral level suggest that the acceleration in productivity growth in recent years is difficult to attribute to any single policy measure but is the likely outcome of a comprehensive set of microeconomic reforms, which

Figure 3.6. **Progress in liberalisation of service sectors in OECD countries**[1]



1. In each year and sector, the indicators have a 0-6 scale ranging from least to most restrictive of competition. They cover public ownership, barriers to entry, market structure, vertical integration and price controls. See Nicoletti and Scarpetta (2003) for details.

Source: OECD Regulatory Database.

combines competition policy, including trade policies, with reforms in labour and financial markets.

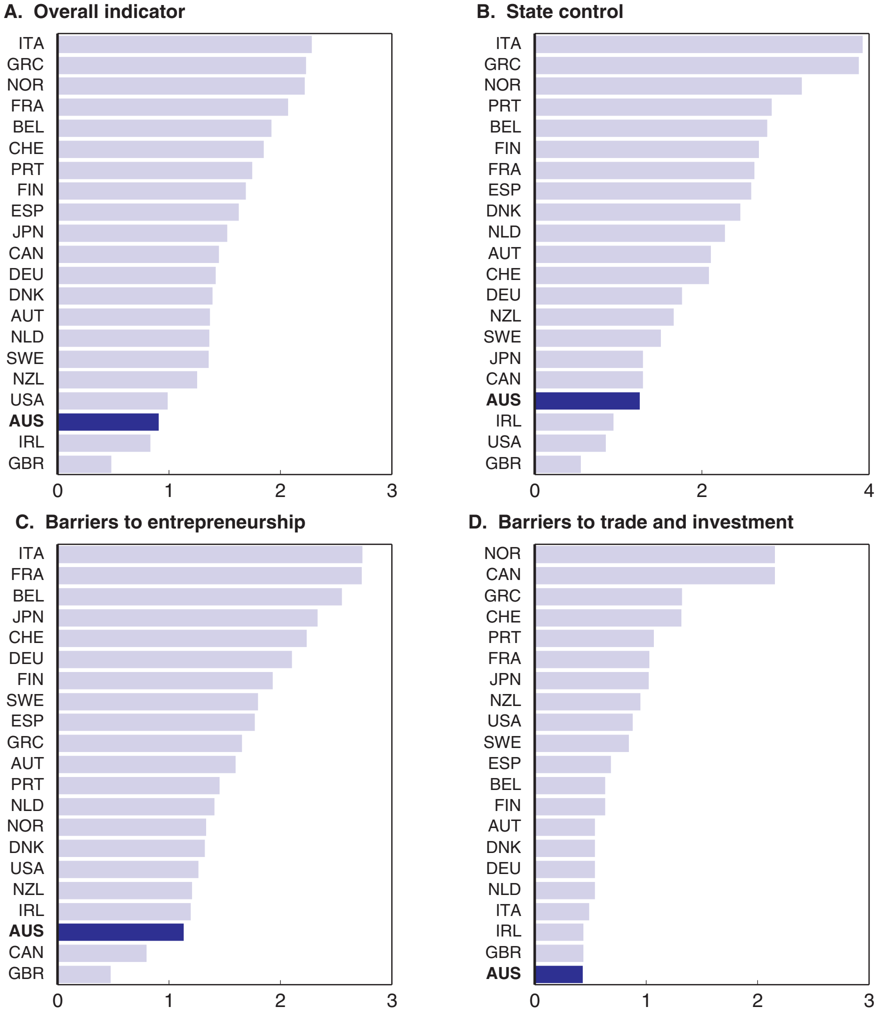
A set of indicators used to document links between competition policies (broadly defined) and aggregate economic performance has been developed at the OECD. These indicators provide a quantitative summary of the extent of barriers to trade and of administrative and economic regulations affecting competition. They suggest that over the past two decades or so, regulatory reform (as measured by both the absolute variation and the percentage decline in the regulatory indicator) was deepest in the United Kingdom, New Zealand, the United States and Australia. The indicators also reveal that at least since the late 1990s, Australia is quite open to competitive pressures, with only two other countries (the United Kingdom and Ireland) having lower obstacles to product market competition (Figure 3.7). These measures of competitive pressures (high scores indicating restrictineness) are inversely related to multifactor productivity growth, suggesting that the low barriers to market entry in Australia have contributed to its strong overall economic performance relative to most other OECD countries (Nicoletti and Scarpetta 2003). But in spite of the low overall degree of anti-competitive regulation, there is still potential for improvement. For example, the study by Scarpetta and Tressel (2002) suggests that in the case of Australia an alignment of the regulatory stance in each industry to best practice in the OECD area could reduce the gap in the level of multifactor productivity between Australia and the technological leaders in each industry by 7½ percentage points[15] (Figure 3.8). Importantly though, this only accounts for one part of the productivity gap between Australia and the United States and suggests that there may be additional unexplored explanations for that gap.

The intensity of product market competition is generally high

An assessment of the intensity of product market competition is required to evaluate the scope for improving economic performance *via* stronger market discipline. However, the strength of product market competition can only be assessed on the basis of imperfect and ambiguous proxy measures, and even then, the data required do not exist for many countries. An indication of the overall intensity of competition in a country can be gleaned from international price comparisons, though these indicators need to be interpreted with caution.[16] Part of the variation in aggregate price levels will tend to be positively related to variations in GDP per capita,[17] and in evaluating price differences as indicators of competition pressures it is necessary to correct for this effect. Figure 3.9 shows that GDP price levels compared on the basis of PPPs and GDP per capita differ significantly across countries. For Australia, the corrected price level below the regression line suggests that there are competitive pressures at work which keep prices lower than expected on the basis of Australia's per capita income. This is con-

Figure 3.7. **Indicators of product-market regulation**[1]

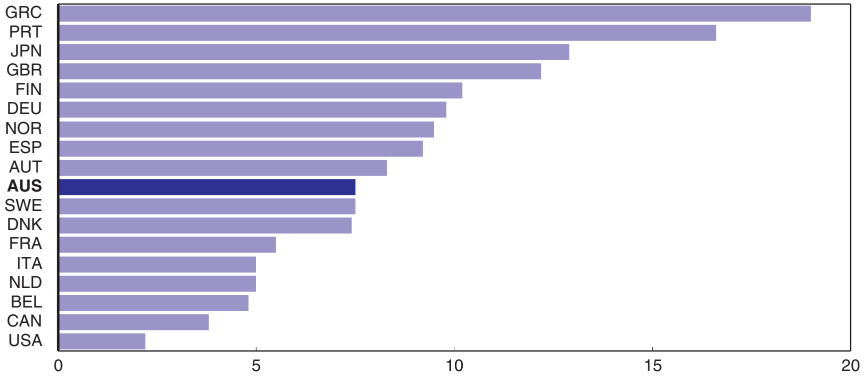
1997-98



1. Synthetic indicators of strictness of legislation. Scores can range from 0 to 6 with higher values representing stricter regulation.

Source: Nicoletti, G., S. Scarpetta and O. Boylaud (1999), "Summary indicators of product market regulation with an extension to employment protection legislation", OECD *Economics Department Working Papers*, No. 226.

Figure 3.8. **Effect of deregulation on the multifactor productivity gap relative to best practice**[1]



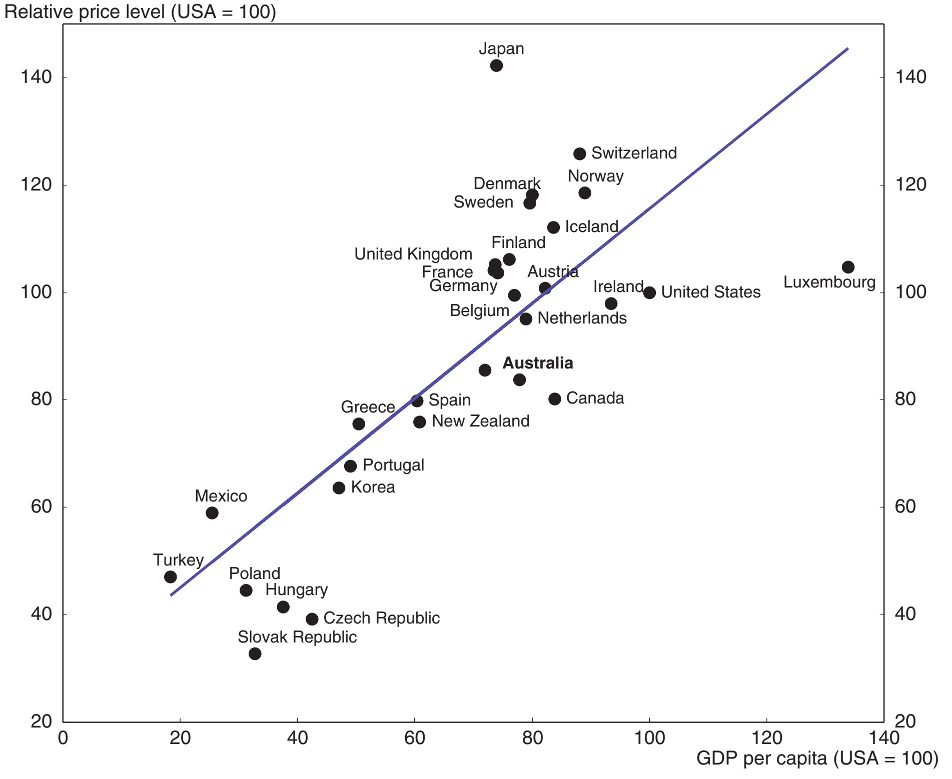
1. The graph shows the estimated effect of a decrease in product market regulation (PMR) by one standard deviation on the level of the long-term multifactor productivity (MFP) gap between a country and best practice abroad (the "leader"). The MFP gap is computed industry by industry and aggregated by taking an average weighted by the initial sectoral value-added.

Source: Scarpetta and Tressel (2002), "Productivity and convergence in a panel of OECD industries: do regulations and institutions matter?" OECD *Economics Department Working Papers*, No. 342.

firmed by the recent study of Bradford (2003) which develops comparisons of domestic prices to world prices for 124 goods based on the prices collected by the OECD to compute purchasing power parities, which are converted to producer prices and adjusted for transport costs. Unfortunately, data availability (and the labour intensity of such calculations) limited the statistics to eight countries covering price quotes from 1991 to 1993. Although these measures are not perfect, the results, summarised for 29 industries in Table 3.3, indicate that Australia (with an "effective tariff", *i.e.* the percentage differential between domestic and world price, of 26.6 per cent) was a decade ago among the most open of the countries considered. In three sectors its price was the lowest of the eight countries and in thirteen of its industries it was one of the three lowest-priced countries.

The strength of competitive pressure also depends to a large extent on how exposed industries are to international competition. The increase in Australia's import penetration ratio (Figure 3.10, Panel A) over time in response to progressive relaxation of trade and investment barriers suggests that producers now face stronger competitive pressure from foreign firms than in the past. While the level of import penetration remains among the lowest of single OECD countries, when factors such as GDP per capita and geographic isolation are taken into account, Australia's level of import penetration is not significantly different to that which is expected. Strong international competition is also reflected in the record-low level of support for farmers, as measured by the OECD producer sup-

Figure 3.9. **Relative price levels and GDP per capita**
Real incomes and relative prices, 2002 in purchasing parities



Source: OECD, *Purchasing Power Parities*.

port estimates (Figure 3.11). – However, very strict quarantine and sanitary regulations can make access to the Australian market on agri-food products difficult.

Stronger competition has helped to improve the labour market performance

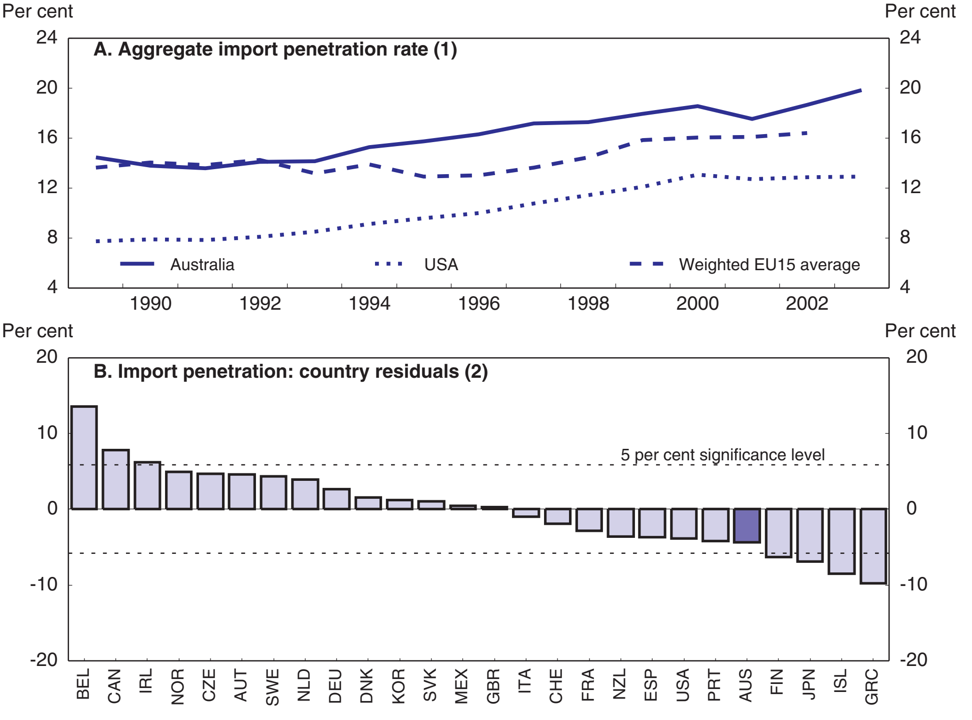
A higher intensity of market discipline imposed on producers also tends to be reflected in a better overall employment performance (Box 3.2). This is supported by the research by Nicoletti *et al.* (2001), which found a significant effect of regulatory reforms on the employment rate in the business sector (excluding agriculture) of OECD countries even after controlling for the impact of various labour market indicators and the public-sector employment rate.[18] The study's results are illustrated in Figure 3.12, which reveals that regulatory reform

Table 3.3. **Ratio of the domestic to world price, 1991-1993**

Industry	**Australia**	Belgium	Canada	Germany	Japan	Netherlands	United Kingdom	United States
Agriculture, fisheries and forestry	1.067	1.157	1.112	1.529	1.584	1.080	1.648	1.158
Processed food	1.086	1.372	1.192	1.447	2.099	1.299	1.202	1.090
Beverages	1.447	1.444	1.535	1.765	1.540	1.328	1.694	1.061
Tobacco	1.472	1.947	1.955	3.531	1.000	1.385	2.217	1.060
Textiles	1.111	1.218	1.163	1.101	1.478	1.140	1.237	1.051
Apparel	1.264	1.569	1.175	1.457	1.384	1.280	1.074	1.158
Leather and products	2.944	1.777	1.236	1.437	1.329	1.658	1.168	1.143
Footwear	1.657	1.823	1.415	1.328	2.289	2.239	1.027	1.111
Furniture and fixtures	1.299	1.958	1.558	1.392	2.707	1.471	2.172	1.020
Paper and products	1.438	1.659	1.060	1.606	1.804	1.965	1.783	1.050
Printing and publishing	1.120	1.310	1.205	1.024	1.186	1.342	1.029	1.005
Drugs and medicines	1.001	1.692	2.680	2.643	1.217	3.349	1.845	3.105
Chemical products	1.092	1.137	1.064	1.107	1.555	1.075	1.064	1.037
Petroleum and coal products	2.127	3.375	1.320	2.847	3.359	4.335	4.067	1.007
Rubber products	1.219	1.680	1.015	1.711	2.016	1.655	1.566	1.032
Pottery, china, etc.	1.727	1.007	1.145	1.511	2.383	1.016	1.082	1.070
Metal products	1.430	1.622	1.328	1.770	1.977	1.837	1.602	1.165
Office and computing machinery	1.008	1.513	1.234	1.446	1.000	2.101	1.666	1.015
Machinery and equipment, nec	1.343	1.682	1.297	1.325	1.559	1.527	1.388	1.175
Radio, TV and communication equipment	1.178	1.558	1.204	1.298	1.226	1.432	1.236	1.034
Electrical apparatus, nec	1.536	1.936	1.316	1.713	2.106	1.556	1.320	1.073
Shipbuilding and repairing	1.278	1.267	1.107	1.354	1.200	1.545	1.536	1.000
Railroad equipment	1.374	1.314	1.093	1.404	1.238	1.509	1.503	1.016
Motor vehicles	1.224	1.351	1.197	1.315	1.000	1.648	1.680	1.106
Motorcycles and bicycles	1.231	1.761	1.252	1.599	1.000	1.385	2.002	1.057
Aircraft	1.191	1.199	1.082	1.282	1.020	1.462	1.454	1.001
Transport equipment, nec	1.516	2.034	1.109	1.888	1.315	2.065	1.924	1.057
Professional goods	1.125	1.571	1.082	1.379	1.077	1.369	1.586	1.074
Other manufacturing, nec	1.237	1.807	1.209	1.863	2.348	1.636	1.416	1.030
Weighted geometric means	1.266	1.555	1.270	1.539	1.567	1.541	1.480	1.118

Source: Bradford (2003), "Paying the Price: Final Goods Protection in OECD Countries", *Review of Economics and Statistics*, Vol. 85.

Figure 3.10. **Indicators of market openness**



1. Imports of goods and services relative to imports plus gross domestic product, in real terms, excluding intra-EU trade.
2. Average residuals for the period 1995 to 2000 after controlling for effects of country size, gross domestic product per capita and transportation costs.

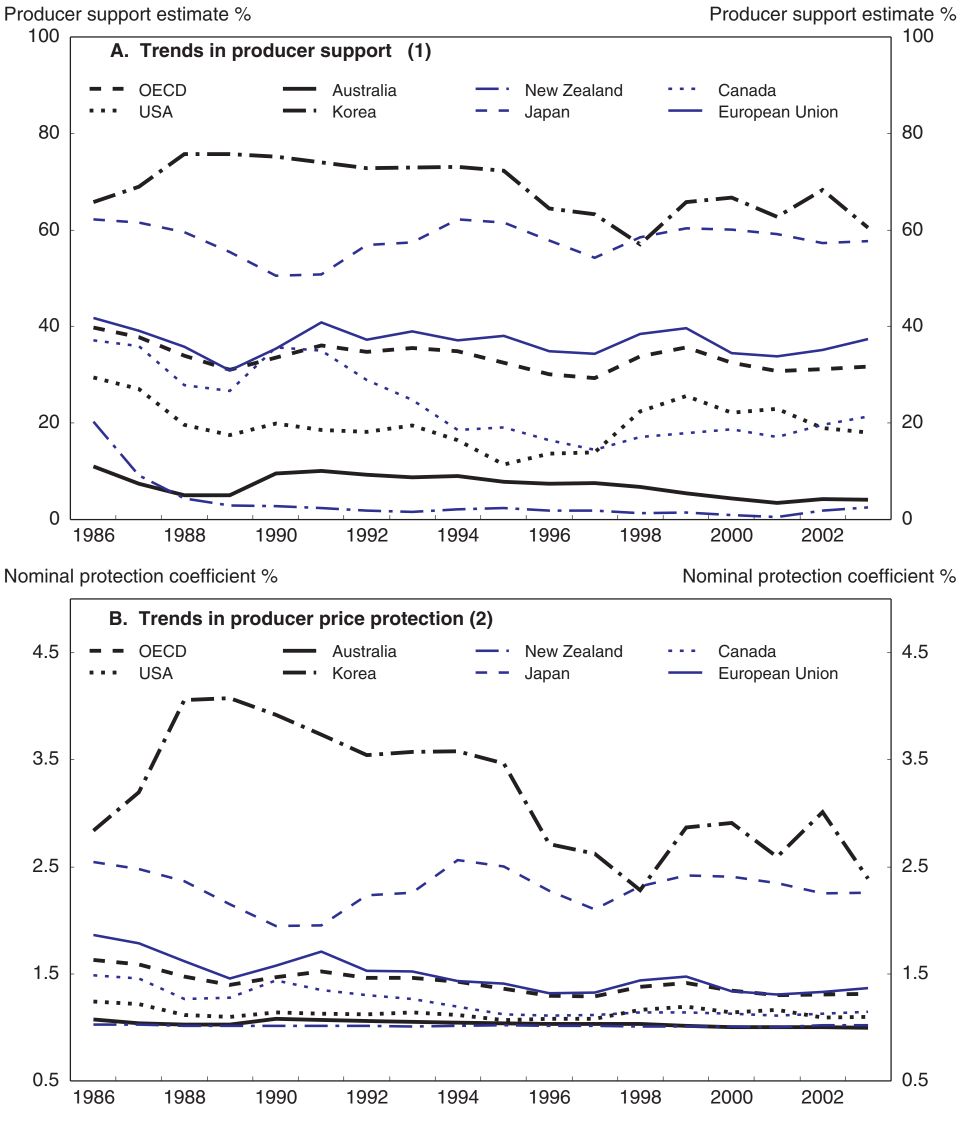
Source: OECD, *Monthly Trade Statistics* and OECD calculations.

since the late 1970s has raised Australia's employment rate by more than 2 percentage points.

Competition legislation and enforcement

The past decade of strong economic performance has coincided with vigorous competition law enforcement and reform of the regulatory system (see Annex 3.A1). Firms were challenged to control costs better, as increasingly effective application of Australia's competition law, the Trade Practices Act (TPA), reduced their power over price, and reforms under the National Competition Policy (NCP) reduced protections and restraints from regulation and state intervention. In part due to the high profile of enforcement and the reform programmes,

Figure 3.11. **An international comparison of agricultural support**



1. An indicator of the value of monetary transfers to agriculture resulting from agricultural policies. It is presented as a share of the total value of production at domestic producer prices.
2. The nominal protection coefficient (NPC) is a measure of market protection defined as the ratio between the average prices received by producers and border prices.

Source: OECD (2004), *Agricultural Policies in OECD Countries at a Glance*.

Box 3.2. The effects of product market reforms on employment and unemployment

At the macroeconomic level, an increase in product market competition that leads to lower profit mark-ups over factor cost will unambiguously raise aggregate labour income. The division of the added labour income between higher real wages and employment gains (and hence lower unemployment) will depend on the flexibility embedded in labour market institutions. With the degree of flexibility in the Australian labour market having increased through industrial relations reforms since the mid-1980s, the gains from stronger competition in product markets is likely to have contributed to the observed employment gain.

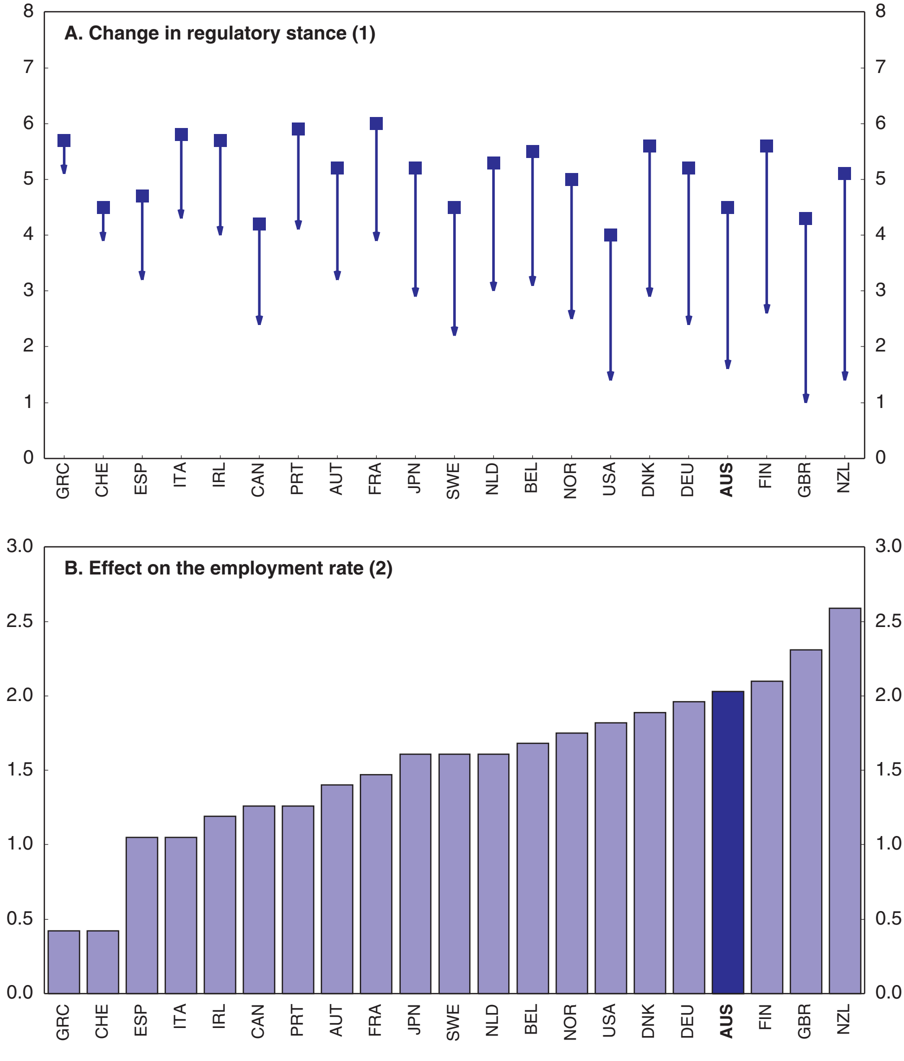
However, stronger product market competition can also improve the functioning of the labour market in other ways. Insofar as wage *premia* are reduced in some sectors, frictional unemployment is likely to decline as incentives would be weaker to prolong spells of joblessness in anticipation of being hired into high-*premia* sectors. Smaller wage *premia* would also reduce artificially high unemployment benefits for displaced workers from high-*premia* sectors (due to benefits being related to previous wages), thus encouraging such workers to accept jobs elsewhere in the economy. Finally, the competition-induced increase in aggregate real wages may encourage labour force participation.

the value of protecting and promoting competition appears to have broad public support. Competition policy is a prominent issue in public debate. But the programme has encountered resistance, too.

The Dawson Committee was created to review the competition provisions of the Trade Practices Act 1974 (TPA), and their administration. The Dawson Review concluded that the competition provisions of the TPA have served Australia well and reemphasised the importance of applying competition principles more broadly across the economy. The provisions of the TPA should not be regarded as a means of preserving particular companies; rather they should preserve the competitive process. Since the Dawson Committee reported however, recent cases involving the application of section 46 of the TPA have reopened debate about regulating for market power. Most of the recommendations made by the Dawson Committee focussed on improving existing processes by providing greater accountability, transparency and timeliness in decision-making. Most of the Dawson Committee's recommendations, and the government proposals to implement them are now under consideration. The following paragraphs characterise the issues involved in this review.

Under the current merger clearance system, there is no formal requirement to notify proposed mergers or obtain approval in advance, so parties may

Figure 3.12. **Product market liberalisation and labour market performance**



1. Reports changes in the regulatory stance in seven non-manufacturing industries (gas, electricity, post, telecommunications, passenger air transport, railways and road freight) between 1978 and 1998. The regulatory stance is measured by a synthetic indicator ranging between 0 (least restrictive) and 6 (most restrictive).
2. Estimated contribution to the change in the non-agricultural business sector employment rate.

Source: Nicoletti, G. A. Bassanini, E. Ernst, S. Jean, P. Santiago and P. Swain (2001, "Product and Labour Market Interactions in OECD countries", OECD *Economics Department Working Papers*, No. 312.

proceed but at their own risk of violating the TPA's prohibition of mergers that substantially lessen competition. In practice, parties often approach the ACCC informally to determine its likely enforcement position and to negotiate changes to their plans to overcome the ACCC's objections. The ACCC has recently amended its informal merger clearance process to provide greater transparency and accountability. This informal process resembles the merger review process in some other Members, notably Japan and Korea. Although such informality can be efficient, it can also appear unaccountable. To make the ACCC's actions and reasoning more transparent, the Dawson Review recommended the introduction of a voluntary formal process for merger clearance. That is, parties would provide notice by application, and the ACCC would be obligated to respond as to the validity of the application and reasons for accepting or rejecting the proposal within a specified time period. Further, if the ACCC indicated that it thought the proposed merger would violate section 50 of the TPA, Dawson recommended that the applicant could appeal to the Australian Competition Tribunal. This procedure is a promising and potentially efficient alternative to mandatory pre-merger notification (which is not under consideration).

A distinctive feature of Australia's competition law is the provision for merger authorisation on grounds of public benefit. Currently, the ACCC considers applications for merger authorisation, however, the Dawson Committee recommended that the question of authorisation for mergers be submitted directly to the Australian Competition Tribunal, without prior consideration by the ACCC and without the possibility of a further substantive appeal (except on legal grounds). Three grounds are given: to avoid strategic appeals by third parties, to speed up the process so as to provide commercially viable timeframes for business (particularly for publicly listed companies), and to avoid having the issue of the public benefit decided by the same body that has examined the competitive effects. There may be risks that a one step authorisation process by the Australian Competition Tribunal will mean insufficient consideration is initially given to competition issues. Delay can be corrected by setting a deadline, for merger authorisations as well as for other authorisation decisions. Combination of responsibility for competition and public benefit issues characterises all ACCC authorisation decisions, not just mergers. That said, the Tribunal already considers public benefit issues, because it decides appeals from ACCC decisions about authorisation. Though the Tribunal is not as well resourced as the ACCC, the Dawson amendments provide that the ACCC will be able to assist the Tribunal in making its decision by providing investigative and other expertise. The members of the Tribunal all serve part-time and consistent with statutory obligations have varied expertise. While the Presidential member of the Tribunal must be a member of the Federal Court, the other nine members of the Tribunal are required to come from a diverse background of industry, economics, commerce, law and public administration.

Mergers that have indirect or cumulative effects on competition are harder to control. Controversies in Australia have focused on "creeping acquisitions" in the retail sector, producing large long-term changes in tiny increments. The ACCC has also been concerned about vertical acquisitions in network industries that may have effects in markets other than the one directly involved in the transaction. Because the statutory prohibition focuses on the individual transaction, it may be hard to deal with such combined or indirect effects. However, the Dawson Committee considered the issue of regulating for creeping acquisitions and did not recommend any change. The Dawson Committee found that section 50 adequately deals with competition issues, including those that might emerge over time from an accumulation of market power. The "substantial lessening of competition" standard is probably broad enough to be applied to these problems.

There are proposals to substantially increase sanctions, including those to strengthen deterrence against horizontal price fixing. The basic sanction against violation is a civil financial penalty, imposed by a court in an action brought by the ACCC. The maximum civil fine against a corporation is A$ 10 million; against an individual, A$ 500 000. In practice, the biggest fines to date, for price fixing of power transformers, totalled A$ 35 million against all parties and included fines against 11 individuals ranging from A$ 35 000 to A$ 150 000. The cap on these fines is to be modified in order to permit larger fines against larger-scale violations. Rather than a fixed number or percentage, the cap on corporate fines will be the greater of A$ 10 million, 3 times the gain from the violation or, where the gain cannot be readily ascertained, 10 per cent of group turnover. These levels would make Australia's theoretical sanctions consistent with practices today in other major jurisdictions.

Individual fines are already common in cartel cases in Australia, but they are typically well below the ceilings. The average individual fine imposed since 1999 was A$ 45 500. The Dawson Committee's additional recommendations to tighten the effect of the civil sanctions against individuals, by prohibiting indemnification and providing for the prohibition of individuals from serving as directors or being involved in management, could also be useful. More fundamentally, the Dawson Committee endorsed developing a criminal penalty against hard-core price fixing and bid rigging subject to finding solutions to key difficulties in introducing such penalties in the Australian legal system. As noted below, the government has accepted this recommendation in principle and is considering how it could be implemented. Many jurisdictions are concluding that effective deterrence against this kind of misconduct requires a credible threat of criminal penalties. Resort to criminal process raises substantial legal complications that must be resolved. In Australia, these include the definition of the "serious cartel behaviour" that will be subject to the new sanction and devising a workable method of combining a clear and certain leniency policy with a criminal enforcement regime that is applied through other institutions. The ACCC has had a formal leniency programme since 2003, whose promise of reduced civil fines has yielded some enforcement successes. Assurance that the first executive to confess to the cartel will stay out of jail could yield even more.

The treatment of market power and the strategies of large or dominant firms has been a source of some controversy. Most of this controversy was generated in private lawsuits brought by smaller competitors, customers or suppliers.[19] Even though only a small number of these lawsuits have been successful, the law has generally been applied in an economically sound way. It has sometimes been argued that the application of law in these cases could make it more difficult to use the law to achieve economically sound results in public enforcement actions. Having considered some of these controversies, the Dawson Committee recommended no changes in the substantive tests or powers in this area. The long-standing conundrum, whether liability for a dominant firm's misuse of its market power should depend on its "purpose" or on its "effect", is no longer considered important. However the test is phrased, sensible enforcement requires considering the market context. Further clarification about the characterisation of market power and the significance of market context in the relevant provision (section 46), would have a greater impact in helping the courts avoid any unintended effects. Such a clarification will be provided by the amendments announced in June 2004. These amendments will ensure that the leveraging of substantial market power for an illegal purpose will be characterised as an abuse of market power. They will also enable market context, such as agreements between firms that boost market power, to be taken into account. A reform proposed by the Dawson Committee to help small businesses implicitly recognises that context matters in assessing whether conduct can affect the degree of competition. As the law currently stands, small businesses can join together to negotiate collectively and may seek authorisation on public benefit grounds, since their collective negotiations would otherwise violate the TPA. In recognition that collective negotiation by small business may often do little to impair competition, the Dawson Committee recommended, and the Government accepted, a more streamlined and less costly notification process for such conduct, providing immunity as soon as a statutory time period has passed. Because the system could be abused, the ACCC will be able to revoke the immunity should the conduct not generate a net public benefit.

The National Competition Policy

The reform framework

The experience of the 1980s suggested that the costs of many government enterprises, which dominated infrastructure services, were inflated by excessive capital investment and over-manning and that the goods and services produced by these businesses often did not meet the standards sought by users. State and

Territory governments had responded with their own reform agendas, but there was growing concern that a fragmented approach would lead to sub-optimal results. Accordingly, Australia's nine governments agreed in April 1995 to a far-reaching programme of competition policy reform – the National Competition Policy (NCP). As a basic principle, the NCP followed the recommendation of the Independent Committee of Inquiry[20] (the "Hilmer Committee") in 1993 to apply the *Trade Practices Act* 1974 (TPA) – Australia's main competitive policy statute – to virtually all areas of the economy. This extended the reach of the TPA's prohibitions of anti-competitive conduct to all government businesses and unincorporated enterprises engaged in intrastate commerce. In general, NCP brought together many elements of a broader programme of economic reform which already began in the early 1980s. Other features of this broader programme included the dismantling of trade barriers, deregulation of the financial system, changes to labour market regulations, taxation reform, and more recently, widespread changes to funding and delivery arrangements for various government services.

The Council of Australian Governments (COAG) is in charge of the national co-ordination of the NCP reform objectives and assessment benchmarks, while Commonwealth, States and Territories are responsible for implementing major elements of the NCP. Although the States and Territories are responsible for significant elements of NCP, much of the direct financial return accrues to the Commonwealth through higher taxation revenue from increased economic activity. Accordingly, the Commonwealth government provides competition payments to the State and Territory governments to redistribute the gains (totalling around A$ 5 billion over nine years). However, in order to receive full competition payments, States and Territories must achieve satisfactory progress in terms of the agreed reform agenda. The National Competition Council[21] (NCC), which was established by the *Competition Policy Reform Act*[22] 1995, assesses whether jurisdictions have met their obligations to implement the National Competition Policy and related reforms in gas, electricity, water and road transport, and makes recommendations on competition payments to the Australian Government Treasurer. 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. A weakness of the "payments-leverage approach" to encouraging compliance with the NCP reform framework is the lack of incentives for compliance (or of sanctions for non-compliance) at the Commonwealth government level, apart from the opprobrium of being found not to comply.

Legislation review

The legislation review and reform programme is a vital element of the NCP. It obliges governments to examine and, where it is in the public interest, reform all existing legislation that restricts competition. It is directed to achieving better regulation, not necessarily less regulation. The guiding principle of the review is that legislation should not restrict competition *unless* the benefits of such restriction outweigh the costs and the objectives of the legislation can only be achieved by restricting competition. New legislation must also meet these principles. The NCP further obliges governments to undertake a legislation review at least every ten years.

In mid-1996, governments undertook to review by mid-2002 (extended to mid-2003), around 1 800 separate pieces of Commonwealth and State legislation which had been identified as containing restrictions on competition. In part because of the enormous scope of the task, but also reflecting opposition from the groups that benefit from protection, no jurisdiction managed to complete its review and reform activity at 30 June 2003. The areas of restriction seen to most impact on competition throughout the process have been water management, primary industries, communications, fair trading and consumer protection, insurance and superannuation, health, legal and other professions, pharmaceuticals, planning and construction, retailing, social regulation and transport. These priority areas account for approximately 800 pieces of legislation. Altogether, substantial progress has been achieved. Australia-wide, around 70 per cent of governments' nominated legislation has been reviewed and, where appropriate, reformed. For priority legislation, the rate of compliance is substantially lower, at around 56 per cent overall. However, much of the priority legislation review and reform activity still under way is expected by the NCC to be completed in the near future.

A comparison of Australian governments' overall compliance illustrates the insufficient incentives for the Commonwealth to fully comply with the NCP. By mid-2003, the Commonwealth government completed the legislation review and reform of around half of its stock of legislation. It reviewed, and where suitable, reformed one-third of its priority legislation and two-thirds of its non-priority legislation. Excluding areas subject to ongoing interjurisdictional processes, the Commonwealth had 22 areas of non-compliance in priority legislation.[23] Accordingly, the Commonwealth compliance rate was the second lowest of all Australian governments and not commensurate with its leadership role in other areas of the NCP.

Infrastructure industry reforms

Access regime

Major infrastructure facilities such as electricity grids, gas pipelines and some communications networks tend to be natural monopolies, that is, a single facility can meet market demand at less cost than two or more facilities. Hence, development of new facilities would be unnecessary and wasteful. Infrastructure owners can enjoy a strategic position in an industry because access to these facilities may be essential for businesses operating in upstream or downstream markets. Infrastructure operators can also seek to exploit their position by charging monopolistic prices to businesses using the infrastructure. This behaviour can harm competition in related markets and be detrimental to consumers. An access regime is one means of restraining prices and maintaining output in these situations; other means would be direct monitoring and control of prices and service standards.

The NCP has established a *National Access Regime* for third party access to "essential" infrastructure services provided by facilities of national significance, affecting infrastructure assets of a value of well over A$ 50 billion. The *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 binding arbitration.

Since its introduction in 1995, the *National Access Regime* has proved to be an innovative, but also complex and often controversial piece of regulation. It has been examined by the Productivity Commission (2001b) with a view to ensuring that access regulation is better targeted and more workable, and to minimising the risk of access regulation deterring investment in essential infrastructure. In response, the Commonwealth government in 2004 proposed changes to the *Regime* designed to clarify its objectives and scope, encourage efficient investment in infrastructure, strengthen incentives for commercial negotiation and improve the certainty and transparency of regulatory processes.

Electricity

A competitive and efficient electricity industry is a key objective of the NCP (NCC 2003a), featuring a national wholesale electricity market and an interconnected national electricity grid. To support this objective, governments agreed to a range of reforms aimed at breaking down barriers to interstate and intrastate competition, including dismantling State-owned monopolies and implementing a third party access regime for transmission and distribution. As an important step, New South Wales, Victoria, Queensland, South Australia and the Australian Capital Territory (ACT) are now part of an interconnected national electricity market. Tasmania is due to join in 2005 on completion of a link to the mainland. Western Australia and the Northern Territory will not join the national electricity market because of the long distances between their load centres and the interconnected electricity network in eastern and southern Australia. Western Australia intends to disaggregate its electricity monopoly into generation, networks (transmission and distribution) and retail entities and to undertake other restructuring measures to provide for more competition in the market.

Following the reforms, 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[24] that three years after the commencement of the national electricity market in December 1998, 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. During the five years ending in 2003-04, electricity prices for households fell in real terms in all States participating in the national electricity market, except South Australia.[25] Total savings made by all households across all capital cities in financial year 2000/01 were estimated at about A$ 70 million. Among other benefits from reform have been greater reliability of supply and system security. Increased competitive pressures have no doubt contributed to keeping Australian electricity prices at the lower end of the OECD spectrum (Figure 3.13).

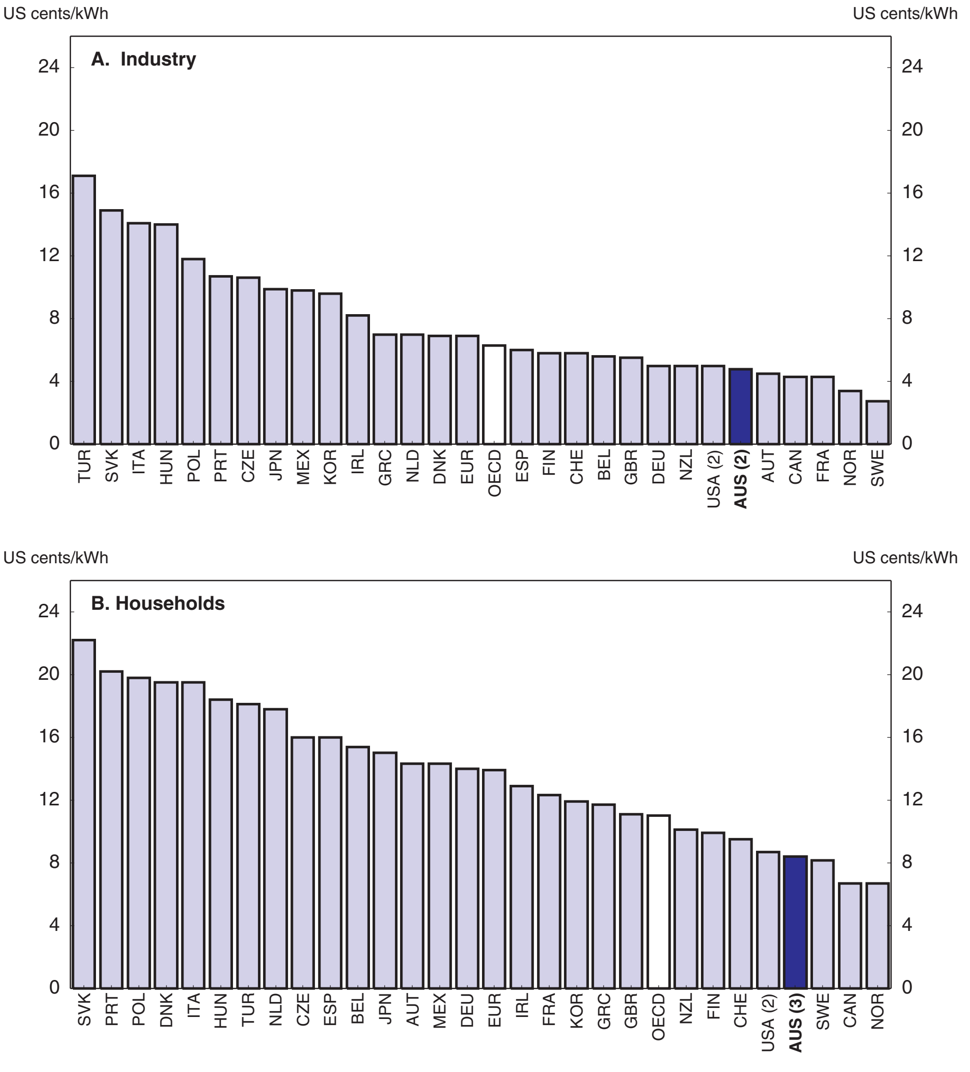
Although the majority of jurisdictions have satisfied their specific obligations under the current electricity agreements, the objective of a fully competitive national electricity market is yet to be realised. For instance, full retail contestability, a key commitment set out in the electricity agreements, has been introduced in jurisdictions at varying degrees only. By enabling customers to choose supplier, including generators, retailers and traders, retail contestability is an essential feature to provide the market depth needed for effective competition,which should lead to more efficient electricity prices, enhanced consumer choice and improved services. It should also improve the efficiency in electricity investment infrastructure through more accurate investment price signals.

NCC (2003a) and other recent reviews, especially the COAG E*nergy* M*arket* R*eview* (2002) have specified as most significant deficiencies of the current national electricity market to be:

- confused governance arrangements,
- too great a number of regulators and overlaps in regulatory responsibility, and
- perceived conflict of interest where governments are asset owners.

This has contributed to inadequate interconnection and poor transmission arrangements which effectively regionalised the National electricity market and held back many of the benefits envisaged from a national market. To remove regulatory inconsistency arising from the existence of both State and national regulators in the energy sector, COAG agreed to establish a single Australian Energy Regulator (AER) on 1 July 2004, with initial responsibility for economic regulation of electricity wholesale and transmission networks and key rule enforcement functions. The responsibilities of the AER will be extended to gas in 2005 (see below) and by 2006, the AER will be in charge of the regulation of distribution and

Figure 3.13. **Electricity prices in industry and households**[1]



1. In 2003 or latest year available.
2. Price excluding tax.
3. Price excluding tax, prior to 2001.

Source: IEA (2004), *Energy Prices and Taxes*.

retailing (other than retail pricing) of energy, following the development of an agreed national framework. COAG also agreed to establish a new Australian Energy Market Commission (AEMC) on 1 July 2004. The functions of the AEMC will include rule-making (a more structured and transparent rule change process) and market development functions aimed at improving planning and cooperation at the national level. The AEMC will be a statutory commission and will replace the three bodies currently performing these functions. Although the new national regulatory bodies should help to reduce duplication, to clarify regulatory roles and lower the cost and complexity of regulation facing investors, clear government policy direction will be needed to develop a consistent regulatory framework.

Gas

– The programme of gas reform under the National Competition Policy comprises three elements:

– the structural separation of transmission, distribution, production and retail sectors of the gas industry;

– the introduction by all governments of third party access regulation for natural gas pipelines; and

– the provision for all gas consumers to choose their supplier, *i.e.* full retail contestability.[26]

The first two of these objectives have already been achieved. Barriers to full retail contestability were removed in most jurisdictions with the notable exception of Queensland which does not intend to implement it at all on account of a cost-benefit analysis which suggests that full retail contestability would impose significant net social costs. It thus is intended to introduce retail contestability only for large gas users (consuming more than 100 terajoules[27] per year). Nevertheless, the reform's removal of restrictions on interstate trade in gas and provision of access to pipelines (transmission and distribution) and to customers (removal of exclusive franchises) has encouraged high investment in gas exploration, production, transmission and distribution in recent years. COAG (2002) noted in this context that the length of Australia's transmission pipeline system nearly doubled to over 17 000 kilometres between 1989 and 2001.

However, as with the electricity sector, there is a need to consider the regulatory framework underlying the natural gas industry. Accordingly, the responsibilities of the new single national energy regulator will be broadened, to include the economic regulation of gas transmission as from 2005. The gas access regime is also likely to be amended – following the Productivity Commission's *Review of the Gas Access Regime* (2004d) – with a focus on reducing the cost of regulation, promoting efficiency and encouraging investment in natural gas pipelines and in upstream and downstream markets. Further consideration will also need to be given how best to preclude states from exempting future arrangements for the joint marketing of natural gas from the competition rules of the Trade Practices Act. Other unfinished business includes the appropriate renewal of existing production licences and a review of the gas industry's principles for third party access to upstream gas processing facilities.

Water

Water supply and wastewater services are significant industries in Australia, with a combined value added of nearly one quarter of that of agriculture and almost three times that of the gas industry.[28] More than 70 per cent of water use in Australia is in irrigation, with urban and industrial consumption also being significant. Excessive allocations to irrigation over most of the past century have caused extensive damage to river systems and groundwater resources, while salinity[29] associated with rising water-tables is rendering infertile large tracts of productive land. In order to establish an efficient and sustainable water industry and to arrest the widespread natural resource degradation caused by water use, COAG agreed in 1994 to include in the NCP framework a fundamental reform of water policies with the objective of attaining a market based system in 2005.

In 2004, COAG enhanced the water reform agenda to reflect improvements in knowledge since the 1994 agreement, and to address variations in progress with water reforms between regions and jurisdictions.

Full implementation of the 2004 National Water Initiative Agreement will result in a nationally-compatible, market, regulatory and planning based system of managing surface and groundwater resources for rural and urban water use and aim to achieve the following:

- clear characteristics for secure water access entitlements;
- transparent, statutory-based water planning;
- statutory provision for environmental and other public benefit outcomes, and improved environmental management practices;
- complete the return of all currently overallocated or overused systems to environmentally-sustainable levels of extraction;
- progressive removal of barriers to trade in water and meeting other requirements to facilitate the broadening and deepening of the water market, with an open trading market to be in place;
- clarity around the assignment of risk arising from future changes in the availability of water for the consumptive pool;
- water accounting which is able to meet the information needs of different water systems in respect of planning, monitoring, trading, environmental management and on-farm management;

- policy settings which facilitate water use efficiency and innovation in urban and rural areas;
- addressing future adjustment issues that may impact on water users and communities; and
- recognition of the connectivity between surface and groundwater resources and connected systems managed as a single resource.

The reform agenda is being supported by a substantial investment of Australian Government funding in areas previously largely left to the states, including water use efficiency in urban and rural environments, and the return of water to flow stressed river systems.

An overview of progress made by jurisdictions with implementing the NCP water reform framework is given in Table 3.4.

Of this programme, the *urban* water reform has made significant improvements. Most urban authorities have introduced consumption-based pricing of urban water to discourage wasteful use. In addition, full cost recovery by water service providers is largely achieved which helps to ensure appropriate investment in infrastructure. Institutional changes have been implemented to encourage efficiency in water provision and to make providers accountable for the quality and cost of water and sewerage services.

R*ural* water reform is much less advanced although all governments are establishing 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 in many cases, and cross subsidies were either eliminated or have been made more transparent. Nevertheless, the price of water supplied to agriculture remains substantially less than that supplied to households. The development of water management arrangements, which allocate water among extractive uses and to the environment, is progressing, with priorities given to stressed and over-allocated systems. Where systems are stressed or over-allocated, governments are reducing the water available for extraction, or establishing arrangements which allow the possibility of future reductions. Australian governments have allocated funds for the compensation of farmers who see their extraction rights reduced. All jurisdictions are developing integrated catchment management frameworks and now have robust arrangements for examining proposals for new rural water infrastructure.[30] However, water trading arrangements, based on a system of water access entitlements separated from land title, are not fully implemented. As yet, standardised trading contracts are not available and some states have restrictions on trading outside the irrigation district where the water is currently used. These constitute important barriers to effective trading. As a result, water trading – although expanding over time – is still in its infancy, with trading volumes applying mainly to temporary transfers.[31]

Table 3.4. **Status of jurisdictions' progress in implementing water reform components, as at May**

Reform	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	MDBC[6]
Pricing									
Urban[1]									
Full cost recovery[2]	✓s	✓	✓s	❑	❑	✓s	✓	✓	n.a.
Two-part tariff	✓s	✓	✓s	✓	✓	✓	✓	✓	n.a.
Cross subsidies removed, others made transparent	✓	✓	✓	✓	✓	❑	✓	✓	n.a.
Rural water[3]									
Full cost recovery	❑	❑	✓s	❑	n.a.	✓	n.a.	n.a.	❑
Two-part tariff	✓	✓	✓	❑	n.a.	✓	n.a.	n.a.	✓
Cross subsidies removed, others made transparent	❑	❑	✓	❑	❑	✓	n.a.	n.a.	❑
Investment appraisal (new rural schemes)	✓	✓	✓	✓	✓	✓	✓	✓	n.a.
Entitlements and trading									
Legislation separating water entitlements from land title	✓	✓	✓	✓	✓	✓	✓	✓	n.a.
Licences converted/allocations defined	✓s	✓s	✓s	✓	✓s	✓s	✓	✓	n.a.
Trading in water entitlements	❑	❑	❑	❑	❑	✓s	❑	❑	n.a.
Environment[4]									
Environmental allocations									
Stressed and over- allocated rivers[5]	❑	❑	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	❑
Other systems surface/groundwater	❑	❑	❑	❑	✓s	✗	✓	❑	n.a.
Water quality management	✓s	✓s	❑	❑	✓s	✓s	❑	✓s	n.a.
Landcare practices (high value rivers)	✓	✓	✓	✓	✓	✓	✓	✓	n.a.
Ecological appraisal (new rural schemes)	✓	✓	✓	✓	✓	✓	✓	✓	n.a.
Institutional reform									
Separate roles	✓	✓	✓	✓	✓	✓	✓	✓	✓
Holistic approach to resource management	✓	✓	✓	✓	✓	✓	✓	✓	✓
Integrated catchment management approach	✓s	✓s	✓s	❑	✓s	✓s	✓s	✓s	✓
Commercial business focus	✓	✓	✓	✓	✓	✓	✓	✓	✓
Performance comparisons	✓	✓	✓	✓	✓	✓	✓	✓	n.a.
Irrigation scheme devolution of management	✓	✓	✓	✓s	✓s	✓s	n.a.	n.a.	n.a.
Community consultation	✓	✓	✓	✓	✓	✓	✓	✓	✓

Note: The summary in the table is a broad indication of progress only. It does not purport to provide a complete picture of the details of reform implementation or of each government's compliance with the National Competition Policy water reform commitments.

✓ = implemented ✓s = substantially implemented ❑ = implementing ✗ = little or no progress n.a. = not applicable.

1. Urban reforms include water and wastewater.
2. Full cost recovery requires governments to set prices so water and wastewater businesses earn sufficient revenue to ensure their ongoing commercial viability (the lower bound) but avoid monopoly returns (the upper bound). The lower bound of full cost recovery requires water businesses to recover, at least, operational, maintenance and administrative costs, externalities, taxes or tax equivalent regimes (not including income tax), the interest cost on debt, dividends (if any) and make provision for future asset refurbishment/replacement. The upper bound comprises operational, maintenance and administrative costs, externalities, taxes or tax equivalent regimes, provision for the cost of asset consumption and cost of capital (calculated using a weighted average cost of capital).
3. Rural water pricing commitments apply to government-owned irrigation schemes, government-owned bulk water suppliers, and commercial users (licensing charges for extraction of surface and groundwater using their own infrastructure). Progress in relation to licensing charges for commercial users is not reported in this table.
4. Jurisdictions established implementation programs in 1999 identifying river systems and groundwater resources (including stressed and overallocated river systems) for which they would complete programs to allocate water (including to the environment) by 2005.
5. Jurisdictions were to demonstrate substantial progress in implementing their allocation programs by 2001, where progress includes at least allocations in all river systems which have been overallocated or are deemed to be stressed.
6. Murray-Darling Bassin Commission.

Source: National Competition Council (2004).

With the completion of rural water reform by 2005 being very unlikely, substantial additional efforts are necessary to accelerate the implementation of the NCP water reform programme. Outstanding among the various unfinished complex tasks is the requirement to specify water rights appropriately, to make them enforceable and fully tradeable.[32] For the unambiguous specification of water rights, better information on the volume and availability of water is needed, which will only be available when water management plans are fully implemented. Such water plans determine water allocation policies for a particular river system or groundwater basin, based on an assessment of environmental, social, cultural and economic considerations. They are critical to the certainty surrounding water access entitlements because they set out the current knowledge of the resource, parameters about the size of the consumptive pool and rules for allocating water to entitlement holders. In addition, enforceability of ownership rights calls for an effective registry system, and transferability requires water trading systems to operate efficiently. It is also important that the setting of environmental minimum flows in rivers where there has been over-allocation of water in the past does not jeopardise the successful introduction of trading. To obtain the full gains from more efficient allocation of water, barriers to trading between irrigation districts and states also need to be removed.

Rail transport

Rail transport accounted for around one-third of all domestic freight over the past 25 years. It has significantly changed character over the last decade or so, and its performance has improved. At the start of the 1990s the Australian rail system was characterised by (State-owned) integrated railways providing passenger and freight services in their respective jurisdictions. Since then all governments have implemented reforms. The Productivity Commission (1999c) lists several factors likely to have encouraged these reforms:

- increased competition from road transport;
- persistent pressure on State Government budgets;
- pressure on railway freight rates from increasing competition in downstream markets; and
- the implementation of the National Competition Policy.[33]

Although all railways face similar problems, governments have adopted different solutions, reflecting that "one framework fits all" does not apply. Generally, reforms have included structural separation (both vertical and horizontal), the introduction of commercial disciplines (incorporation and privatisation) and arrangement for third party access to track infrastructure. As in many other countries, Australian railways have thus undergone landmark changes in aspects of their organisational structure, ownership and access arrangements over this period (Owens, 2003). Encouragingly, there have been improvements in the productivity of government-owned railways in providing freight and passenger services in Australia over the 1990s, leading to about 30 per cent decrease in freight rates in real terms. There is still scope for further improvements, though, as the level of technical efficiency[34] remains 30 per cent below the best performing countries. Freight rates[35] on average in 1998 were still higher than in Canada and the United States, although lower than in most European countries and Japan.

The Australian government has made further progress in rail reform since the Productivity Commission's report of 1999, but challenges remain. The Australian government released its response to this report in April 2000, and has since then undertaken some initiatives in advancing rail reform which are consistent with the report's recommendations. Among these initiatives is the sale of government interest in National Rail Corporation Ltd., announced 31 January 2002, and thereby pursuing the Government's policy of not owning or operating rail services. In January 2004, the National Transport Commission (NTC) was established. This followed agreement by the Australian Transport Council to various recommendations from a consultant's *Review of the National Road Transport Act 1991* (2002). The NTC's agenda is to push forward regulatory and operational reform for road, rail and inter-modal transport in order to deliver and sustain nationally consistent outcomes. Specifically, the Australian rail systems have perpetuated technical and other non-uniformities and inconsistencies that still have to be tackled (*Australian Rail Industry: Overview and issues*, 2003). There is also some evidence of dissatisfaction in the rail industry and among its customers with the outcomes from reform to date and the rates at which further improvements were planned (*Status Report of the Progress of Rail Reform in Australia*, 2001). Of all the reform issues examined in that report, there was most dissatisfaction with the progress of the national access and infrastructure pricing regimes, and the majority of stakeholders regarded the then current arrangements as poor.

In July 2003, the first complete three-year Strategic Plan of the National Transport Commission was presented (NTC, 2003). It was based on consultation with a broad range of stakeholders in transport regulatory reform from public and private sectors. It identifies initiatives for the indicative 2004/05 work programme that contribute to achieving the major national outcomes sought for the three years of the plan. These are safety, environment, efficiency, compliance and evaluation of implementation, maintenance and review. However, it fails to address the apparently widely held view among rail stakeholders that the system of competitive access has not succeeded in removing barriers to entry by third party operators. Such accusations deserve scrutiny. In the absence of barriers it could be argued that access pricing issues are purely a matter for commercial negotiations between infrastructure owners and access seekers. Hence, government intervention through the NTC, or any other body is not warranted. The current access regime is established under the CPA and operates generically for all natural monopoly infrastructure that falls within its scope. Still, the discontent by all stakeholders suggests that the framework is not working well. The main problem stems from the multiplicity of access regimes arising from separate State arrangements. To avert a major void in the process ahead, competitive access is a key reform principle, and a review of existing rail access arrangements should be launched.

Road transport

The road transport situation looks reasonably healthy. The aim now is to harmonise rules related to safety and operation since differences on these matters could be exploited to distort competition to some extent. Aiming to create a consistent national regulatory framework and focus, the National Road Transport Commission developed an initial national road transport reform package, comprising 31 initiatives in six modules: 1) registration charges for heavy vehicles; 2) transport of dangerous goods; 3) vehicle operations; 4) heavy vehicle registration; 5) driver licensing; and 6) compliance and enforcement. According to the 2003 NCC assessment, most states had completed all NCP road transport reform obligations at 30 June 2003, while the Commonwealth, Western Australia and the ACT were close to completing their reforms.

Land transport

On 7 June 2004 the Australian Government released its White Paper on its national land transport plan, A*us*L*ink*. A*us*L*ink* provides for a long-term, strategic approach to the planning and funding of Australia's national roads and railways, and outlines Australian land transport infrastructure funding for the next five years. A*us*L*ink*'s key objectives are to promote sustainable national and regional economic growth, development and connectivity by contributing to the development of an integrated national network. A*us*L*ink* also seeks to meet significant forecasted growth in freight demand through the promotion of intermodal integration between all forms of transport. A*us*L*ink* will be implemented through a cooperative intergovernmental process. Significant additional funding has been committed by the Australian Government to increase investment in national and inter-regional transport corridors, both road and rail, and improve intermodal transport links.

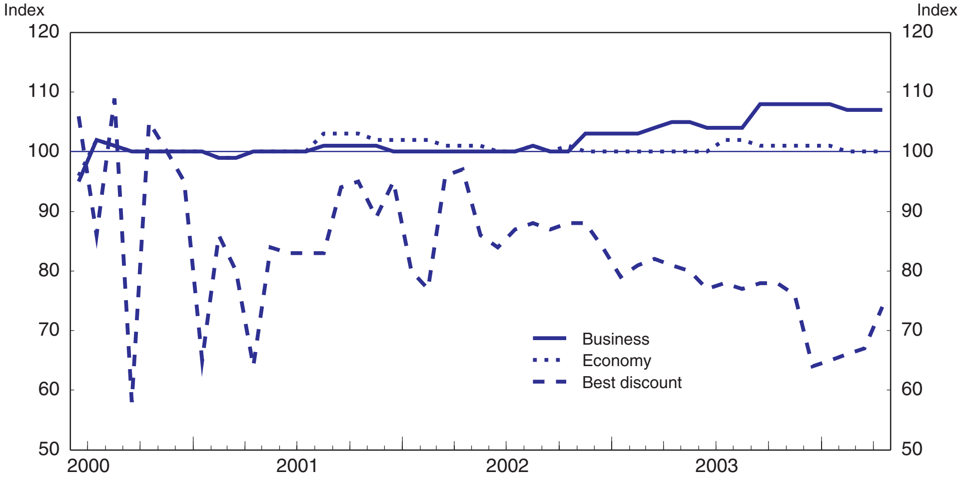
Sea transport

Australia's regulatory regime for ocean shipping conferences (Part X of the TPA) is currently under review by the Productivity Commission. This legislation provides limited, conditional exemptions from general competition law for liner conferences. The current review seeks to determine a preferred option for regulation of ocean shipping. The Productivity Commission has released a draft report for public consultation. The draft report suggests there is scope to enhance efficiency in this area through the repeal of Part X and applying general competition law to this sector, supported by appropriate transitional arrangements. If Part X is retained, the Productivity Commission recommends amendments to improve overall outcomes. Following consultation, the Productivity Commission will forward its final report and recommendations to the Australian Government in the near future. Coastal shipping reform also should be addressed.

Air transport

Against a background of significant market-structure changes,[36] Australia's air market has recently been dominated by a major actor (Qantas) on trunk routes, but Qantas is increasingly being challenged by a second actor (Virgin Blue) which has gained a 30 per cent share of traffic on major routes. A new low-cost Qantas subsidiary Jetstar has entered leisure markets. In this environment discount air prices have fallen (Figure 3.14) and standard economy and business class fares have been stable. Nonetheless, economic theory and practical experience suggest that duopoly is not inherently stable, and continuing vigilance is desirable to detect any emergence of tacit collusion. Granting cabotage rights to foreign carriers flying into Australia and continuing to open Australia to investment cabotage could continue to reduce the risk of tacit collusion. Investment cabotage has added considerable flexibility to the aviation market, as has been demonstrated

Figure 3.14. **Real domestic air fares excluding taxes and charges, monthly index**
November 2000 = 100

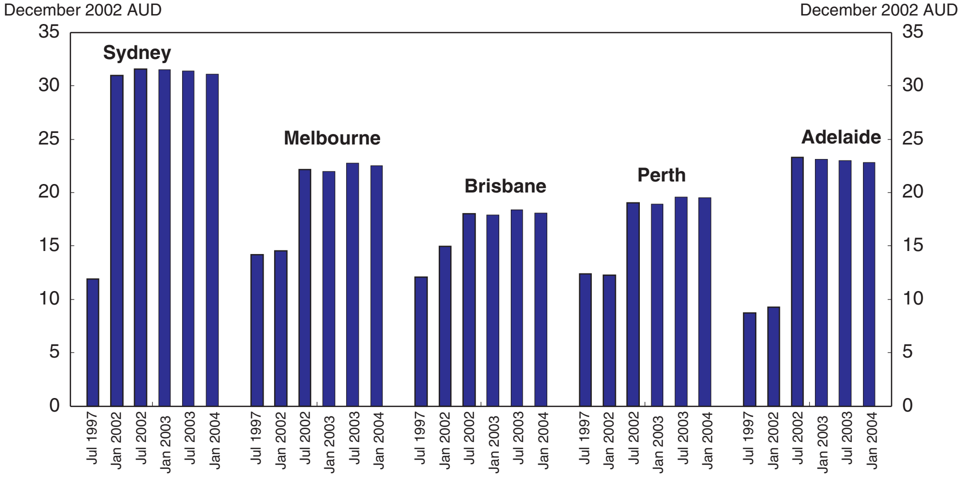


Source: Bureau of Transport and Regional Economies.

by the ability of Virgin Blue, which was then majority foreign owned, to respond to the collapse of Ansett, Australia's second major carrier.

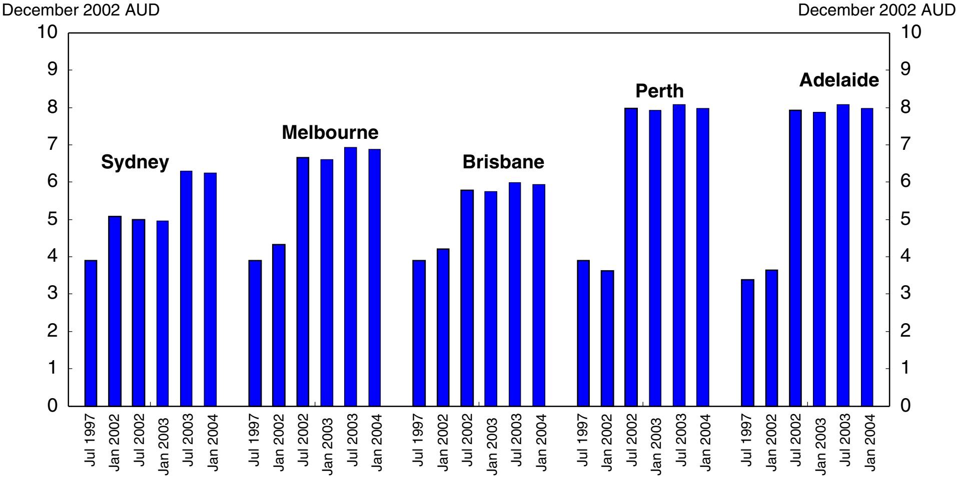
At the time the Government began privatising Federal airports,[37] it established a comprehensive economic regulatory framework to apply to airport lessees. The arrangements were intended to promote operation of the airports in an efficient and commercial manner, while at the same time protecting airport users from any potential abuse of market power by airport operators. Arrangements included price monitoring and price caps on aeronautical charges. The Productivity Commission provided its report on the Price Regulation of Airport Services on 25 January 2002. The Commission recommended that there were insufficient grounds for an airport-specific access regime as the general access provisions available under Part IIIA of the TPA (and Part IV) provide sufficient safeguards for those seeking access to airport facilities. Instead, the Commission recommended five years of price monitoring (but no price caps) at Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra, and Darwin airports. The Government has accepted the Productivity Commission's recommendation. The price monitoring took effect 1 July 2002. Toward the end of the five-year period an independent review is to be carried out to ascertain the need for future airport price regulation. Figures 3.15 and 3.16 illustrate that airport charges have been relatively stable the last couple of years. The price level is higher than the late 1990s, though, which may be due to

Figure 3.15. **Real international charges for a B747-400 landing and takeoff by airport**
Total charge per return passenger



Source: Bureau of Transport and Regional Economies.

Figure 3.16. **Real domestic charges for a B737-800 landing and takeoff by airport**
Total charge per return passenger



Source: Bureau of Transport and Regional Economies.

enhanced profit orientation in the wake of the 1997 liberalisation and the increased emphasis on security.

Telecommunication

The Australian Competition and Consumer Commission (ACCC) is responsible for the regulation of the telecommunications sector. The main player in this market is Telstra, of which approximately 51 per cent is owned by the Australian Government. Major legislative reforms have contributed to increased competition in the telecommunications industry and delivered benefits for consumers in terms of price and choice.[38] In 1991, Telecom Australia (as Telstra was then known) lost its statutory monopoly position in the provision of telecommunications services. The Government adopted a duopoly policy for a fixed time frame and licensed Optus to be a second fixed network carrier, and Optus and Vodafone to be mobile telephone carriers in competition with Telstra. The Government allowed full competition in services in the Telecommunications Act 1997, and there are currently around 100 carriers (companies who own specified infrastructure facilities) and 1 000 service providers (NCC 2003b). The ACCC estimated Telstra's market share to be 43.5 per cent in the mobile phone market in 2001-02 and Telstra's market share has been reported to be about 60 per cent in the corporate market. While there are many carriers and service providers, Telstra and Optus dominate the fixed and local access market, providing around 70 and 19 per cent of the market respectively (PC 2001b).

In order to improve the efficiency of the regime regulating access to telecommunications network facilities, the Telecommunications Competition Act was passed in 2002. The Act seeks to prevent those owning and controlling networks from taking undue advantage of their powerful position. Measures include:

- speeding up access to core telecommunication services;
- facilitating investment in new telecommunications infrastructure (by facilitating investment certainty); and
- providing a more transparent market (by introducing an accounting separation framework for Telstra).

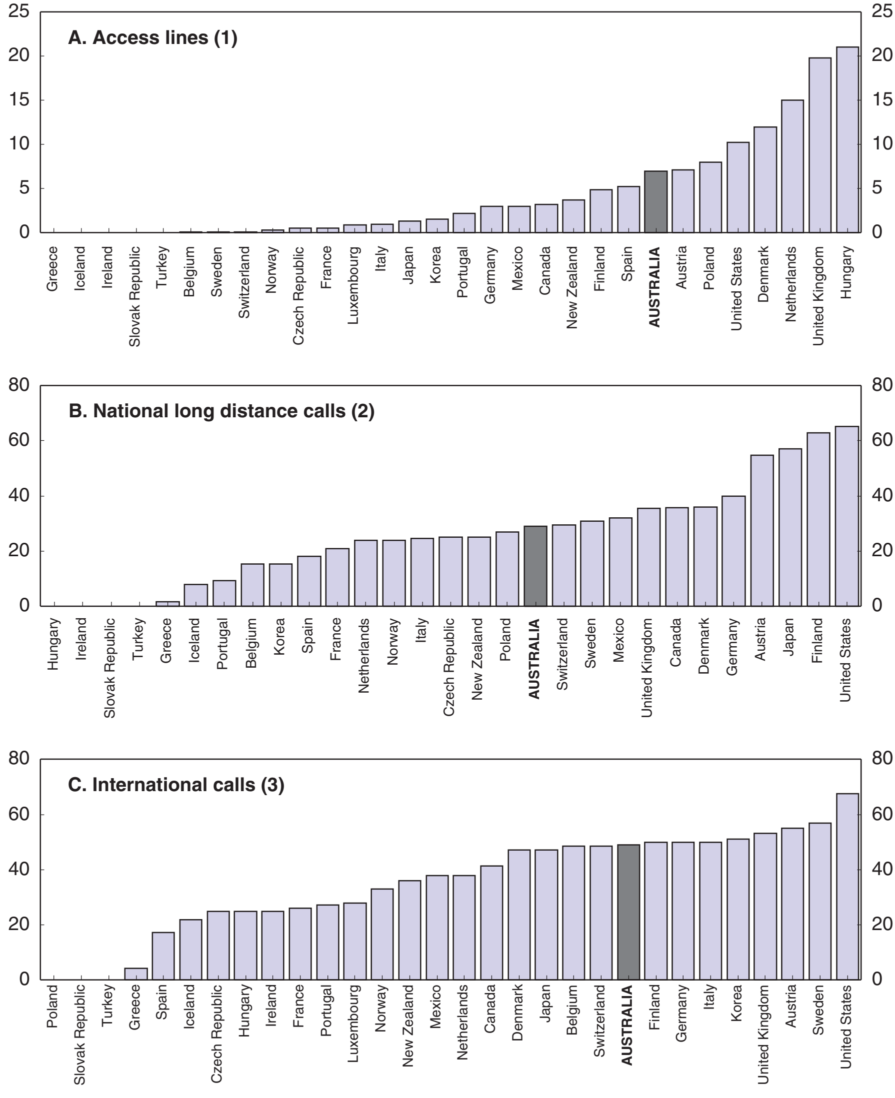
All of these measures are crucial in achieving a well-functioning telecommunications market, and as discussed below there are indications that the Australian market still has some way to go.

The key issue that encapsulates the three above measures is to establish a framework in which separate telecommunications companies along with Telstra could compete on common terms, making competitors less reliant on Telstra's infrastructure. The government, owning half of the incumbent, could prove reluctant to such a development, though, since it means decreasing rents. A necessary condition for a successful development in the telecommunications market is therefore to further privatize Telstra. There has also been some discussion about the structure of Telstra. NCC (2003b) suggested structural separation of the fixed network as an option, but this solution has been rejected by the government. Nevertheless, the unbundling[39] of the local loop in 1998 was imperative to promoting competitiveness and thus lower prices.

The potential for improvement is apparent. Although the liberalisation since 1997 has had a positive impact on new entries (Figure 3.17), leading to significant decreases in call charges, prices in all segments of the market remain high when compared internationally (Figure 3.18). Further, the broadband market is developing slowly, reflecting the high internet access charges (Figure 3.19). All this suggests that access prices may be excessively high. Since March 2004 there have been dramatic price falls in the broadband market. As a result, broadband take-up increased to approximately 1.5 million (or 7.5 subscribers per 100 inhabitants) as of October 2004. However, it is yet unclear whether the price drop at the retail level has been fully reflected in access pricing. A way to tackle the problem would be to go ahead with the full privatization of Telstra and with unbundling the local loop to create a level playing field for competitors. What currently has been done, in the Competition Act of 2002, is that Telstra is required to provide separate accounts of its network and retail operations. Although accounting separation would help to increase transparency, it is a weak measure. There is a considerable

Figure 3.17. **Estimates of market shares of new entrants**

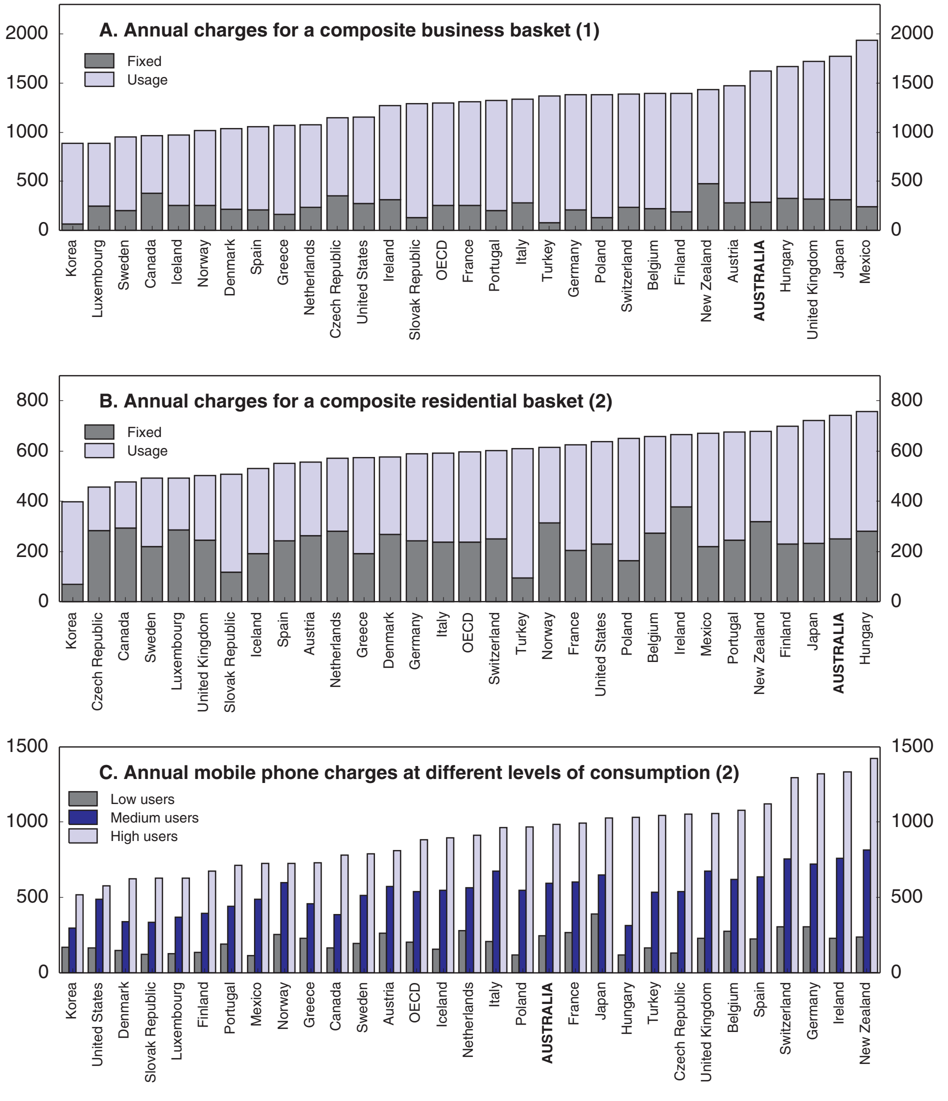
2001



1. Percentage of access lines. For Japan and Switzerland data refer to 2000.
2. Percentage of switched minutes. For Ireland and New Zealand: 1998; for Japan, Switzerland and United States: 2000.
3. Percentage of minutes of international traffic. For Ireland, Japan, Switzerland and United States: 2000; for New Zealand: 1997.

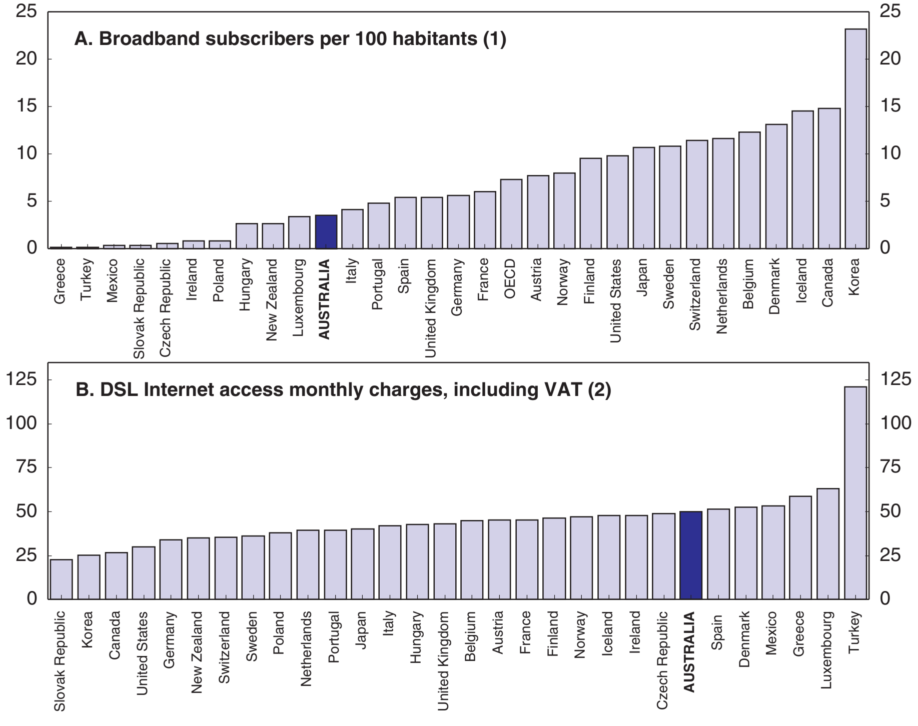
Source: OECD, Communications Outlook database.

Figure 3.18. **Telecommunications charges**
US dollars, August 2004



1. Excluding VAT.
2. Including VAT.
Source: OECD, Communications Outlook database.

Figure 3.19. **Broadband penetration and user charges**



1. December 2003.
2. USD per month. Modem rentals are excluded, as in most countries they can be purchased by users. October 2003.

Source: OECD, Communications Outlook database.

scope for the network provider to load costs both of services and common costs onto the network. Acknowledging this problem, the Competition Act should be strengthened by demanding legal separation of network and retail, if the benefits of separation would exceed the costs.

Television broadcasting

The regulation of television broadcasting in Australia is the responsibility of the Commonwealth Government, and is not currently maximising competition. In its review of broadcasting, the Productivity Commission (2000b) described the regulatory arrangements as one that delays consumer adoption of digital technology and deprives businesses of opportunities to develop new products and services for the world as well as Australian markets. Entry into the free-to-air (FTA) sector is strictly controlled by government regulations that limit the number of commercial broadcasting licences. The three incumbents: channel Seven, Nine and Ten and their regional affiliates own most of the 53 commercial television licences in Australia. The increase in capacity resulting from digitisation of FTA broadcasting could provide increased opportunities for new services, greater choice and perhaps new entry into this market. However, government regulations prohibit many of these opportunities from emerging as they otherwise could (ACCC, 2003). By following this path, the government can still consider advice from the above mentioned Productivity Commission review; access to spectrum should be sold through a competitive bidding process and all broadcasting licence holders should pay fees based on their use of spectrum rather than on their revenue. The proposals would free up spectrum availability and make it possible for more broadcasters to enter the industry, and they should be adopted. The Government has also commenced a series of reviews into the digital regulatory framework, including into whether restrictions on the types of additional services FTA broadcasters can provide on their digital spectrum can be changed. There is also a review of arrangements applying to commercial television broadcasting after 31 December 2006, when the current moratorium on issuing new commercial television broadcasting licenses is to end. The review will examine the processes for taking decisions on the licensing of new entrants.

The Australian pay TV industry is highly concentrated, with three major players (Foxtel, Optus and Austar). Telstra owns 50 per cent of Foxtel, which again supplies 60 per cent of the metropolitan pay TV subscribers. The incumbent also owns two of the three major local access networks outside major cities. This dominant position is disquieting, as also pointed out by the commission and NCC (2003a). There is no effective competition in pay TV because the owner of the distribution networks, Telstra, also partly owns the major pay TV operator, Foxtel, making it virtually certain that other pay TV operators cannot face a level playing field. Further, following digitisation, Foxtel will be able to provide data services such as e-mail and internet access over its pay TV network. However, Telstra will have every incentive to restrict the development of such services by Foxtel where they would compete with services by Telstra. In so doing, a potential new source of competition in the future may therefore be diminished by Telstra's ownership of Foxtel. Consequently, Telstra should be required to divest the cable network and its shareholding in Foxtel, provided independent assessment shows the benefits of divestiture would exceed the costs.

Postal industry

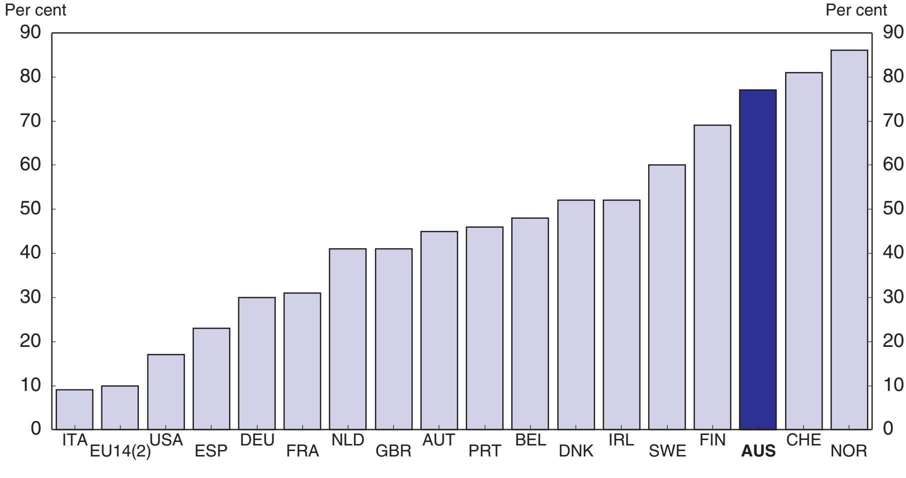
Draft legislation which sought to reduce Australia Post's reserved service and to open the postal market to increased competition through the introduction of a postal access regime, was withdrawn from the Parliament in early 2001 as it did not attract sufficient support. Another effort should be undertaken to enhance competition in the postal services market.

Other regulatory reform areas

- Retail distribution

Australia's retail sector has undergone a marked restructuring over the past 20 years or so, transforming a sector of small independent shops to one where large retailers capture significant shares of their relevant markets. The trend towards concentration is particularly evident in the grocery sector,[40] with the two vertically integrated supermarket chains accounting for approximately 77 per cent of grocery and perishables sold nationally – a high market concentration by international standards (Figure 3.20). The high and increasing concentration is driven largely by the growing importance of economies of scale and scope. Significant developments in the industry include the expansion by the major market participants into liquor and pharmaceutical retailing, and the convergence of petrol and grocery retailing, particularly through "shopper dockets", binding petrol discounts to grocery purchases.

Figure 3.20. **Concentration in food retailing**[1]



1. Market shares of the first three firms based on sales, 1996 data.
2. EU15 excluding Greece.

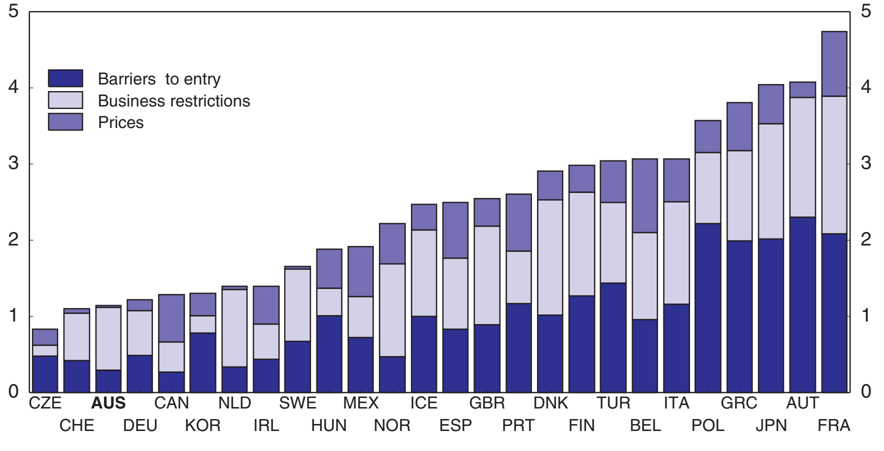
Source: O. Boylaud and G. Nicoletti (2001), "Regulatory Reform in Retail Distribution"', OECD *Economic Studies* No. 32, 2001/1.

These changes have occurred against a background of an easing of regulation. OECD evidence suggests that less stringent regulations on opening hours and large-scale stores have positive effects on efficiency and performance, while over-regulation is likely to result in higher prices and inhibit modernisation (Boylaud and Nicoletti, 2001). In international comparison Australia had in 1998 one of the least restrictive regulations in retail distribution in the OECD area (Figure 3.21), which might have contributed to good productivity performance of the sector. However, this does not mean that there is no scope for further regulatory easing. Despite significant changes in state-level legislation on shop opening hours, remaining restrictions continue to hamper competition by discriminating between categories of sellers on the basis of location, size or product sold.[41] Some jurisdictions restrict the trading hours of large retailers, in order to permit small retailers to trade at certain hours without competition of larger retailers. The evidence, however, reveals that such restrictions do not serve the public interest (National Competition Council, 2003a). Two more specific competition issues in the retailing sector emerge from the liquor licensing laws and the legislation governing petrol retailing both imposing barriers to entry by potential sellers (see Annex 3.A2).

In general, the current structure of the retail sector appears to be beneficial for consumers. According to the 1999 Report by the Joint Select Committee on

Figure 3.21. **Summary indicators of regulation in retail trade**

1998[1]



1. The scale of indicators is 0-6 from least to most restrictive.

Source: Boylaud (2000), "Regulatory Reform in Road Freight and Retail Distribution", OECD *Economics Department Working Papers*, No. 255.

the Retailing Sector ("the Baird Committee") and a 2004 Report by the Australian Competition Consumer Commission (ACCC), competition in the sector is deemed healthy. This is despite the expansion of major supermarket chains, with the retailers competing briskly among themselves on price and choice. Improved consumer welfare is evidenced by a fall in real prices of many grocery items since the mid-1980s, a significant expansion in product range and services (one-stop shopping), and extended trading hours.

While the restructuring of grocery retailing tends to improve consumer welfare overall, concern has been raised about the impact of the expansion of the major chains on the ability of small and independent retailers to compete on equal terms in the sector. Although the Baird Committee concluded that the market was competitive, it also concluded that the sector was "heavily concentrated and oligopolistic in nature", with vertical integration enhancing further the market power of the major chains and giving them commercial advantages over the independents. However, the Committee did not find a compelling case for the imposition of a market cap on the share of each major chain – as proposed by the National Association of Retail Grocers of Australia – or for divestiture of stores in the current market structure (although it pointed to the potential merit of divestiture as a safeguard to competition in cases of high concentration).[42] The Dawson Committee in 2003 also considered and rejected such interventions. Concerns have also been expressed about the marketing practices facilitating the convergence of petrol and grocery retailing, and in particular, about the effects of shopper docket discount schemes, offered by major chains, on the number of independents operating in the retail petroleum industry (see Annex 3.A2). These issues were considered by the ACCC in 2004. The ACCC concluded that shopper docket arrangements had encouraged competition and lower prices for consumers. Further, the ACCC found that the arrangements between grocery and petrol retailers would be unlikely to result in a substantial lessening of competition.

In addition to allowing shopper docket schemes to continue, the Australian Competition and Consumer Commission (ACCC) has also decided not to oppose the acquisition by a major domestic chain (Coles Myer Ltd) of a number of independent supermarket outlets,[43] as this was not deemed likely to lead to a reduction in competition that would breach the relevant provision in the Trade Practices Act (section 50).[44] ACCC found on previous occasions that the major grocery chains in Australia have, in general, acquired independent supermarkets in areas where they were not represented, thereby unlikely to raise competition concerns at the local retail level. However, the ACCC recognised the challenges posed by "creeping acquisitions", noting that it would continue to scrutinize any further moves by major grocery chains to purchase smaller independent operators. Creeping acquisitions allow major chains to build their market share by attrition, through the purchase of smaller independent operators over time. As such, it has been put to the ACCC that this type of acquisition may effectively circumvent the relevant Trade Practices Act clause, as it would be unlikely for an individual purchase to lead to a substantial increase in concentration. While the current market structure is judged to be in general competitive, raising no important concerns over the short run, the issue of "creeping acquisitions" will continue to require attention in order to prevent an unacceptably high degree of concentration and upward pressure on retail prices in the longer run. In addition, increased market concentration changes the balance of power between retailers and suppliers, creating oligopsony in the upstream market, with negative effects on competition (ACCC, 2004). By reducing sellers' profitability, increased buyer power may discourage entry of new producers. That said, the ACCC concluded that the grocery industry is 'dynamic, innovative and competitive' (ACCC 2004). This has been underlined by the recent entry and expansion of some new players. The issue of creeping acquisitions was also considered by the Dawson Committee in 2003. The Committee found that the statutory test of "substantial lessening of competition" could deal with this problem.

Summing up, the retail sector in Australia appears to operate in a competitive environment at present, with a considerable amount of rivalry between the major chains in grocery retailing. Reductions in prices of many grocery items since the mid-1980s, and significant expansion in product range provide support to this view. However, market power on the part of large retailers needs to be closely monitored and assessed by the competition authority. Claims about predatory pricing were examined by the Baird Committee. Below-cost pricing is not prohibited by the Trade Practices Act, except where there is a misuse of market power (section 46). The Committee recommended the granting of wider powers to ACCC to bring representative actions and to seek damages on behalf of third parties. This recommendation has been accepted and the relevant amendments were made in 2001. Moreover, a package of reforms to the Trade Practices Act, announced by the Treasurer in June 2004, includes an amendment to the current clause regarding the misuse of market power to provide some additional guidance to courts in the consideration of predatory pricing cases. The issue of creeping acquisitions should continue to be carefully scrutinised. Although the dominant retail chains compete strongly with each other at present, the temptation to collude to protect margins might arise in a future economic downturn. If the dominant retailers were to fall to such a temptation, the full force of the TPA can be applied and enforced by the ACCC.

Professional services in Australia are subject to a broad range of regulations, comprising both statutory provisions and a significant element of self-regulation.[45] Examples of professional regulation include: entry and registration requirements, restrictions on the use of the title and on the practice of profession, disciplinary processes, restrictions in advertising under the rules for business conduct, and business licensing requirements. Regulation of professional services is widespread in OECD countries and is usually justified as a way to protect consumers by alleviating information asymmetries and ensuring quality. There is little empirical evidence, however, to suggest that regulatory interventions in the area of professional services that prevent competition improve consumer welfare. In practice, these restrictions have been associated with higher prices and weaker innovative activity without significant quality improvements, serving mainly the interest of the profession.[46]

Restrictions on competition

A wide variety of laws, regulations, professional rules and responsibilities govern entry and practice within the health and legal professions. Key regulatory restrictions on competition include reserved areas of practice and rules on business conduct, especially in relation to the ownership, advertising, and professional indemnity insurance[47] (see Annex 3.A2). An additional issue arise from the registration of certain health professions in some but not all jurisdictions, raising questions about the public benefit from continued registration.

An emerging trend of the legislation review of health professions is towards the introduction of mandatory professional indemnity insurance requirements. Such type of insurance – designed to cover the costs for professionals of any judgment of liability due to professional malpractice – is obligatory for registered legal practitioners in all jurisdictions. The National Competition Council (NCC) considers that compulsory indemnity insurance requirements are consistent with the National Competition Policy principles. However, the means of provision of this type of insurance may have significant competition implications.[48] Reform involving professional insurance could be facilitated (or made effective) if insurance provision itself were more competitive.[49]

Regarding architects, the Productivity Commission (2000a) assessed that the costs of current regulation outweigh benefits, suggesting a repeal of the various Architects Acts (after a two-year notification period) in all jurisdictions. The Commission noted that consumer protection and spillover related to the building industry could be obtained more effectively through self-regulation and other existing legislation. A national working party (with a representative of each state) was set up to develop a response to the review. The group recommended, instead, a reform of existing legislation by removing those elements considered as restricting competition (such as practice reservation). Accordingly, each government committed to the implementation of the reform set up by the national working group.

The reform process

The implementation speed of reform varies across professions, being particularly slow in pharmaceuticals and more satisfactory in other areas, such as that of building occupations.[50] Regarding pharmaceutical services, the Council of

Australian Governments commissioned in 1999 a national review of pharmacy legislation – the Wilkinson review. Following it, jurisdictions agreed to implement a range of reforms. These include removing caps on the number of pharmacies a pharmacist can own, and permitting non-pharmacists to have a pecuniary interest in pharmacies other than based on ownership (for example, profit sharing or joint venture arrangement). It was also agreed to temporarily retain legislated ownership restrictions, preventing non-pharmacists from owing pharmacies, with limited exceptions (regarding pharmacies owned by friendly societies,[51] and those owned by non-pharmacists before the current ownership restrictions came to force). Ownership restrictions cover pharmacies in all states (apart from the Northern Territory). The main reason for postponing their reform was that it could have a disruptive impact on the pharmacy industry in the short term, in light of the perceived transitional/structural costs involved in the other reforms recommended by the review. Changes agreed by the Australian Government with individual states and territories have gone some way to relaxing the restrictions on the ownership of pharmacies and to move toward, but not fully meet, the reforms recommended in the Wilkinson review process.

Summing up, although the pace of reforms varies across professions, implementation could be faster. There is still scope for relaxing some existing regulation governing professions or reforming them, so as to minimise their distorting effects on competition. Replacing, for example, remaining ownership rules in the areas of dentistry[52] by less stringent schemes, allowing non-health professionals to own health care practices but call for disciplinary action in cases of inappropriate commercial influence on decision making, would ensure accountability for professional conduct, while having less impact on competition (see Annex 3.A2). As a positive step, many jurisdictions are conducting reviews of most, or all, health practitioner legislation aiming to make entry requirements more flexible (including a replacement in some states of broad practice restrictions by specific core practice restrictions), while providing, in general, for uniform regulation for most health professions in such areas as advertising and disciplinary processes. However, reforms are proceeding at a slow pace. Moreover, the assignment of power to the relevant health profession boards to create specific requirements for particular professions requires close monitoring, as it may facilitate the pursuit of their own interests to the detriment of those of their affiliates. Delays are also observed with regards to the implementation of the agreed state-level reforms in pharmaceutical services, where continuing ownership restrictions have the potential of disadvantaging the community, for example, through reduced access to services and increased costs of pharmaceuticals. These reforms should be further combined with a timely removal of restrictions on the number and location of Pharmaceutical Benefits Scheme (PBS) – licensed pharmacies, forming significant barriers to competition in the industry.

Reducing market segmentation arising from differences in professional regulations across the states would also be welfare-enhancing. This is particularly true in the case of legal professions, where state-differentiation of regulations governing the profession creates significant obstacles to legal firms wishing to work across state borders, while necessitating the maintenance of expensive and complex business structures in order to comply with the different regulations, with the additional cost often being passed on to clients (NCC, 2000a). The development of consistent regulations under the National Model Laws project is a step in the right direction, expected – as highlighted by the NCC – to lower hindrances to competition across jurisdictions, and significantly increase competition in the industry at a national level. However, the reform programmes are lagging behind schedule.

Trade policy

Steps to trade liberalisation

Although a strong momentum for liberalisation opened markets all over the world for much of the post-war period, Australia's level of average tariffs has only quite recently come down to that of other OECD-countries. However, Australia has been an active international negotiator since the 1990s, pressing multilateral trade liberalisation forward in the GATT/WTO rounds and even implementing a series of unilateral tariff cuts to facilitate increased competition on its domestic market. Although Australia typically has favoured multilateral or unilateral trade liberalisation, it has also negotiated some bilateral agreements, *e.g.* with New Zealand (1983), Singapore (2002), and Thailand (2003). Most recently, it has negotiated a Free Trade Agreement (FTA) with the United States. Annex 3.A4 provides a brief description of the major milestones in Australia's trade liberalisation process.

Bilateral and regional trade agreements can usefully complement the multilateral trading system by allowing a smaller group of countries to go further in some sectors than would have been possible in a multilateral setting and to serve as laboratories for future consideration in multilateral negotiations. Nevertheless, bilateral and regional trade agreements can have a trade distorting as well as a trade creating component. There is furthermore a danger that the coherence and predictability offered by multilateralism will be weakened if governments increasingly turn to regional agreements to manage their trade interests. A maze of conflicting regional regulations, standards and rules of origin risk becoming the new "walls" between blocks.

Against this background, the recently negotiated FTAs with Singapore, Thailand and the US merit close scrutiny, as they run counter to Australia's general unilateral/multilateral approach. Although it is too early at present to give a plausible estimate of the net economic impacts of such agreements, two general concerns should be raised. Firstly, the increased complexity such agreements inherently impose on traders could very well contribute to hamper overall trade. Secondly, a decline in economic efficiency can be expected because of import distortion effects. True, trade diversion effects can be dampened, at least for the least developed countries, through the General System of Preferences. In fact, in the case of Australia, since 1 July 2003, it has provided tariff and quota-free entry for all goods originating in Least Developed Countries, subject to a broad local content rule.

Scope for further improvement

Although Australia should be commended for its recent multilateral and unilateral trade liberalisation efforts, there is, as in most other countries, unfinished business in the pursuit of freer trade.[53] After reducing protection over the past 15 years, textiles, clothing and footwear (TCF) producers have been increasingly exposed to competition. In 2001, the industry managed to reach an agreement with the government to freeze tariffs at the 2000 level until 2005, when TCF tariffs will be reduced, and to receive A$ 678 million in transitional budgetary support in the same period.[54] In 2003, the Government announced a continuation of the tariff reform process which will see most TCF tariffs reduced to 5 per cent in 2010, the general tariff rate.[55] To assist industry adjust to the lower tariff environment the Government also announced a further $ 747 million in transitional budgetary support over 10 years. The tariff reforms and the assistance package by the Government are generally in line with that recommended by the Productivity Commission (2003c), which achieves reform in a measured manner and continues to provide industry with an element of predictability.

The automobile industry is also subject to special assistance. Generally, the key elements of the current assistance arrangements, including a freeze of the 15 per cent tariff rate, are due to terminate in 2005. Under arrangements announced by the Government in December 2002, tariffs for passenger motor vehicles and automotive components will be reduced to 10 per cent from 1 January 2005 and to 5 per cent from 1 January 2010. The government has also allocated $4.2 billion in assistance to the industry over 10 years through the post-2005 Automotive Competitiveness and Investment Scheme (ACIS). The ACIS, which will operate from 1 January 2006 to 31 December 2015, aims to encourage competitive investments by firms in the automotive industry in order to achieve sustainable growth.

Lastly, Australia has strict quarantine, sanitary and phytosanitary regulations. This reflects its island geography, which has isolated it from many diseases and pests in its flora and fauna. Many countries find that access to the Australian market on agri-food products is particularly difficult. Especially, they complain about the lengthy risk assessment procedures, which may take years to complete before eventually changing the import rules. Currently the dispute settlement body of the WTO is handling a complaint regarding the Australian quarantine regime, but a conclusion to this complex issue is not expected anytime soon. Recent initiatives to allow the testing and certifying of products in exporting countries, using recognised procedures and institutes is a positive step.

Overall assessment and scope for further action

In sum, enhancing product market competition has been central to microeconomic reform in Australia and has been a crucial element in improving general economic performance. Following the trade liberalisation of the 1970s and 1980s, competition in product markets has intensified since 1995, as a result of the National Competition Policy (NCP), the most extensive economic reform programme in Australia's history. NCP has set out competition principles which extended the reach of competition law to previously exempt activities, including Government Business Enterprises and a broad range of professional and occupational services. It has provided a coherent framework for reforms already underway in major infrastructure industries as well as providing impetus to complete these reforms. Using competition payments to leverage reform outcomes in areas of State and Territory responsibility and charging an independent body – the National Competition Council (NCC) – with assessing reform progress has proven highly effective. There is no doubt that reform would have been far slower and less comprehensive without competition payments. Although these payments (now at around A$ 800 million per annum) are not very large relative to jurisdictions' budgets, they nevertheless represent a significant source of incremental funds. Moreover, tying performance to financial rewards has enabled governments to resist pressure from lobby groups by claiming that they have no choice other than to meet their NCP commitments.[56] The NCP arrangements are currently under review. The Productivity Commission is conducting an inquiry into the future of NCP and has released a discussion draft report (with a final report due by the end of February 2005). This will inform discussions about the future of competition policy and a future reform agenda in the COAG review of NCP to be conducted in 2005.

Among major achievements of the competition policy reform are the establishment of an overarching national access regime – together with sector-specific regimes – which introduced third-party access arrangements for infrastructure services such as gas pipelines and rail track networks. Independent authorities were also established in all jurisdictions to monitor and set prices for monopoly services. Some 1 800 individual pieces of legislation have been assessed and many of those which were found not to provide a net public benefit have been reformed. The framework for a more competitive electricity market has been established, trade in gas has been liberalised, and progress has been made toward developing a viable and sustainable water industry. The NCP road transport commitments are almost completed. The telecommunications market was fully liberalised in 1997 and regulation separated from the commercial activities of the incumbent telecommunications operator Telstra. In addition, the increasingly effective application of Australia's competition law, the Trade Practices Act (TPA), reduced the power of firms over prices and forced them to control costs better. A leniency programme was introduced in 2003, whose promise of reduced civil fines in cartel cases has yielded some enforcement successes. Among the recently debated proposals to reform the TPA are increased sanctions to strengthen deterrence against horizontal price fixing. Altogether, the implementation of Australia's ambitious and comprehensive competition policy reforms over past nine years or so has undoubtedly made a substantial contribution to the recent improvement in labour and multifactor productivity and in economic growth.

Unfinished business encompasses the completion of the legislation review, which has fallen well short of initial expectations, which was for a closure of this element of the NCP by mid-2002. Areas where reforms are yet to be completed include agricultural marketing arrangements, liquor licensing, compulsory insurance schemes, pharmacies, the professions and occupations (health and legal practitioners and some building related trades), and the regulation of taxis. Bringing the reform programme to completion according to an announced timetable is important to avoid the impression that difficult reforms can be deferred *ad infinitum*, which would jeopardise future reform programmes. Among jurisdictions, the federal government in particular should make stronger efforts to raise its own compliance rate, which has been among the lowest of all Australian governments and is not consistent with its ambition to raise overall competitive pressures. This would also strengthen the federal government's position in its endeavours to convince those opposing reform of the overall beneficial effects of enhanced product market competition.

Looking to the future, discipline on all government could be enhanced further by making all legislation reviews public, which was not required hitherto. In some instances, this has allowed jurisdictions not to release reviews where outcomes had been controversial. More effort should also be put on specifying required policies more clearly, to avoid governments to approach reform processes in a minimalist way.[57]

Regarding infrastructure services, a fully competitive national electricity market has yet to be realised even across the contiguous eastern states, including full retail contestability. As an important prerequisite, regulatory inconsistency needs to be removed, which arises from the co-existence of state and national regulators in both the electricity and gas sectors, as planned. Moreover, grid interconnection should be improved and competition in electricity generation intensified by setting better incentives for investment in transmission and generation.[58] And while urban water reforms are largely complete, the pace of rural water reform is slow. Main issues which need to be addressed are the specification, enforcement and trading of water property rights as well as the determination and pricing of appropriate environmental allocations. Accordingly, the Council of Australian Governments' National Water Initiative of 2004 aims to improve the security of water access entitlements, ensure ecosystems health and encourage expansion of water markets and trading.[59] Cross-subsidisation of water usage as between urban and rural users, and also between different types of agricultural users, should be phased out over time.

The NCP road transport reform commitments, which cover a narrower range of reform modules than initially proposed by the National Road Transport Commission, are now almost complete. Like rail reform, other road reform is being pursued outside the NCP framework through a co-operative intergovernmental process. Recently announced national land transport reforms planned under the *AusLink* framework need to be effectively implemented, to ensure efficient long-term investment and better integration of the network. Efforts should be made to promote competition in ocean shipping. More broadly, Australian governments should seek to establish an integrated reform agenda within a co-operative assessable framework covering all elements of land transport and shipping transport. Competition in fixed-line telecommunications should be promoted by strategies designed to facilitate further access by competitors and Telstra should be required to divest its cable network and its shareholding in a major pay-TV supplier, provided independent assessment shows the benefits of divestiture would exceed the costs. Another effort should be undertaken to open the postal services market to competition.[60]

In the context of network industries which operate over several geographical jurisdictions there is the issue of ensuring efficient infrastructure investment, a problem which is not resolved by established national access regimes themselves. Efficient infrastructure investment is a complex problem in any economy, as market signals often do not provide sufficient guidance, market power creates gaps between private and social rates of return, and investment decisions have significant redistributive impacts across regions. There is no obvious "best practice" solution to this problem, and the Australian approach will have to take into account the specific constitutional allocation of competences. But in general, economic efficiency is most likely to be achieved if the analysis is undertaken at a national level, and decisions coordinated across levels of government.

As noted, the future of NCP will be the subject of a review by COAG in 2005. The review will need to consider the appropriate framework for a reinvigorated, nationally coordinated reform programme including the role of financial rewards and assessment processes. It will also need to consider reform priorities and expanding the scope of reform efforts to new areas. Health, education, childcare and community services are areas which offer a great potential for closer coordination of reforms across Australian governments to enhance efficiency, given Australia's brand of fiscal federalism with constitutional powers and responsibilities residing with sub-central governments. This is all the more so as the ageing of the population will impact on government services, revenues and retirement income policies. Environmental degradation represents another risk to future growth. An integrated sustainability package could extend to matters such as land use planning (and clearing), and pollution (including greenhouse gas abatement),[61] using market-related instrument approaches to environmental management; only the NCP water reform programme addresses such matters at present. This has inter-jurisdictional implications as the Constitution has left most environmental responsibilities to the states, but their interests differ depending on energy production patterns, biodiversity concerns and water-use. Hence, a co-ordinated regional and national approach is needed to deal with cross-state spillovers and the need to implement commitments made under international agreements, as well as to ensure that there is a sufficient range of instruments available to cope with environmental problems. There may also be scope to apply an NCP-type framework to improve the efficiency of the labour market, with the industrial relations system having an important inter-jurisdictional dimension. In particular, the Australian dual system of federal and State industrial relations system results in significant inefficiencies for many enterprises which have some employees covered by the federal system and some by the relevant state system (see next Chapter).

Box 3.3. Recommendations regarding product market competition

Competition law and policy

A formal process for reviewing proposed mergers should be established to make the Australian Competition and Consumer Commission more accountable.

The maximum level of civil fines for cartel violations should be raised, to bring Australia into line with other major jurisdictions.

New legislation should be introduced to reduce the uncertainty in the current law on the control of abuses of dominant positions of firms and to avoid overly legalistic analyses of the significance of market power.

Legislation review

The reforms in the areas identified by the legislation review should be completed. They include agricultural marketing arrangements, liquor licensing, compulsory insurance schemes, pharmacies, the professions and occupations (health and legal practitioners and some building related trades).

The federal government in particular should make stronger efforts to raise its own compliance with the imperatives of National Competition Policy (NCP), which would strengthen the government's position in its endeavours to convince opposing parties of the overall beneficial effects of enhanced product market competition.

Box 3.3. **Recommendations regarding product market competition** (*cont.*)

Network industries

General

The federal Government should explore ways of ensuring cost-effective and timely investment decisions in regulated network sectors that operate across several jurisdictions.

Electricity and gas

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

- grid interconnection should be improved and competition in electricity generation intensified by setting better incentives for investment in transmission and generation; and
- regulatory inconsistency, arising from the co-existence of state and national regulators in both the electricity and gas sectors, needs to be removed as planned.

Transport

Recently announced national land transport reforms planned under the A*us*L*ink* framework need to be effectively implemented, to ensure efficient long-term investment and better integration of the network. Efforts should also be made to promote competition in ocean shipping with a current review by the Productivity Commission suggesting that repeal of the industry-specific regime for international liner cargo shipping will improve outcomes. More broadly, Australian governments should seek to establish an integrated reform agenda within a co-operative framework covering all elements of land transport and shipping transport.

Telecommunications

Competition in fixed-line telecommunications should be promoted by strategies designed to facilitate further access by competitors.

Telstra, the dominant telecom operator, should be required to divest its cable network and its shareholding in a major pay-TV supplier, provided independent assessment shows the benefits of divestiture would exceed the costs.

Postal services

Another effort should be undertaken to open the postal services market to competition.

Box 3.3. **Recommendations regarding product market competition** (*cont.*)

Water provision

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

The security of water access entitlements should be improved, the ecosystems health is ensured and the expansion of water markets and trading be encouraged.

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

The future reform agenda

The Productivity Commission is currently undertaking an inquiry into the future of NCP in the lead up to a review of NCP by the Council of Australian Governments (COAG) in 2005. This opportunity should be taken to address the unfinished business of the current NCP agenda, reinvigorate the commitment to reform, and extend competition and efficiency enhancing reforms to appropriate new areas, including social policy.

Notes

1. The findings of the OECD Growth Project are summarised in OECD (2003).
2. See Productivity Commission (1999a).
3. See OECD (1992).
4. Australia's economic decline relative to other countries nurtured fears at the time that it risked becoming a "banana republic" and that, in particular in view of the performance of some Asian countries, "within two generations, unskilled Australian workers could be looking for jobs as maids and waiters in Kuala Lumpur" (Hughes, 1985).
5. The structural weaknesses in the Australian economy prior to reform were discussed by expert reviews such as the Vernon Committee Report (1965) and the Jackson Committee Report (1975). These findings are summarised in Productivity Commission (1999a), Box 3.1.
6. Significant tariff reductions on manufacturing imports were already implemented in 1973, along with reforms to improve efficiency in major export industries in the agricultural sector.
7. For a brief discussion of the significant impact of macroeconomic policy settings on output per capita across countries as well as in the Australian context see the 2003 OECD *Economic Survey of Australia*, Chapter 2.
8. For example, during the 1990s, Australia's annual GDP per capita growth rate, at constant prices, averaged 3.6 per cent, up from 1.5 per cent over the 1970s and 1980s. This compares with 3.2 per cent in the United States, 2.3 per cent in the United Kingdom and 1.9 per cent in both Germany and France.
9. PPPs are defined as the rates of currency conversion that equalise the purchasing power of different currencies by eliminating the differences in price levels between countries. In other words, PPPs are price relatives which show the ratio of the prices in national currencies of the same good or service in different countries.
10. 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.
11. The market sector excludes activities which are not valued in the market. The sectors excluded are: property and business services; government administration and defence; education; health and community services; and personal and other services, including ownership of dwellings. In recent years, the market sector accounted for a little less than two-thirds of GDP. Over the past three decades, increased multifactor pro-

ductivity accounted for around two-thirds of the 80 per cent rise in per capita incomes in Australia, the rest being due to increased inputs of labour and capital.

12. See Parham (2004), Productivity Commission (2002a), Parham (2002a), Parham (2002b), Bean (2000), Dowrick (2000), Forsyth (2000), Productivity Commission (1999a), and the 2001 and 2003 OECD Economic Surveys of Australia.
13. For further examples of cost and price reductions in infrastructure services during the 1990s see Productivity Commission (1999a) and the 2001 OECD *Economic Survey of Australia*, Table 17.
14. See the 2001 OECD *Economic Survey of Australia*, Box 3.4.
15. It should be noted, though, that no country in the sample is the technological leader in all sectors.
16. Price differentials provide only an indirect indication of the degree of competition. For example, a price difference in a given sector may not necessarily be due to a competition problem in the sector, but to the induced effect of high prices in other industries. Price comparisons are also biased by differences in distribution and transport margins and indirect tax across countries (Pilat 1996). However, VAT (or GST) rates are lower in Australia than in most OECD countries.
17. This is because wages in low-productivity service sectors may be determined by wages in high-productivity manufacturing sectors, resulting in relatively high prices for services. Since the relative demand for services tends to rise with per capita income, higher income countries will tend to have systematically higher price levels than lower income countries.
18. The study applied a time-varying indicator of the regulatory stance in seven network industries from 1978 to 1998 to represent the evolution of the general regulatory framework in individual countries. Although the speed of progress varied, substantial regulatory reforms were implemented in all OECD countries over this period, increasing individual countries' employment rates by an average of 1½ and up to around 2½ percentage points where reforms have been pursued most vigorously.
19. Experience in other jurisdictions shows that when such issues arise in private litigation involving complaints by competitors, courts may narrow interpretations in order to avoid finding liability in cases where the motivation of the parties may not be consistent with the public interest.
20. See Hilmer *et al.* (1993).
21. 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".
22. 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.
23. The most significant areas of non-compliance for the Commonwealth include legislation on wheat marketing, broadcasting and postal services, and the incomplete review and reform of health-related legislation and legislation on industry assistance (see NCC 2003a).
24. Short, Swan, Graham and Mackay-Smith (2001).
25. Productivity Commission (2002a).

26. National Competition Council (2003a).
27. 1 terajoule equals 1012 joule which in the case of gas equals about 26 300 cubic metres.
28. National Competition Council (2003a), p. xiii.
29. 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. Dryland salinity stems from reduced water use while wetland salinity results form increased water use. A discussion of the salinity problem is in the special chapter on "Enhancing environmentally sustainable growth" in the 2001 OECD *Economic Survey of Australia*. See also the section on "Sustainable development" in Chapter 4 of the 2003 OECD *Economic Survey of Australia*.
30. National Competition Council (2003a), p. xiv.
31. In Victoria, for example, permanent water transfers increased during the 1990s, to almost 1 per cent of the total volume of water entitlements in 2000-01. In recent years, temporary trade ranged between 3 to 8 per cent of total water entitlements, depending on climatic conditions. See National Competition Council (2003c).
32. National Competition Council (2003d).
33. 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.
34. Some of the gap in productivity level is due to factors that inherently disadvantage Australia, such as scale of operation. Technical efficiency is adjusted for such effects.
35. Freight rates are measured as the average selling price of freight services – total freight revenue divided by net tonne-kilometre.
36. The structure of Australia's aviation market has changed markedly in the recent years. Virgin Blue commenced operations in Australia in August 2000. In September, only days after the terrorist attacks on United States, Ansett Airlines was placed in the hands of an administrator and reduced operations before ceasing operations all together in early 2002. The demise of the airline, which held 39 per cent of the domestic air travel market, allowed Qantas to raise its domestic market share from 55 per cent to more than 80 per cent shortly after Ansett's failure. The obvious risk of Qantas taking advantage of its dominant position appears not to have materialised, though. Since the Ansett bankruptcy, Virgin Blue, number two in domestic air passenger transport, has clawed back market shares from Qantas. Virgin Blue's domestic fleet has grown from 22 aircraft in June 2002 to 33 in June 2003, and a further six were added in the third quarter that year.
37. In 1997, the Commonwealth Government commenced the sale to private operators of long-term leases for 17 of the 22 airports operated at the time by the Federal Airports Corporation (FAC). The remaining five federal airports – the four Sydney basin airports and Essendon Airport – were leased but not privatised, with their ownership transferred to two wholly Government-owned companies in 1998. The FAC subsequently ceased operation. Subsequently, Essendon Airport was sold in September 2001. The Sydney Airport sale was completed the next year, as was the sale of the three other Sydney basin airports.

38. Doove *et al.* (2001) extend the research done by the OECD (Nicoletti *et al.*, 2000) and find that there is a positive relationship between regulation and telecommunication prices, although not very strong. In Benefits Resulting from Changes in Telecommunications Services (2002) the Allen Consulting Group models that the net impact from the telecommunications industry reform has been a significant boost to GDP. In 1997-98, national output was 0.14 per cent higher than it would have been had the changes to the telecommunications market not been introduced. Thereafter, the output dividend has grown each year, rising to 1.62 per cent above the case of no change by 2001-02.

39. This means that the network provider must provide local loop network services unbundled from their other services. If the local loop is unbundled then there will be a separate tariff just for this item.

40. The grocery industry includes a range of different operational structures, such as one-stop shops, national convenience retail stores, and specialist operations, including fruit and vegetable and meat outlets (Australian Competition and Consumer Commission, 2004).

41. With exception of Western Australia, all jurisdictions have significantly deregulated shop trading. See National Competition Council (2003b) for a detailed review on the legislative restrictions in the retail sector.

42. The National Association Grocers of Australia (NARGA) proposed that the market share of each major chain to be capped at 25 per cent, with divestiture taking place within 5 years in case that a chain surpasses this limit (Commonwealth of Australia, 1999).

43. In June 2003, Coles Myer Ltd had advised the ACCC of its plan to acquire 12 independent supermarket outlets (ACCC, 2004).

44. Section 50 of the Act prohibits a merger if it would have, or be likely to have the impact of substantially lessening competition in a substantial market.

45. Few professions in Australia are entirely self-regulated nowadays. Rather, the majority of them are "co-regulated", with the statutory rules complemented by professional codes of conduct. For a discussion for the advantages and limitations of self-regulated schemes, see Deighton-Smith *et al.*, 2001.

46. See, for example, Nguen-Hong (2000), Paterson *et al.* (2003), and OECD (2004).

47. For a discussion, see National Competition Council (2003a, d).

48. According to NCC, there has been a call for reforms of professional indemnity insurance arrangements in response to recent increases in premium and the collapse of the United Medical Protection. The Royal Australasian College of Surgeons, for instance, proposed the establishment of a monopoly supplier of professional indemnity insurance for medical practitioners (NCC, 2003b).

49. A recent study by the Productivity Commission (PC) on workers compensation arrangements and occupational health and safety, which examines issues similar to those affecting legal professional indemnity insurance, concludes that the literature does not provide clear evidence in favour of either public monopoly or competitive private provision for workers' compensation insurance. However, the PC deemed that, on balance, private provision was preferable to the public monopoly one because private capital is directly at risk; competition in the insurance market encourages greater innovation and efficiency; and that there is greater transparency of any governmental influence over premiums (PC, 2004b).

50. For a review, see National Competition Council (2003a, d).

51. Friendly Societies are owned by their Members, they are non-profit companies, and provide financial and other services.
52. Ownership rules for dental practices still apply in South Australia and Western Australia.
53. The next paragraphs, which deals with TCF and automotive assistance, are largely based on Productivity Commission (2003d), Review of TCF Assistance and Productivity Commission (2002b), R*eview of A*utomotive *Assistance*.
54. Tariffs on apparel and certain finished textiles are to be reduced from 25 per cent to 17.5 per cent. Tariffs on cotton sheeting, woven fabrics, carpets and footwear are to be reduced from 15 per cent to 10 per cent, and sleeping bags, table linen, tea towels and footwear parts will see a tariff reduction from 10 per cent to 5 per cent. Tariffs on items currently at 5 per cent will not change.
55. The tariff rate for clothing and finished textiles will be reduced from 17.5 per cent to 10 per cent while the tariff rate for all other items will become 5 per cent.
56. See National Competition Council (2004).
57. See National Competition Council (2004).
58. See National Competition Council (2003a).
59. Productivity Commission (2004a).
60. Draft legislation which sought to reduce Australia Post's reserved service and to open the postal market to increased competition was withdrawn from the Parliament in early 2001 as it did not attract sufficient support.
61. See National Competition Council (2004).

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Annex 3.A1

Competition policy institutions

Australia's competition law is a complex combination of general principles and particular detailed prohibitions. It is the product of a long evolution. Australia first adopted a competition law in 1906, but constitutional weaknesses and court interpretations limited its scope and undercut its effectiveness. While the competition law was largely unused, high concentration and industry co-ordination behind tariff-wall protection characterised the Australian economy for much of the 20th century. After some unsuccessful attempts at reform, the Trade Practices Act 1974 finally placed competition law on a sounder constitutional footing. The institutional structure took its present form in 1995, when the ACCC was created, as part of the Hilmer Commission's NCP reforms, by consolidating the Price Surveillance Authority into the Trade Practices Commission and adding consumer protection authority to the mix.

The TPA covers – competition law, consumer protection, and regulation of network monopolies. The ACCC, an independent statutory authority, has unusually wide-ranging authority. It is principally responsible for enforcement of competition and consumer protection law and for deciding about terms and prices for access to essential facilities. The ACCC has been active in promoting competition in telecommunications, broadcasting and energy. The Australian Competition Tribunal (Tribunal) is the appeal body for review of the ACCC's decisions about authorizations and access to essential facilities. The States and Territories have the power to apply their own laws about competition and sectoral regulation, but the competition provisions of Part IV of the TPA apply uniformly through all jurisdictions and are enforced by the ACCC. The National Competition Council (NCC), which does not have a direct law enforcement role, was created to oversee the implementation of the inter-governmental reform agreements and commitments that are embodied in the National Competition Policy; in addition, the NCC has some formal responsibilities in the system for making recommendations on applications for access to essential services. Another independent statutory authority, the Productivity Commission, undertakes public inquiries and advises about microeconomic policy and regulation. The Department of the Treasury oversees all of these independent entities and is responsible for policy. The Treasurer has some power to direct the ACCC to undertake certain work, but not in the handling of particular enforcement matters. Members of the independent bodies serve under conditions that protect their independence, but the process of appointment of a member of the ACCC must be supported by a majority of governments (that is, the states and territories and the commonwealth). Keeping enforcement decisions independent from political influence is ultimately guaranteed by the role of the courts. Only the courts can issue binding orders and impose financial penalties against violations.

The ACCC, with a broad range of responsibilities, is a large and prominent institution. It has 7 full-time members and 4 associates, plus 4 ex-officio members who are economic regulators from other federal, state and territorial bodies, supported by a staff of about 465. The ACCC decides applications for authorisation, accepts notifications and undertakings, investigates complaints and initiates civil actions in court to obtain orders and penalties against violations. Several of the Dawson Committee's recommendations address controversies over the extent and exercise of the ACCC's powers. The most practical one is to set a deadline of 6 months for ACCC decisions on non-merger authorisation, assessed on the basis of public benefit. It has been difficult for parties to use the authorisation process because of delays and because of a belief that the ACCC would rarely if ever approve an application. Applicants can appeal to the Tribunal if the ACCC denies their application, but they cannot appeal until the ACCC has made a decision. The ACCC took over a year to decide an application in 1998-99. But the average time dropped to 6 months in 2001-02 and under 4 months in 2002-03, and the number of applications and decisions increased. Setting a deadline will not change current practice very much, but it will limit how the ACCC could use delay as a bargaining lever. In addition, the Dawson Committee proposed some useful technical improvements in the ACCC's investigative powers, notably to empower the ACCC to search and take possession of evidence (pursuant to a warrant issued by a magistrate). But it rejected the claims that the ACCC needed new power to issue interim relief, on the grounds that the courts could do so in appropriate cases. This is probably sound, but there is a risk of unacceptable delay if a court that is unfamiliar with competition issues founders over complexities in what should be a rapid, summary process. Some of the recommendations to curb the ACCC would have created a bureaucratic tangle of potentially competing overseers and ombudsmen; the government has not pursued them. The government has endorsed the Committee's recommendations to lower the ACCC's media profile, by supporting a policy of "no comment" on its investigations and limiting descriptions of its court proceedings to ensure that descriptions of court decisions are "consistent with the sole objective of ensuring public understanding of the court's decision".

The TPA's rules about restrictive agreements are based on sound broadly applicable principles which are reflected in legislation that can sometimes be complex and detailed. Legislation drafted in such detail requires adjustment when its rules inadvertently discourage or prevent efficient business strategies. The Dawson Committee proposals to correct some of these effects, for example by applying an economically-informed test of actual competitive effects to "third line forcing" rather than prohibit them *per se* (subject to the possibility of authorisation) and to provide a defence for joint ventures against per se prohibitions where they do not substantially lessen competition, are sound.

Nearly all of the economy is now subject to general competition law, thanks in substantial part to the NCP process. A key element of the NCP has been an ambitious, sustained programme to reduce regulation which unnecessarily restricts competition. It involved systematic review of existing legislation and controls on new legislation, applying to each a general presumption 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. The federal constitutional structure posed particular challenges in designing and implementing this process. The formal allocation of constitutional powers limits what the commonwealth-level government can do directly about the behaviour of those who are not corporations. Conduct by individuals (such as professionals), by non-corporate bodies such as marketing boards operating within a state, and by state government entities is constitutionally subject to state-level authority. Broad, uniform coverage has been achieved principally through agreement among governments to co-ordinate and harmonise state and commonwealth legislation. To encourage change, the 1995 agreement creating the NCP provides for "competition payments" to states and territories. These are conceived as their share of additional revenues raised because of pro-competitive reforms. If an assessment from the NCC finds that reforms have lagged, though, the payment is to be reduced.

The NCP has tried to set controls in order to limit exemptions to the competition provisions of the TPA. To authorise or require anti-competitive conduct (that is, conduct that would otherwise violate the TPA), legislation must be explicit and specific, both about the conduct at issue and about the intention to create an exemption from the TPA. The government enacting it must notify the ACCC within 30 days after adoption. The law must be subject to regular review under the Competition Principles Agreement framework at least once every 10 years. In that review, the NCP's basic general test is to be applied: legislation is not to be retained unless the benefits to the community as a whole from the restriction on competition outweigh its costs. Regulations implementing any such legislation are subject to a 2 year sunset.

At the commonwealth level, there are industry-specific regimes for telecommunications and ocean shipping and in addition there are exemptions for postal services and wheat exports. The conference-cartel ocean shipping system has been under challenge in most jurisdictions in recent years, although some form of special treatment for them remains common. Australia's retention of a broad exemption, despite its geographically inevitable dependence on cost-efficient ocean shipping services, is an anomaly.

A vast amount of legislation has gone through the NCP process. Of some 1 800 laws reviewed between 1996 and 2003, nearly half were in the priority areas of water, primary industries, communications, fair trading and consumer protection, insurance and superannuation, health, legal and other professions, pharmaceuticals, planning and construction, retailing, social regulation and transport. But no government actually completed the process. Overall, about 70 per cent of nominated laws were reviewed and reformed, but for the priority areas the percentage completed is substantially lower, at 56 per cent. Performance varies among governments, with some (including the Commonwealth itself) only completing 40 per cent or less of the priority legislation, while others completed nearly 80 per cent. (NCC 2003) The NCP system is to be reviewed by September 2005; in preparation, the PC is examining the impact of reforms to date and opportunities for significant gain through further reforms. The PC report is expected in early 2005.

The NCP also led to a novel, comprehensive approach to reforming traditional infrastructure monopolies. Its basic guiding principles included competitive neutrality for government business activities, structural reform of public monopolies as they are privatised and their markets are opened to competition, and independent oversight of pricing policies of government business enterprises. Procedures to facilitate access to monopoly infrastructure services are embodied in the "National Access Regime", a set of rules and institutions for dealing with problems encountered in many reform settings when potential new competitors need the services of the historical incumbent. In broad outline, the NCC and the relevant minister determine whether a particular "service" is "declared" to be subject to an access regime; when a service is declared, the ACCC then has the task of overseeing the design of the access rules and deciding disputes that arise. Complaints about denial of access to essential facilities are thus treated, appropriately, as analogous to complaints about refusal to deal by a firm with market power. It is not a one-size-fits-all system, as there are different regimes for different sectors. In some situations, regimes rely more on negotiation and arbitration, while others rely more on rules. The National Access Regime has been reviewed and should be retained with only relatively minor proposals for change to improve the Regime's focus and operation.

Annex 3.A2

Competitive industries – some aspects

Liquor licensing and petrol retailing legislation

There are significant differences across the states in the legislation that controls liquor licenses. Overall, liquor laws designed to support the social standards of the community, such as minimum age for legal alcohol consumption, have not been questioned under the National Competition Policy (NCP) as they do not significantly affect competition. There are some regulations, however, for which a public benefit justification is required since they hamper competition in the liquor retailing market. Licensing laws often restrict the number of potential sellers, through, for example, the requirement in some jurisdictions of a "public needs test" for an additional liquor outlet in a specific area. In addition, in some states, legislation discriminates among different sellers of packaged liquor (favouring general license holders) and/or regulates the market conduct of license holders.[1] Concerns have been raised by independent liquor outlets about the impact on competition from the ongoing expansion of major grocery retail chains in the market. The introduction of "warehouse" style liquor stores by the two major chains (and some independents) may also affect competition in the underlying market through lower prices on a wide variety of products (ACCC, 2004). In Victoria, the government introduced a package of measures to help independent liquor stores to remain competitive after the deregulation of the market in 2006. These include business advice and training to independent liquor stores, and financial support to programmes promoting the responsible sale of alcohol. In addition to liquor licensing laws, two jurisdictions – Western Australia and South Australia – have legislation that constrains competition in petrol retailing, with the underlying arrangements limiting freedom to set prices or precluding the entry of new sellers. Recent statistics suggest that the Australian packaged liquor industry is broadly competitive, with Metcash,[2] Coles and Woolworth's accounting for 82 per cent of the market.

Shopper docket petrol discounts

"Shopper docket" schemes – binding petrol discounts to grocery purchases – have been feared as having the potential for enhancing the market power of the major chains, with long run adverse implications for competition and economic welfare. This issue – along with that of the acquisition of a number of independent supermarkets by a national grocery chain – was addressed in a recent inquiry by the ACCC. It decided to permit shopper docket discounts to continue, as it considered that there were "substantial benefits" for consumers arising from these schemes. These offers encourage competition and lower prices in the fuel market, while providing the incentives for retailers to become more innovative in non-price aspects (such as wider range of services) to acquire or retain their market share (ACCC, 2004).[3]

Regulation of health and legal services

Practice reservations, which permit only qualified or registered professionals to practice a profession, may be justified in cases that poor professional practice would expose consumers to significant risks, either in health or financial terms. However, such restrictions can also increase the cost of professional services, if they limit their availability. In this context, wide-ranging reservations of practice are likely to create distortions, as they may lead to an inappropriate restriction of some common low risk practices.[4] The regulation of the legal profession provides an example in which broadly-defined practices restrict competition by inhibiting appropriately trained non-lawyer providers to enter the market. The state-level legislation makes it an offence for unqualified persons to provide legal services, reserving this right exclusively to registered legal practitioners. However, the definition of legal work – which differs across jurisdictions[5] – is somewhat imprecise, making no clear distinction between services requiring comprehensive legal training and others, of less technical nature, which do not require such skills. In three jurisdictions, for instance, the practice of property transactions ("conveyancing") continues to be defined as legal work, while in the rest is permitted for non-lawyers in competition with legal practitioners. The opening up of the market in New South Wales has led to a 17 per cent decline of the services fees between the years 1994 and 1996. Competition concerns may also emerge from the method of practice reservation, and in particular in cases of restrictions on receiving financial reward for a task, in the absence of prohibition on performing the task, as this often implies a commercial objective rather than directly related to public protection.[6]

Restrictions on business ownership arise from an alleged conflict between professional and commercial obligations, with some jurisdictions, in the case of health professions, prohibiting the employment of health practitioners by non-professionals, or requiring the owners of health care business in areas, such as dentistry or optometry, to be practitioners. Ownership restrictions cover pharmacy in all states (apart from the Northern Territory), with the underlying legislation further containing numerical restrictions on ownership, and preventing non-pharmacists from having pecuniary interests in a pharmacy. The Australian Government regulation also imposes restrictions, by regulating the number and location of pharmacies under the Pharmaceutical Benefits Scheme (PBS) (See Box 3.A1.1).[7] As for legal services, rules restricting business ownership require, in general, law firms to be owned by lawyers, permitting only lawyers to share in the profits. This restricts the ability of legal practitioners to share profits with non-lawyers, making it hard for them to form multidisciplinary practices with other professionals, such as accountants and management consultants.

The usual justification for ownership controls is that they preserve professional independence, thus protecting the public from inappropriate commercial interference in decision making. There is limited evidence, however, that supports the link between ownership restrictions and the preservation of professional morals.[8] Rather, such restrictions have the potential of imposing a cost on both consumers and professionals, through limiting the market entry for new providers and constraining innovation. Several jurisdictions took steps towards reducing inappropriate commercial influence on clinical-making decisions by making such interference an offence. While involving some costs of enforcement for the governments, such an approach evades the costs on the patients and health professionals stemming from ownership restrictions. An additional constraint on commercial behaviour regards advertising restrictions, sometimes considered as means to ensure that consumers are not misled by deceptive claims. Nevertheless such rules can potentially hamper competition by making it more difficult for new entrants to promote their business and for the consumers to make comparisons of the available services and prices. Review activity under NCP has generally seen a relaxation of advertising controls. But restrictions remain, raising

Box 3.A1.1. The Australian Government health legislation and its impact on competition*

The Australian Government regulates the health and pharmaceutical sector through legislation on the Medicare system – providing rebates for private sector medical services, free at point of service hospital care on the basis of need, and subsidised access to pharmaceuticals. The general objective of federal legislation is to ensure equitable geographical access to high quality and cost-effective health care, by regulating who can provide services that are eligible for Medicare or pharmaceutical benefits.

The key restrictions on competition contained in the Australian Government health legislation according to the 2003 NCP assessment report by the NCC – relate to:

- *Medicare provider numbers*: The Australian Government introduced legislation in 1996 that limits entry to private medical services, as it requires new medical graduates to complete additional training before they gain access to the register of a Medicare provider number. Legislation aims at improving the quality of general practice and promoting an even distribution of medical practitioners. The NCC assessed that the Australian Government has met its CPA obligations in relation to Medicare provider numbers. Changes to general practice training under the 2000 Budget were deemed to have reduced the extent to which restrictions on the Medicare numbers hamper competition.
- *Pathology collection centre approvals*: The Health Insurance Act 1973 restricts, under the licensed collection centre scheme, the number of pathology outlets that can provide services eligible for Medicare benefits, preventing entry to the market. One of the objectives of the scheme was to facilitate managing Medicare costs. The approved collection centre scheme, which replaced the licensed collection centre scheme in December 2001, retains restrictions on the number of collection centres that an approved pathology authority may operate. It however entails a partial deregulation of pathology collection centres, as the method for allocating approvals is based on pathology episode activity over a 12-month period, rather than the number of participants in the scheme. In its assessment report, the NCC considered that there is a public interest case for maintaining the new scheme (to be phased in four years from December 2001) until 2005 to realise its benefits, as its deregulation feature promotes competition.
- *Pharmaceutical Benefits Scheme* (PBS) *dispensing rights for pharmacies*: The PBS is regulated by federal government legislation, supplemented by the Australian Community Pharmacy Agreement. The main intervention of the federal government in the pharmacy sector is through restrictions on the number and location of PBS-licensed pharmacies, designed to ensure an equitable distribution of pharmacies across the country and to contain PBS expenditure. The legislation also restricts approvals for relocations of existing pharmacies. The Wilkinson review (1999) recommended the removal of location restrictions for both new and relocating pharmacies from mid-2001, as there

Box 3.A1.1. **The Australian Government health legislation and its impact on competition*** (*cont.*)

was no convincing evidence that such restrictions provide a net public benefit. The Australian Government argued, instead, for phased and targeted easing of the existing location rules, with an opportunity for their review during the period to the next Australian Community Pharmacy Agreement (commencing in July 2005). The NCC considered that there is a public interest case for phasing in reforms, but not for retaining the restrictions. It assessed that the Australian Government has met its CPA obligations with regard to pharmacy location restrictions, in view of the agreed, between the federal government and the Pharmacy Guild of Australia, review of these restrictions between over the period 2001-05.

- *Restrictions on private health insurance*: There are restrictions governing the private health insurance, including registration requirements for the funds and product and price controls. These regulations are aiming to encourage private funding of health services in Australia and ensure its accessibility to a large part of the population. Under the National Health Act and associated regulations, the Australian Government restricts, for instance, the services covered by private health insurance funds, and requires community rating of private health insurance. Such regulations however hamper competition among health funds, with adverse implications for consumer choice and business costs. Community rating, for example prevents, a premium differentiation by the insures on the basis of sex, age, or health status, as every contributor pays the same premium. This implies, however, an increased burden for the younger and healthier members, who pay relatively more. The 'lifetime community rating' implemented in 2000, amended community rating to allow a premium reflecting the age at entry for the new entrants. The NCC considers that the lifetime community rating may be consistent with the CPA principles, but it sees no clear longer-term net benefit arising from such scheme. To this end, it recommends a formal examination of this benefit through a review of the community rating principles.

* The Box draws on NCC (2001a, 2002b and 2003b).

competition issues. In the case of legal professions some new advertisement restrictions have been introduced recently in some jurisdictions in response to the increasing public liability insurance premiums (Deighton-Smith 2001; NCC 2001a, 2003b).

Competition in the area of health professions is further hampered by restrictions on the number of medical practitioners trained in Australia, as well as the limits on overseas-trained medical practitioners entering the country. The Australian Government determines the number of subsidised medical school places, while the availability of training places in various medical specialities is influenced by the workforce planning targets set by the Australian Medical Workforce Advisory Committee. Barriers for the overseas-trained professional to enter the practice arise from Australian migration requirements, and medical registration requirements. In addition to the likelihood of excluding competent practitioners, such restrictions have the potential of creating an "artificial" shortage of supply, with adverse consequences on heath care prices and the quality of services provided in terms of waiting times for the patients (NCC, 2000b).

Other professions

In addition to the health and legal professions, regulations limit competition in other areas of professions and occupations, although not to the same degree. These regulations include licensing or registration provisions for a range of occupations such as commercial and private inquiry agents, security service providers, driving instructors and others. There are differences across the states with regard to the licensing requirements, ranging from complex tests of practitioners' qualifications and character, to a "negative licensing scheme", not requiring applicants to be registered. An issue also emerges from the licensing or registration of certain occupations (including auctioneers, conveyancers, and employment agents) in some but not all jurisdictions, raising the question of the necessity of such regulations (NCC, 2003a).

Annex 3.A3

Australia's current trade policy stance

The general tariff on manufacturing goods has now fallen to 5 per cent. A 15 per cent duty on passenger motor vehicles (PMV) and up to 25 per cent duty on textile, clothing and footwear (TCF)[9] pull up the average, although both these sectors will undergo further tariff reductions in 2005. Credit schemes that provide assistance for both the PMV and TCF industries are in effect. At the other extreme, imports such as food, books, medical and scientific equipment enter Australia duty-free. Of the remainder, the government levies a general tariff of 5 per cent. The average level of tariff protection to agriculture, 0.3 per cent, compares favourably with most other countries. This does not reflect the non-tariff barrier of the strict quarantine and inspection regime.

Some goods or countries receive special treatment. For those goods where the general tariff rate is 5 per cent and there is no Australian manufacturer of equivalent goods, a successful application of a tariff concession order will reduce the duty rate to 3 per cent for business inputs and 0 per cent for consumption goods. Additionally, a provision for duty-free entry exists if these goods also qualify as being for the use in the mining, minerals-processing, agriculture, food-packaging and food-processing industries. Further, Australia provides quota and duty-free access to all goods originating from Least Developed Countries recognised as such by the United Nations Conference on Trade and Development and East Timor. For New Zealand, Canada and Singapore, preferential duty rates apply to imports on the basis of bilateral trade agreements. Most goods imported from these countries are brought in duty free.

Quotas have been entirely abolished, but other non-tariff barriers still exist. Goods imported into Australia in contravention of the strict quarantine regulations are detained and may be forfeited. There are also strict controls on the correct labelling of imported goods. Anti-dumping and countervailing activity may be imposed where there is evidence that dumped or subsidised goods are causing significant injury to Australian industry. The number of Australian initiations of anti-dumping and countervailing cases has been relatively stable over the past five years, with 15 cases initiated in 2002-03. Cases initiated in 2002-03, all of which was antidumping actions, is almost three times that of 1994-95, but only around a quarter of the 1992-93 level. In 2001-02, Australia accounted for 5 per cent of the anti-dumping and countervailing cases initiated internationally. This made Australia the seventh largest user of anti-dumping and countervailing duties. The top three on this list was the United States, the European Union and India (Productivity Commission, 2003b).

Annex 3.A4

Assessing trade policy

The impact of trade liberalisation on Australia's economy

This section suggests that when explaining Australia's impressive economic development since the 1990s, trade liberalisation is one important explanatory variable. In principle, the transmission between increased exposure to trade and economic growth can run through several channels. First, lower import prices translate into lower domestic prices and a once and for all boost to consumer welfare. Second, if trading partners also lower import barriers, higher exports boost output (if output is below capacity) and then export prices (and therefore better the terms of trade). Lastly, permanently increased competition on the domestic market can trigger innovation and greater efficiency, possibly helping to raise potential growth rates of GDP. Although rationales abound, modelling the impact of increased trade openness on underlying growth is a more troublesome exercise. Still, the general conclusion that can be drawn from recent empirical literature is that, on balance, the weight of evidence based on cross-country regressions supports the view that trade promotes growth. There is also some evidence that trade assists convergence in per capita income (see Ahn and Hemmings, 2000, for an overview of empirical studies).

The trade liberalisation process made a major step forward at the beginning of the 1970s with a 25 per cent across-the-board tariff cut on manufacturing imports, along with reforms to improve efficiency in major export industries in the agricultural sector (Box 3.A4.1). This was followed a decade later by other landmark reforms, when the internationalisation of the Australian economy was extended by floating the dollar and removing foreign exchange controls. Greater exposure to international competition created pressures for more efficient delivery of utility services and greater flexibility in factor markets.

Trade has become an increasingly important part of the Australian economy, as for all other countries (Table 3.A4.1). During the 1990s, trade openness (trade/GDP ratio) has increased somewhat more in Australia than for the OECD-average. Driving this development has been trade in goods, while trade in services has yet to become a significant contributor to economic growth. Second, total exports are heavily dependent on non-manufactured goods,[10] and intra-industry trade is comparatively low. The low share of intra-industry trade reflects the tendency for a high proportion of Australia's manufactured exports to consist of relatively simple transformations of raw materials with which the country is well endowed, and that such transformations are not suited to division across different countries (OECD, 2002). Finally, this latter point is underpinned by the data on export ratios and import penetration, showing that high-tech industries clearly are the most integrated industries internationally.

It is plausible that falling import protection has stimulated increased export orientation in Australia's manufacturing sector (Marks and Sadeghi, 1998). Importantly, notwithstanding

Box 3.A4.1. A brief on Australia's trade policy evolution

Along with the bevy of microeconomic reforms discussed in Chapter 3, liberalising trade is thought to be an imperative factor when explaining how the sluggish Australian economy at last gained strength after the nadir around 1990. Reforms unfolded over the 1970s and especially the 1980s. Tariff reductions over the period have brought significant reductions in levels of effective assistance to import-competing industries. For example, the average effective rate for the manufacturing sector has declined from 35 per cent in 1972-73 to about 5 per cent for 2002-03. However, progress over the period has not always been smooth, as depicted below. Further, other than for the PMV and TFC sectors and some recent FTAs, there have been no systematic reductions since 1996. The Productivity Commission (1999b) outlines the main steps in Australia's path towards a more liberal trade policy:

- In 1971, the Government announced a program of review of tariffs by the Tariff Board. The Government was careful to point out, however, that this would involve no commitment on its part to implement any recommendations made.
- In 1973, tariffs were reduced across the board by 25 per cent. In later public discussions, subsequent increases in unemployment were attributed primarily to these tariff cuts, against the evidence of analytical studies. Further across-the-board reductions were seen as politically difficult.
- Consequently, there was a return to the piecemeal approach. Non-tariff measures gained favour in response to increasing unemployment. Market sharing through import quotas was introduced as a "temporary" measure in the mid-1970s, mostly in highly assisted industries (in two cases, they were not removed until 1988 (Automotive) and 1993 (TCF)).
- In 1982, the Government announced that general reductions in protection were precluded for the time being.
- Governments adopted a broader industry-wide approach to reviewing industry assistance from the early 1980s. Industry plans were introduced in some industries from 1983, attempting to establish greater uniformity in assistance, improve intra-industry efficiency and instil an export focus. The Government increasingly determined industry development measures on a generic basis – for example, generally available encouragement of research and development.
- An agreement for Closer Economic Relations between Australia and New Zealand entered into force in 1983. It established a progressive move toward free trade in most goods between the two countries and has undergone three reviews, including widening the scope of the agreement to include the harmonizing of a range of non-tariff measures.
- In 1988, the Government announced a four-year program of phased reductions in nominal tariff rates for most imports (excluding the PMV and TCF sectors). Tariffs above 15 per cent were to be phased down to 15 per cent and those between 10 per cent and 15 per cent were to be phased down to 10 per cent.

Box 3.A4.1. **A brief on Australia's trade policy evolution** (*cont.*)

- In 1991, the Government announced the continuation of this program of phased tariff reductions. General tariffs were to be phased down to 5 per cent over the four years to July 1996. Tariffs on passenger motor vehicles were to be phased down from 35 per cent in 1992 to 15 per cent in 2000. Tariffs on textiles, clothing and footwear were to be phased down to a maximum rate of 25 per cent by 2000.
- In 1997, the Government announced that tariffs in the textiles, clothing and footwear industries and the automotive industries were to be frozen at their year 2000 levels until a further reduction in 2005.
- In 2002 and 2003 the Government announced further tariff reforms/reductions for the PMV and TCF sectors respectively.
- In 2003 Australia and Singapore signed an FTA, Australia's first since the FTA with New Zealand. Australia also signed a Trade and Economic Framework with China involving a commitment to undertake a joint feasibility study into a possible FTA between the two countries.
- In 2004, Australia and the United States signed an FTA, which is due to be brought into force on 1 January 2005. Australia also signed an FTA with Thailand in 2004, which is expected to come into force on 1 January 2005.

Source: Productivity Commission (1999b); OECD.

the historically comparative advantage in the production of certain raw materials, opening up to trade seems to have sparked a process of change in the export composition. Traditional Australian exports of minerals and fuels and agricultural products still form a relatively large share of Australia's merchandise exports, but have fallen as a proportion of exports reflecting strong growth in exports of finished manufactures. Figure 3.A4.1 illustrates the relationship between falling protection levels and growth in finished exports. Arguably, this reflects the fact that finished exports have become more competitive. Trade liberalisation has facilitated this outcome by providing industries with cheaper imported and domestic inputs. Australia's import penetration increased quite substantially in the 1990s, and dependency on imports for subsequent exports increased in the same period (Figure 3.A4.2). At the end of the day, Australia has experienced a trend towards increasing the level of value added to Australia's raw material exports, boosting national income.

As mentioned above, trade in services remains limited. As a share of GDP, trade in services only increased from 3.9 per cent in 1990 to 4.5 per cent in 2001. Trade in goods increased from 12.7 per cent to 17 per cent over the same period. The relatively minor role for services in international trade, a general phenomenon, stands in stark contrast to the contribution of services in the domestic economies, where the proportion of total value-added contributed by services usually is around 70 per cent and rising. Of course, services are more

Table 3.A4.1. **Exposure to international trade competition in selected OECD countries**[1]

Average of export ratio and import penetration

	1991	1999
Computers	46.7	60.8
Aircraft	41.7	53.1
Scientific instruments	27.3	39.3
Radio, TV, communications	28.1	39.2
Textiles, clothing	24.7	35.3
Machinery, equipment	27.2	34.6
Motor vehicles	30.1	34.6
Electrical machinery	21.1	33.8
Chemicals	24.8	32.6
Other transport	31.5	31.5
Pharmaceuticals	16.4	27.4
Total manufacturing	19.7	25.8
Shipbuilding	22.4	24.3
Basic metals	19.0	22.8
Other manufacturing	15.6	22.2
Rubber, plastics	17.5	20.7
Wood	12.5	15.3
Non-metallic minerals	10.7	12.9
Food, drink, tobacco	9.8	11.8
Petroleum refining	12.5	11.8
Metal products	8.6	11.1
Paper, printing	9.8	10.9

1. OECD includes Australia, Austria, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Norway, Portugal, Spain, Sweden, the United Kingdom, the United States.

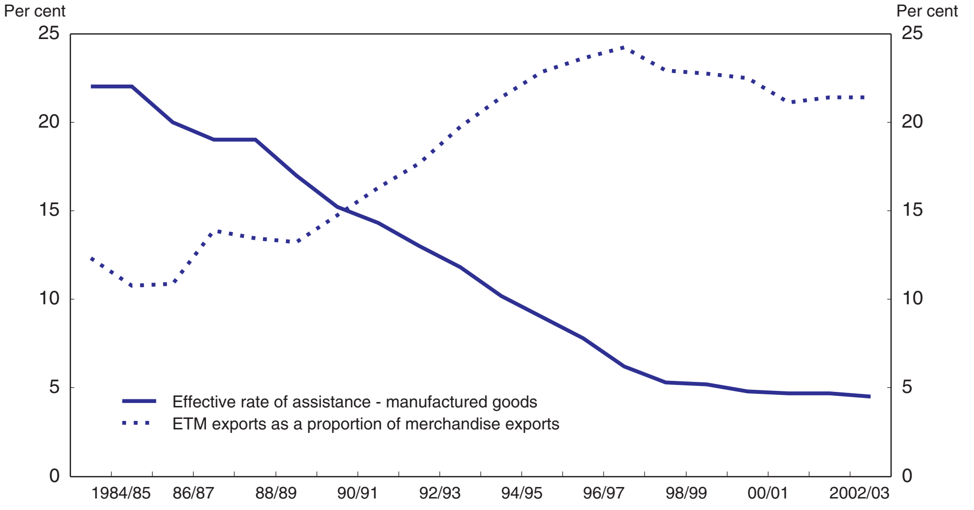
Source: OECD, STAN database, June 2003.

difficult to trade internationally, emphasising the importance of physical proximity between supplier and customer. Another reason may be that the service cannot be traded separately from its production. Consequently service producers may find it necessary to establish a commercial presence in countries they wish to trade in, in order to be close to their customers. Accordingly, foreign direct investment flows in the OECD-area have spiked during the 1990s, but Australia seems to have fallen short of the average trend (Figure 3.A4.3). As in other OECD-countries, the fastest growing service exports and imports the last decade have been computer and information services (Figure 3.A4.4). Imports of insurance and financial services have declined in the period, contrary to the OECD trend, indicating that outside pressure on domestic businesses is relatively limited in these sectors. On the other hand, imports of other services like legal services, accounting and management consulting has increased rapidly, although from low levels.

Is Australia shifting its approach towards trade liberalisation?

Although Australia's average tariffs came down only recently in line with its industrial partners, it is nonetheless noteworthy that much of Australia's trade liberalisation policies have been unilateral, undertaken regardless of other countries' action. Such an approach

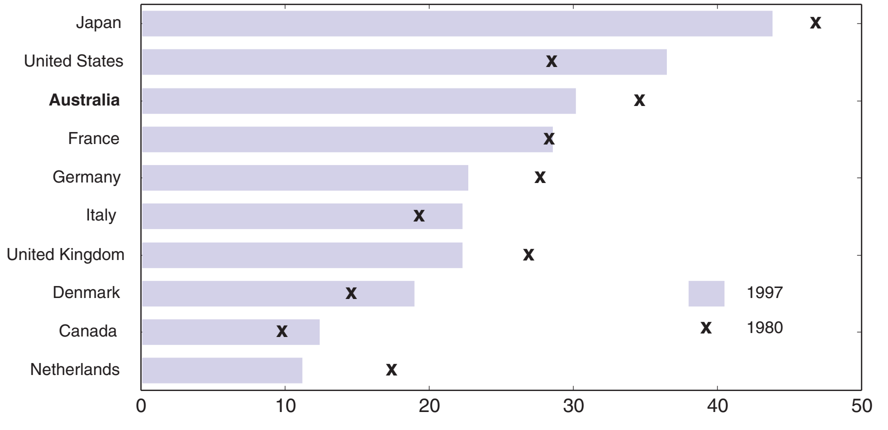
Figure 3.A4.1. **Finished exports and protection**



Source: Productivity Commission and Department of Foreign Affairs and Trade.

Figure 3.A4.2. **Import contents of exports**[1]

1980 and 1997

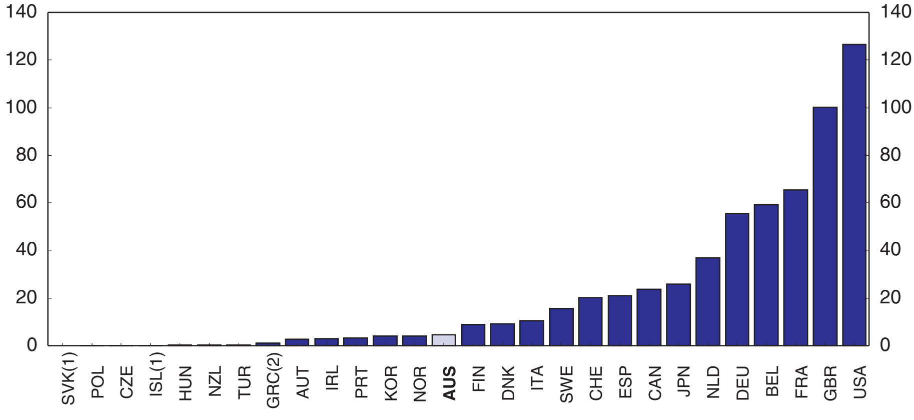


1. Defined as the share of imports used in production to make one unit of export, including energy.

Source: OECD, Input-Output database, February 2003.

Figure 3.A4.3. **Outward foreign direct investments**

Average 1994-2001



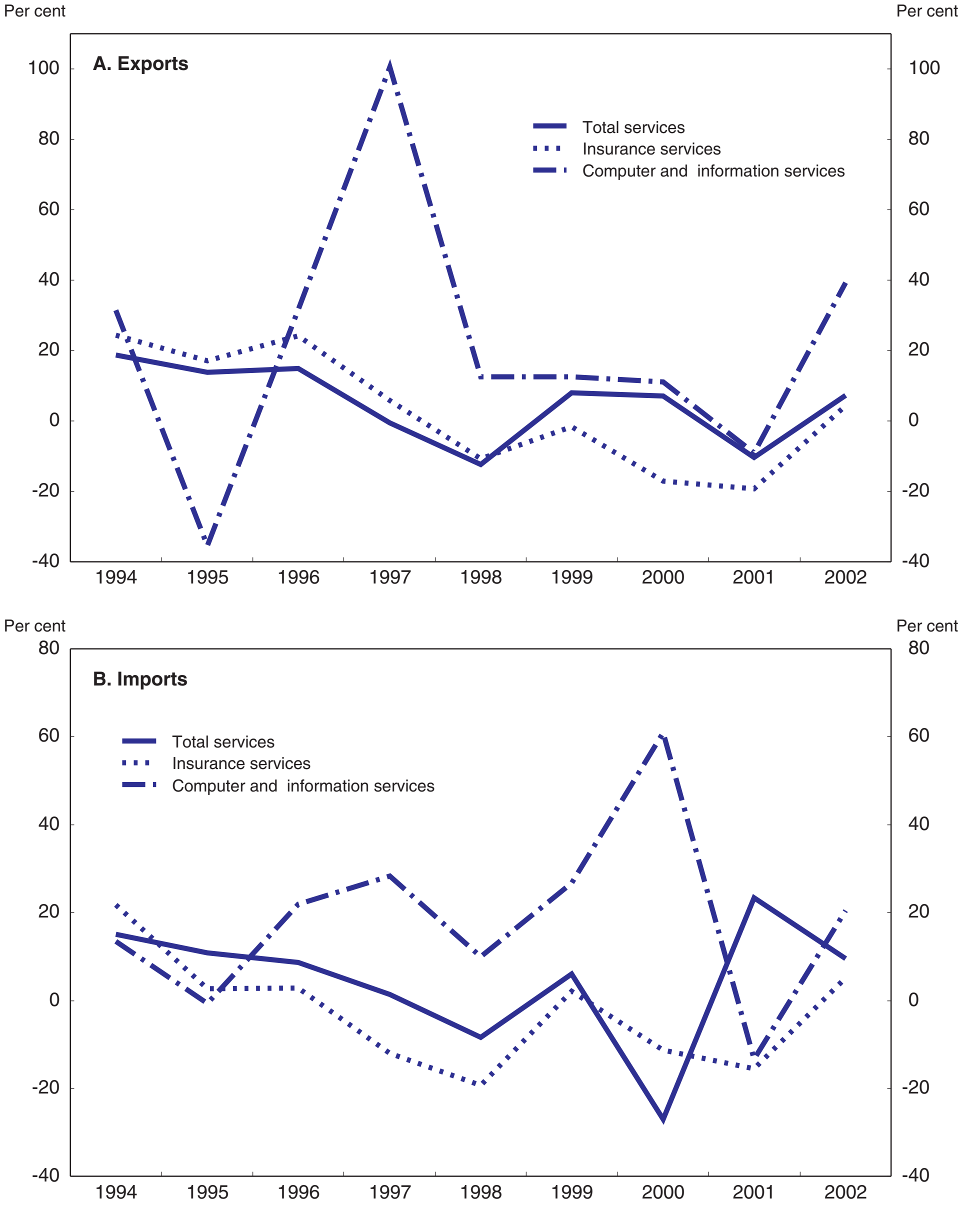
1. 1994-2000.
2. Excluding 1998.

Source: OECD (2003), *Science, Technology and Industry: Scoreboard of Indicators*.

reflects the recognition that the benefits of trade come more from opening the economy to cheaper imports, than waiting for other countries to open their markets. As a result, domestic productivity and resource allocation improves, paving the way for higher living standards, as well as making exports more competitive. Of course, there should be additional gains if foreign barriers decline as well, but the focus on getting "concessions" from trading partners during trade talks misses the point.

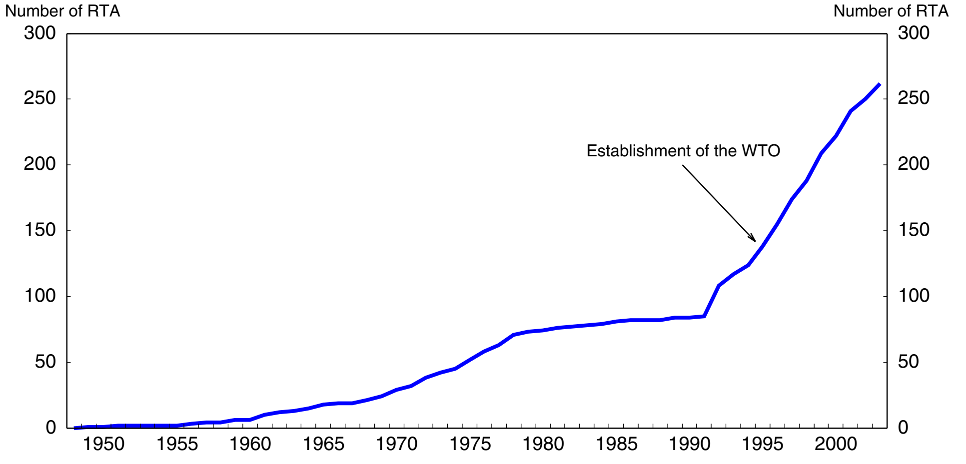
While there are benefits to be collected both from unilateral and multilateral trade liberalisation, the case for regional or bilateral agreements is less clear cut.[11] Whether such agreements will prove to be building blocks or stumbling blocks for wider liberalisation remains contested. What seem clear in the meantime, however, is that countries excluded from these agreements face considerable risks (Banks, 2003). Nonetheless, regional and bilateral trade agreements have been increasingly popular. Two decades ago, only 20 regional or bilateral trade agreements (PTA) were in force around the world, with the European Union being the major regional agreement. However, the number of PTAs has increased substantially over the past decade (Figure 3.A4.5). By 2003, 273 of these agreements had been notified to the WTO. Australia follow suit. In February 2003, Australia and Singapore signed a free trade agreement (FTA), Australia's first since the two decade old Australia-New Zealand Closer Economic Relations Agreement. Australia also signed an FTA with Thailand in July 2004 and most recently has negotiated an FTA with the United States.

Figure 3.A4.4. **Average annual change in Australia's service trade**



Source: OECD, *Statistics on International Trade in Services*.

Figure 3.A4.5. **The evolution of Regional Trade Agreements in the world**[1]
1948 to 2003



1. Regional Trade Agreements notified to the GATT/WTO, cumulative.
Source: World Trade Organisation.

Notes

1. According to the NCC, the reform of liquor laws that restrict competition has proved difficult to be implemented, with Victoria, the Australian Capital Territory and Tasmania being the only states having met their Competition Principles Agreement obligations in relation to liquor licensing by the time of the 2003 NCP assessment report by the Council (NCC 2003a and 2004). New South Wales has since reformed its liquor laws that restrict competition.
2. Metcash is Australia's largest independent grocery wholesaler, distributer of groceries, refrigerated goods and general merchandise to independent retails in all states (apart from Western Australia).
3. The shopper docket petrol discount schemes reviewed by ACCC relate to discounts offered by the two major chains Coles Myer Ltd and Woolworths Limited. Shopper docket discounts are a form of third line forcing, which is prohibited under the Trade Practices Act 1974 (TPA). However, immunity from legal action may be obtained by notifying the ACCC. The ACCC assesses third line forcing conduct notifications by weighting the potential benefits to the public against the particular detriments, particularly the anti-competitive one.
4. In some professions, such as the dental, different areas of practice are reserved to related professional and para-professional groups, with some services allowed to be provided by different types of para-professionals, while other, higher risk activities are reserved to dentists only (Deighton-Smith *et al.*, 2001).
5. The definition of legal work varies across the states, but in general entails drawing or preparing wills or documents which affect rights between parties, impact real or personal property, or relate to legal proceedings, and probate work (NCC 2001b).
6. See, Deighton-Smith *et al.* 2001; and NCC (2001b and 2003a).
7. Both the federal and state governments regulate pharmacies. As with the other health professions the State and Territory pharmacy legislation includes entry standards, registration requirements, and reservation, as well as also reserved areas of practice and business conduct restrictions.
8. Following its review under NCP, the New South Wales derived the conclusion that the achievement of professional legal objectives requires focussing on the accountability of individuals rather than restrictions on ownership (NCC 2001a).
9. Tariffs on apparel and certain finished textiles are currently 25 per cent, while tariffs on cotton sheeting, woven fabrics, carpets and footwear are 15 per cent and tariffs on sleeping bags, table linen, tea towels and footwear parts are 10 per cent.

10. For Australia, Iceland, New Zealand and Norway, non-manufactures were at least 40 per cent of the total value of exports in 2000, more than double the world average, see Le Fouler *et al.* (2001).
11. See for example Snape, Adams and Morgan (1993), OECD (2002b), Bhagwati (2002) and Productivity Commission (2003c).

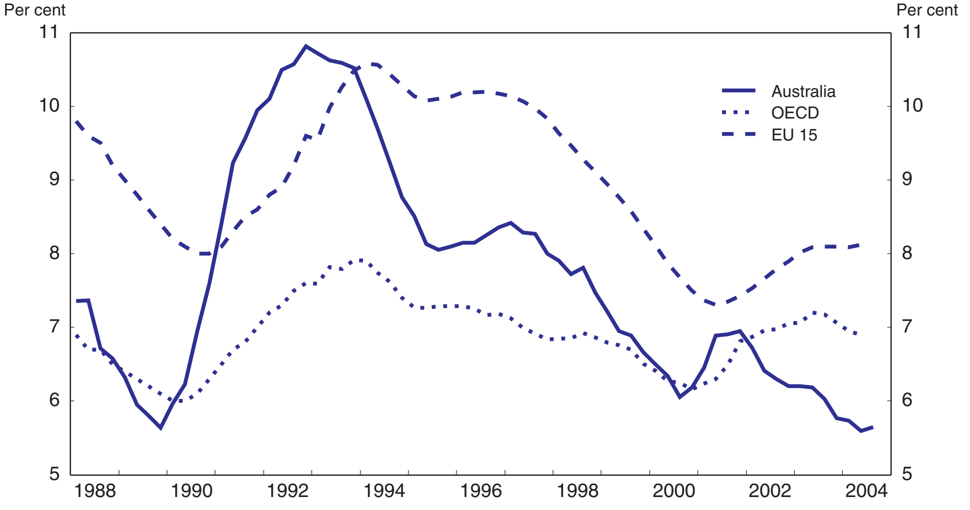
4. Policies to lower unemployment and raise labour force participation

Overview

Supported by strong domestic demand, the Australian labour market has resisted several adverse shocks, such as the drought and the weak global environment during much of the 2001 to 2003 period. The growing importance of services has spurred part-time employment, which has grown almost four times as fast as full-time employment in the past 25 years.[1] Nevertheless, over 70 per cent of employed people are in full-time jobs, currently around 6.9 million persons. The unemployment rate has fallen from a peak of 10.8 per cent in mid-1993 to just above 5½ per cent in mid 2004, the lowest rate in about 23 years and close to the OECD estimate of the non-accelerating inflation rate of unemployment (NAIRU). Australia's unemployment rate has also been below the OECD average since late 2001 (Figure 4.1). In response to labour market reforms, the Australian government projects in its *Intergenerational Report* 2002-03 (Budget Paper No. 5) a decline of the NAIRU to 5 per cent within a few years.

Nevertheless, there are a number of OECD countries which enjoy both lower actual and structural unemployment.[2] And although Australian employment-to-population ratios and labour force participation ratios are above the OECD average and are still on a rising trend, there are several countries where both indicators of labour utilisation are significantly higher.[3] In particular, 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 or generally elsewhere, which leaves much scope for better integration of older workers. Despite the strong growth in employment amongst people aged 55 to 64 in Australia in the past couple of years (Table 4.1), getting more older people to stay in work would help counter the projected decline in aggregate labour force participation as the large "baby-boomer" cohort moves out of the high-participation prime-age group into the low-participation group over 55. In addition, lower unemployment and higher labour force participation are also powerful factors in reducing poverty and contributing to a more even income distribution across the population.

Figure 4.1. **International comparison of standardised unemployment rates**



Source: OECD, Main Economic Indicators Database.

Apart from better integration of older workers in the labour force, Australia's high incidence of part-time employment offers another potential source of additional labour supply. At over 28 per cent of total employment in 2003, Australia has the second-highest overall rate of part-time work in the OECD, after the Netherlands (34½ per cent). This may reflect a flexible labour market that allows many people to choose the number of hours of work that best suits their individual circumstances. But it may also be a way by which employers escape rigidities in the regulation of full-time employment. According to the Australian Bureau of Statistics (ABS),[4] one quarter of part-time workers would have liked to work longer hours in 2003, on average more than 15 additional hours of work per week.[5] Based on an average of 16 hours worked per week by part-timers and around 41 hours per week worked by full timers in 2003, mobilisation of this potential would provide the equivalent of 320 thousand full-time jobs[6] (more than 4½ per cent of full-time employment).

In the context of the challenges of increasing labour utilisation, the remainder of this chapter discusses the scope for further reforms to the industrial relations system, the labour market assistance provisions, the income support arrangements and the education and training system. The main objectives of industrial relations reform are to increase the flexibility of labour markets, to reduce employment transactions costs and to achieve a closer link between wages and productivity. The transformation of the labour market assistance

Table 4.1. **Employment trends by age groups**[1]

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
15-24 years															
Thousands	1 720.7	1 581.9	1 539.7	1 531.5	1 594.9	1 637.4	1 617.6	1 568.7	1 593.8	1 594.5	1 618.9	1 616.6	1 637.3	1 696.0	1 742.9
Percentage changes	–1.6	–8.1	–2.7	–0.5	4.1	2.7	–1.2	–3.0	1.6	0.0	1.5	–0.1	1.3	3.6	4.0
In per cent of total	21.8	20.5	20.1	19.9	20.1	19.8	19.3	18.6	18.5	18.2	18.0	17.8	17.7	17.9	18.1
25-54 years															
Thousands	5 447.8	5 425.3	5 439.8	5 493.5	5 629.6	5 865.1	5 968.5	6 066.8	6 178.8	6 280.6	6 409.1	6 464.4	6 532.5	6 603.0	6 628.7
Percentage changes	3.0	–0.4	0.3	1.0	2.5	4.2	1.8	1.6	1.8	1.6	2.0	0.9	1.1	1.1	0.9
In per cent of total	69.2	70.5	71.0	71.4	70.9	71.0	71.4	71.8	71.7	71.7	71.3	71.1	70.5	69.6	69.0
55-64 years															
Thousands	608.9	589.4	577.0	574.1	603.8	633.1	654.5	674.7	710.8	749.4	815.6	859.0	943.3	1 023.6	1 067.7
Percentage changes	1.3	–3.2	–2.1	–0.5	5.2	4.9	3.4	3.1	5.4	5.4	8.8	5.3	9.8	8.5	6.3
In per cent of total	7.7	7.7	7.5	7.5	7.6	7.7	7.8	8.0	8.2	8.6	9.1	9.4	10.2	10.8	11.1
65 and over															
Thousands	99.3	101.5	103.4	100.1	113.4	120.3	123.7	134.2	134.7	137.2	145.1	150.9	157.6	158.7	164.2
Percentage changes	5.5	2.3	1.8	–3.2	13.3	6.1	2.8	8.5	0.4	1.8	5.8	4.0	4.5	0.7	7.6
In per cent of total	1.3	1.3	1.3	1.3	1.4	1.5	1.5	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7
Total															
Thousands	7 876.7	7 698.2	7 660.0	7 699.3	7 941.7	8 255.9	8 364.4	8 444.4	8 618.8	8 761.8	8 988.6	9 091.0	9 270.7	9 481.3	9 603.5
Percentage changes	1.8	–2.3	–0.5	0.5	3.1	4.0	1.3	1.0	1.7	1.7	2.6	1.1	2.0	2.3	2.2
In per cent of total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. Percentage changes are calculated with seasonally adjusted data, from previous half year, at annual rate.

Source: Australian Bureau of Statistics, Labour force detailed Survey Cat 6291.0.55.001 (August 2004).

provisions focuses in particular on ways to provide new jobs for jobseekers which respond best to their competencies. The overhaul of the income support arrangements ("Welfare Reform") aims at raising the labour force participation of income support recipients. And reforms of the education and training system seek to make education and training outcomes more relevant for the labour market, and – together with a modernised industrial relations system – to facilitate the introduction of productivity-enhancing work practices and technologies.[7] All of these reforms should help to further enhance the resilience of the labour market to external shocks and to cushion the effects of a future cyclical downturn on employment and unemployment. It also suggests that policies which make the labour market more attuned to the needs of employees and employers could assist in sustainably raising labour force participation and lowering unemployment.

Industrial relations reforms

For most of the past hundred years, Australian wages and conditions of work were determined by a complex set of highly prescriptive and centrally-determined awards,[8] based on compulsory arbitration by industrial tribunals at both the federal and the state level. This led to high wage uniformity across enterprises. Against the background of rising unemployment in the 1980s, legislation was introduced in several steps during the past two decades to increase regulatory flexibility in industrial relations, in particular by a gradual shift in wage bargaining away from national awards to the enterprise level (Box 4.1). The new system marked a decisive break with the philosophy of the award system and enables employers to trade off wage increases for changes in work practices. With decentralised bargaining allowing wages and employment conditions to better reflect local conditions and individual skill levels, the focus of the new industrial relations system is in line with a central recommendation of the OECD *Jobs Study* (1994).

Enterprise bargaining was further encouraged through the implementation of the *Workplace Relations Act* 1996 (WRA) which greatly simplified the award system.[9] The formerly comprehensive coverage of awards was reduced to twenty "allowable matters" as benchmarks against which the "no-disadvantage test" of enterprise agreements is conducted, with all other terms of employment being settled at enterprise or workplace level. This restricted the role of awards to a safety net of prescribed minimum wages and other core conditions of employment, rather than, as previously, to a wider safety net containing many more detailed prescriptions of other employment conditions and workplace practices. The transition to enterprise bargaining was further facilitated by easier access of "non-unionised" enterprises to reach collective

Box 4.1. Key developments in the federal industrial relations system

Initiatives in the federal system

1987	A two-tiered wage system is introduced with the second tier offering wage increases of up to 4 per cent in exchange for productivity improvements which meet certain restructuring and efficiency requirements set by the Australian Industrial Relations Commission (AIRC). Matters typically addressed include: greater flexibility in working hours (for example, span of hours worked at ordinary time rates, changed overtime rates); removal of some restrictive work practices (for example through job sharing, greater casual employment and task broadening); and wage differentials.
1988	The AIRC's "Structural Efficiency" principle provides for wage increases based on commitments to award restructuring, focusing in particular on new skills-related career paths, multi-skilling and flexible forms of personnel utilisation.
1991	The AIRC endorses the introduction of a system of collective enterprise bargaining between employers and unions (consent awards and certified agreements).
1994	The *Industrial Relations Reform Act* 1993 comes into force in March 1994 establishing a process for collective workplace agreements to be negotiated either between employers and unions (Certified Agreements) or between employers and groups of employees (Enterprise Flexibility Agreements – EFAs). EFAs do not require that unions be parties to agreements but unions can challenge their ratification by the AIRC. The AIRC must be satisfied that the terms and conditions in an agreement do not disadvantage employees when compared with the relevant award.
1997	The *Workplace Relations and Other Legislation Amendment Act* 1996 (WRA) comes into effect in January 1997, effectively ending "paid rates" awards and restricting awards to a safety net of minimum wages and other core conditions of employment. It also guarantees the choice of bargaining agent and allows bargaining agreements to be concluded with individual employees (AWAs). The Act makes Certified Agreements and AWAs subject to a new type of "global no-disadvantage" test, where individual conditions are allowed to fall below award level, provided that, on balance, the overall terms and conditions of employment are not reduced.
1998-2004	Further reform bills are submitted by the Commonwealth Government on termination of employment, award simplification, agreement making, and secret ballots prior to industrial action but meet resistance in the Senate. However, amendments are adopted which make separate wage rates for youths more widely available and exempt them from the age discrimination provisions of the WRA. A new law of March 2004 empowers the AIRC to make interim orders to stop or prevent industrial action.

Source: Commonwealth Department of Employment and Workplace Relations.

agreements (Certified Agreements)[10] and, to a lesser extent, individual agreements. The measures included:

- improved protection for freedom of association;
- a ban on union preference clauses in agreements and awards;
- the prohibition of industrial action (*i.e.* strike and lock out) during the period of an agreement's operation;
- the requirement to notify proposed industrial action outside the period of the agreement;
- the prohibition of strike pay and strengthened sanctions against unprotected industrial actions, and a strengthening of the Australian Industrial Relations Commission's (AIRC) powers to give directions to stop or prevent unprotected industrial action.[11] 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

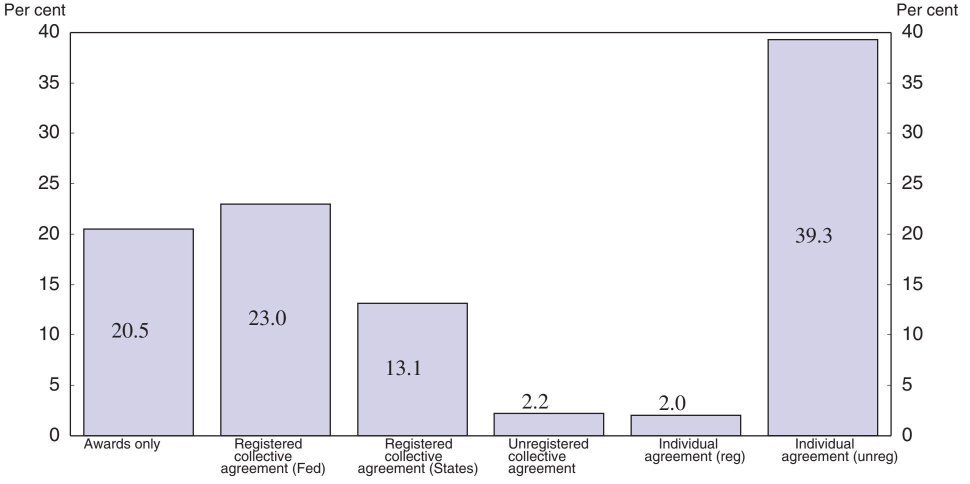
Some 38 per cent of employees now have their remuneration and employment conditions fixed through collective agreements between employers and employees (Figure 4.2). Another 41 per cent rely on individual agreements reached between an employer and an employee, mainly through informal arrangements or common law contracts, whereas the percentage of employees whose pay is determined by awards has fallen from 67 per cent in 1990 to about 21 per cent in 2002, with considerable variation across industries and firm size (Table 4.2).

Remaining problems in industrial relations

The role of awards

The relatively low share of employees reliant on awards for pay determination nevertheless underestimates their true importance, because this figure only refers to their role in setting wage and salary increases and not the extent to which reform has changed work conditions. If enterprise agreements which are "add-ons" to awards are included, then award coverage is much higher, possibly over 80 per cent of the labour force.[12] Many enterprise agreements cover only a relatively narrow range of topics. Hence, there is still much scope for raising their importance. One way would be to reduce the number of "allowable award matters" to a less comprehensive set of core conditions of employment, and to tighten their specifications further. This would reduce the role of awards as benchmark against which the "no-disadvantage test" of enterprise agreements is conducted, whereby the AIRC retains its power to refuse to certify proposed agreements that fail to satisfy the no disadvantage test. Indeed, the twenty "allowable matters" constitute quite an extensive list,[13] although their reduction meets considerable political

Figure 4.2. **Workplace pay agreements**
All employees, May 2002



Source: ABS cat. No. 6306.0. Employees earnings and hours (EEH), May 2002, final.

resistance. The Government proposes to advance amendments which, if passed, will more clearly define allowable award matters under the WRA and limit their range.

Another problem is that "safety-net awards" are arguably too high, given that minimum wages in Australia are estimated at around 58 per cent of median earnings for adult full-time employees, the second highest among OECD countries (Figure 4.3) They may therefore constrain employment prospects for the low-skilled. Negative employment effects of minimum wage increases were found by Leigh[14] (2003, 2004a) for Western Australia and by Harding and Harding[15] (2004) for Australia.[16] It is also worth noting in this context that the "safety net" sets not only wage minima for low-paid workers, but establishes wage floors for higher-paid employees, hence a whole ladder of wage minima.

Harmonisation of federal and state industrial relations systems

Although awards have become less prescriptive, enterprises are still bound by arbitration decisions from six separate federal and state industrial relations systems.[17] Many enterprises have some employees covered by the federal system and some by the relevant state system, and are thus obliged to deal with two or more distinct systems. This absorbs considerable managerial resources[18] and may lead to time-consuming jurisdictional disputes. Hence, substantial effi-

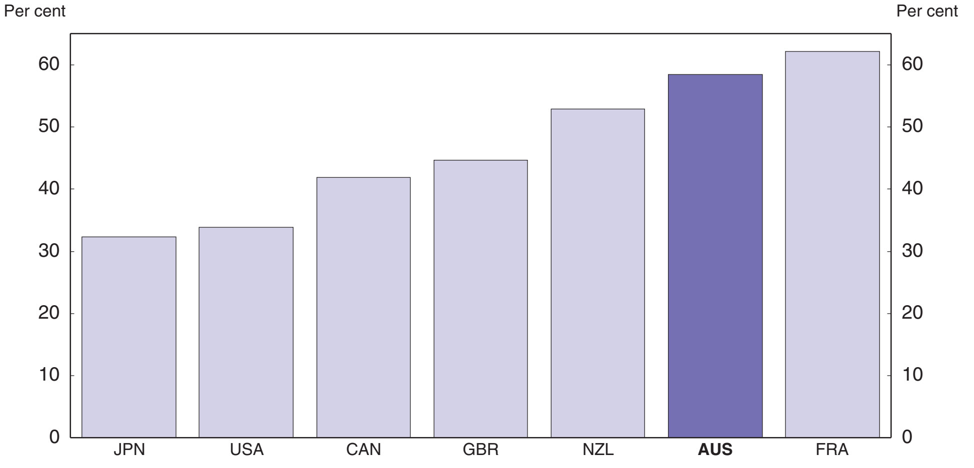
Table 4.2. **Coverage of non-farm employees by pay setting arrangements**
May 2002

	Awards only	Collective agreements[1]	Individual agreements[2]
	Per cent		
All employees	20.5	38.2	41.3
Sector			
Private	24.6	25.0	50.4
Public	4.6	89.8	5.7
Fewer than 20 employees	26.1	4.2	69.6
20 to 49 employees	32.4	13.9	53.7
50 to 99 employees	27.2	29.8	43.0
100 to 499 employees	22.2	42.8	35.0
500 to 999 employees	19.8	52.3	27.9
1 000 and over employees	5.2	84.8	9.9
Industry			
Mining	5.9	40.5	53.6
Manufacturing	12.5	37.5	50.0
Electricity, gas and water supply	1.1	78.1	20.9
Construction	17.1	23.1	59.8
Wholesale trade	11.7	7.9	80.4
Retail trade	34.2	30.3	35.4
Accommodation, cafes and restaurants	61.2	6.8	32.0
Transport and storage	16.4	40.3	43.3
Communication services	2.4	69.1	28.4
Finance and insurance	4.9	50.0	45.1
Property and business services	18.1	11.7	70.1
Government administration	6.0	86.6	7.4
Education	7.8	83.5	8.7
Health and community services	30.3	49.5	20.1
Cultural and recreational services	10.9	31.2	57.8
Personal and other services	22.2	42.6	35.2

1. Includes registered and unregistered collective agreements.
2. Includes registered and unregistered individual agreements.
Source: ABS Employees Earnings and Hours Survey (EEH Survey) Australian Bureau of Statistics, Cat 6306.0.

ciency gains could be reaped by moving to a more unified system. As a significant step towards harmonisation, the Victorian government referred to the Commonwealth further industrial relations powers in 2003, which brings Victoria much more closely into line with the system of the Australian Capital Territory and the Northern Territory. In consequence, these three jurisdictions will share essentially the same workplace relations system. Co-operation between different judicial systems has also increased in recent years.[19] As another step towards unification of the various workplace relations systems, the Australian government has attempted to apply its constitutional powers to cover the large majority of employees by the federal unfair dismissal law. However, in March 2004, the bill[20] was defeated in the Senate for the second time.

Figure 4.3. **International comparison of minimum wages**[1]



1. Adult minimum wages as a percentage of full time median earnings in 2002.
Source: OECD estimates and OECD earnings structure database.

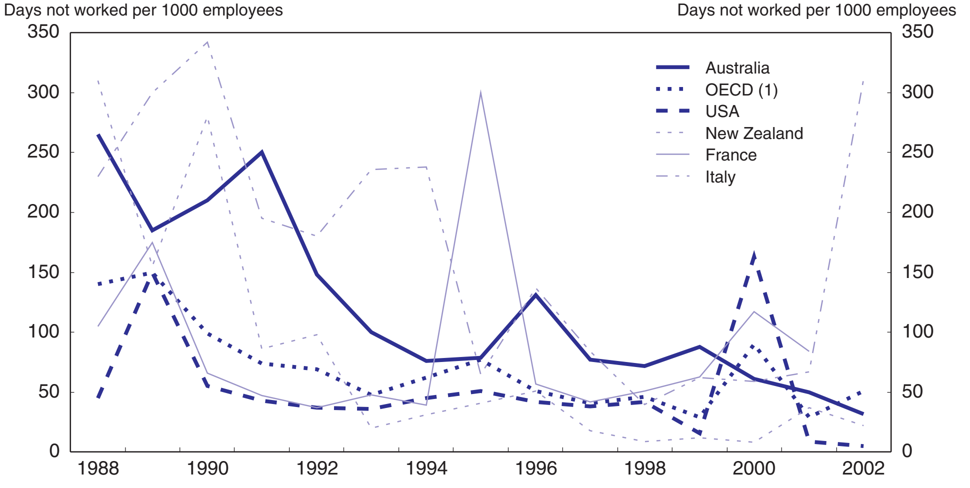
Industrial dispute resolution

The *Workplace Relations Act* has undoubtedly contributed to the continued reduction in the level of disputes in Australian workplaces, which fell by more than two-thirds over the ten years ending in 2002. The decline in the number of work-days lost by industrial action in Australia stands out by international comparison (Figure 4.4). More recently, the federal government proposed legislation[21] requiring secret ballots to be held at the workplace level and then only if the applicant was genuinely negotiating to reach an agreement. However, the Bill was twice rejected by the Senate. But a new law[22] which empowers the AIRC to make interim orders to stop or prevent industrial action passed the Senate in March 2004. Currently a bill is before the Senate which proposes cooling-off periods and provides for the suspension of bargaining periods on application by a third party who is threatened with significant harm from industrial action.

Termination of employment legislation

OECD studies consistently rank Australia as one of the countries with the least restrictive employment protection legislation (EPL),[23] which should limit disincentives to hiring workers – the principal undesirable side-effect of such law (Figure 4.5). To make EPL more employment friendly, federal legislation has been amended by the *Workplace Relations Amendment (Termination of Employment) Act* 2001, *inter alia* to reinforce disincentives to speculative and unfounded claims in the context

Figure 4.4. **Working days lost in labour disputes**

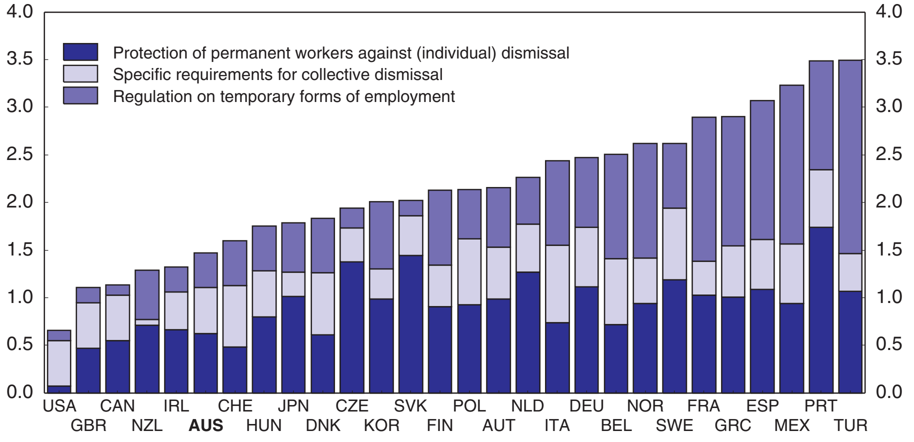


1. Weighted average, excluding France, Belgium, Luxembourg and Turkey in 2002.
Source: Davies, *Labour Market Trends*, April 2004.

of termination of employment. Among these amendments is a requirement that new employees have to be employed for three months before they can claim unfair dismissal compensation,[24] and a clause that the AIRC must consider the firms' sizes when assessing whether their dismissal procedures were reasonable. A further Act of 2003 restored an exemption from the unfair dismissal provisions for short-term casual employees. All this should lower the costs of managing the workforce and thus encourage hiring. It may also have contributed to the marked decline in the number of unfair dismissal cases lodged in both federal and state jurisdictions in recent years.[25]

Nevertheless, there are indications from business surveys[26] and from hearings before parliamentary committees that current unfair dismissal laws may in particular discourage small businesses (fewer than 20 employees) from hiring.[27] Accordingly, the Government has proposed on several occasions draft laws which sought to alleviate the impact of unfair dismissal legislation on small businesses. Although some legislative progress has been made in this direction, general exemption of small businesses from the unfair dismissal provisions of the *Workplace Relations Act* 1996 was repeatedly rejected by the Senate. There is also concern about new disincentives to hiring from the decision of the AIRC in 2004 to remove the exemption of small businesses from the requirement of redundancy payments, which had been in force since 1984.[28] A likely consequence of this ruling is an increased recourse of small firms to casual workers,

Figure 4.5. **Overall strictness of employment protection legislation**[1]
2003



1. The scale of indicators is 0-6 from least to most restrictive.
Source: OECD, *Employment Outlook*, June 2004.

who are excluded from redundancy pay provisions, at the expense of permanent employment.

Assessment

The systematic and far reaching industrial relations reforms of recent years introduced a large measure of regulatory flexibility in the industrial relations system, especially by facilitating and encouraging the setting of wages and employment conditions at the enterprise level, making it less costly to reallocate labour and adopt new work practices. There is still much scope for further easing of the regulatory requirements for collective and for individual agreements. A major step in this direction would be a further reduction of the number of allowable award matters, and the tightening of their definitions and specifications, as intended by the federal government. "Safety Net" award wage increases should also take into account the employability of low-skilled workers. Legislation should also address the practice of industry level pattern bargaining[29] which goes against the intention of the reforms. Further unfinished business includes harmonisation of federal and state industrial relations and the streamlining of regulations which minimise the incidence of unlawful industrial action. Finally, disincentives to hiring should be kept as low as possible through policies which contain the cost of dismissal procedures, without abandoning substantial social and economic benefits of employment protection.[30]

Labour market assistance reform

Job Network

The centrepiece of the 1998 reform of the labour market assistance system is *Job Network* (Box 4.2), a contestable employment placement market, with competition between private, community and government contracted service providers.[31] The rationale underlying the reform is that fees paid to *Job Network* organisations provide a supply-side incentive to match jobs to job-seekers and that competition encourages a high level of service. Fees are usually paid only after job-seekers gain employment that removes their reliance on income support for a sustained period, with the highest fees being paid for those who are most at risk and hardest to place in a job. Service providers may not refuse clients, which limits their ability to "cream" job-seekers. The use of innovative information technology solutions also has encouraged competition and improved the outcomes. Incentives to job search have been further intensified *via* the introduction of the *Mutual Obligation* initiative, a major change in activity-tested income support. It promotes more active job search by the unemployed and participation in activities which improve work skills and habits. If job-seekers fail to undertake an agreed activity, they may be subject to penalties, which include reduction or loss of benefit payments.

The Active Participation Model

The widespread practice of "parking" job-seekers with low probability of finding and keeping a job in the *Intensive Assistance Programme*[32] has been identified by the Productivity Commission (2002) and others as a major shortcoming of the *Job Network*. "Parking" occurs when job seekers are judged by the service provider as unlikely to generate income to the provider. There was also the problem of limited options for re-referring disadvantaged job seekers to other, more appropriate programmes, such as *Work for the Dole*. Moreover, there were difficulties of access for young people and indigenous job seekers.

In response, the so-called *Active Participation Model* was implemented on 1st July 2003 in conjunction with the *Third Employment Services Contract*, which seeks to improve the linkages between the *Job Network* and other complementary employment and training programmes. The new model is designed to avoid referral of job seekers to inappropriate programmes and to offer simpler and faster access to services. A key feature of it is that each job seeker is supported by a single *Job Network* member throughout their period of unemployment. This *Job Network* member assists the job seeker through a continuum of assistance support until they are off income support. Job seekers receive more intensive assistance the longer they are unemployed. The model aims at active engagement of job seekers in job search from the onset of unemployment, and

Box 4.2. Main features of the Job Network System

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

- *Centrelink* is the first contact point for most job-seekers and thus the gateway to the *Job Network*. It undertakes the registration, assessment and referral of job-seekers to a *Job Network* member and provides job-seekers with information about available employment services. 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, location and labour market skills. Based on reference to their JSCI score, *Centrelink* refers newly registered job-seekers with scores above a particular threshold to *Job Network* members for early access to *Intensive Support Customised Assistance*.
- *Job Network*, the Commonwealth Government's primary employment service, is a national network of over 100 private, community and government organisations contracted by the Government to deliver employment services to assist unemployed people into jobs. *Job Network* is a contestable employment placement market, with competition between contracted service providers for the provision of placement and case management services. The third contract commenced in July 2003 and will 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. *Job Network* includes the following three key services:
- *Job Placement*, which is the gathering of available vacancies and assisting eligible job-seekers into jobs through the provision of labour exchange services. Under the Active Participation Model, Job Placement services are also provided by over 400 Job Placement Licensed Organisations that drawn from the general recruitment industry and also includes Job Network Members;
- *Job Search Support* provides job search facilities, the collection of vocational details and placement of these on Australian JobSearch. New technology allows daily matching of all job seekers to jobs listed on JobSearch.
- *Intensive Support* provides a continuum of assistance for job seekers who have been unemployed for more than 3 months, beginning with job search training. Intensive Support integrates regular periods of mutual obligation activities and provides Intensive Support customised assistance for all job seekers after 12 months unemployment. Highly disadvantaged job seekers have immediate access to Intensive Support customised assistance. Under Intensive Support customised assistance Job Network members deliver substantial one-on-one services to address the job seeker's barriers to employment which may include training, work experience, counselling and may also include referral to complementary employment and training services for specialist services.

Source: Department of Employment and Workplace Relations.

ensures that they are clear on what assistance they can expect to receive from their *Job Network* member. A government-funded *Job Seeker Account* has been introduced which can be used by providers to purchase services for job seekers, for example accredited training, work experience, fares assistance or interpreter services. Although it is too early to assess definitely the efficiency of the *Active Participation Model*, the number of job placements has increased substantially since its implementation, suggesting that these reforms are going in the right direction.

Assessment

Critical assessments[33] of the reformed labour market assistance system generally conclude that it has improved the quality of service to job-seekers and facilitated job placement. Three net impact studies of the Department of Employment and Workplace Relations (DEWR) were conducted in 2002.[34] Both *Intensive Assistance* and *Job Search Training* were found to be effective forms of assistance with significant impacts from both referral[35] to and commencement[36] in the programme or service (Table 4.3).

A recent longitudinal study (Department of Employment and Workplace Relations, 2004) examined the dynamics of how some of the most disadvantaged people fare in the labour market up to two years after assistance has ceased. The report on *Job Search Training*, *Intensive Assistance* and *Work for the Dole* programmes examines the sustainability of employment and changes in type of employment, occupation and earnings over time. The study concludes that:

- employment outcomes had improved between 3 and 12 months after participation, particularly for *Job Search Training*, with 30 per cent higher employment, and *Work for the Dole* with an improvement of over 50 per cent;

Table 4.3. **Employment net impacts for Intensive Assistance and Job Search Training**
Percentage points

	May 2002	August 2002	November 2002
Impact for Referral			
Intensive Assistance	4.0	4.4	4.0
Job Search Training	10.0	12.5	9.6
Impact from Commencement			
Intensive Assistance	6.8	5.0	6.2
Job Search Training	4.4	10.1	11.6

Note: The net impact calculation compares the employment share of a group of job seekers sixteen months after referral to or commencement in an employment assistance programme with a reference group receiving no assistance. The table gives the difference in employment shares of both groups in percentage points.
Source: Department of Employment and Workplace Relations (2003).

- a significant proportion of programme participants had moved into full-time jobs between three and twelve months after participation;
- there was also a strong movement from temporary or casual jobs to permanent jobs for participants of each of the programmes and services;
- there was a significant increase in earnings over the twelve months period, due to both an increase in the amount of work as well as an increase in rates of pay.

Of those in employment three months after exit from *Work for the Dole* and *Intensive Assistance*, around 57 per cent were still employed after another nine months. The corresponding figure for *Job Search Training* was at 63 per cent. Where an outcomes payment was made for a job placement in *Intensive Assistance*, around 65 per cent were still employed fifteen months after placement in the initial job and nearly 50 per cent had been continuously employed for the entire fifteen month period. This suggests that jobs obtained by participants of these programmes are sustainable in the longer term. Outcomes may improve over time as service providers learn what works best, and poor service providers lose their contracts.

Compared with labour market assistance provided under the previous *Working Nation* programme, the *Job Network* seems to have achieved a substantial reduction in the unit costs of employment assistance. For example, in 2002-03 the cost per employment outcome for *Intensive Assistance* was A$ 3 900 compared with A$ 12 800 for equivalent programmes under *Working Nation*. The cost per employment outcome of *Job Search Training* was A$ 1 300 compared to A$ 2 700 for the *Working Nation's Job Clubs*.[37] It has to be kept in mind, however, that these differences in cost may also reflect changes in economic conditions and different programme client groups.

Among the remaining problems with the functioning of the *Job Network* system are the costly and complex tender process and the high compliance burden imposed on service providers (in response to detected abuse of the system).[38] There is also the question whether some poorly targeted programmes such as the *Harvest Trail* and the *Self Employment Development* programme should continue to be subsidised. Nevertheless, there is little doubt that competition within the framework of the *Job Network* has produced substantial efficiency gains,[39] and the recent evidence is also in favour of improved effectiveness in getting people into work.

Improving participation rates

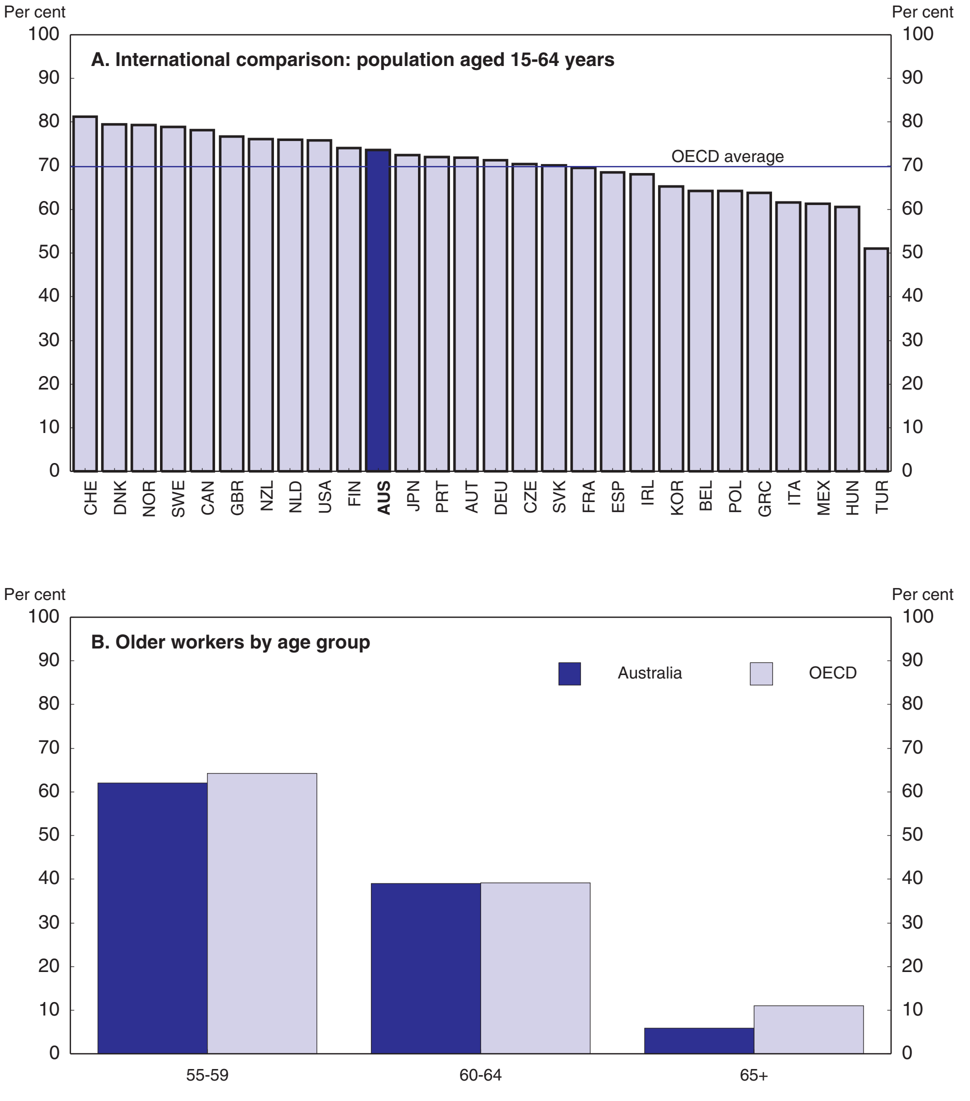
Welfare dependency persists

A key factor for boosting growth potential is higher labour force participation. Comparison with other OECD countries indicates that there is still scope for catch up in this respect (Figure 4.6, Panel A). The desirability of higher participation is heightened by the prospect of population ageing which, as in most other advanced economies, is expected to result in a decline in the overall participation rate, since there will be relatively more people in the 55-64 age group, where participation rates are lower.[40] Raising participation will depend critically on removing the impediments facing people in the transition from income support to work, and discouraging the reverse transition. Notwithstanding strong economic growth over the past decade, or so, welfare dependency persists in Australia, with over 20 per cent of the working-age population (around 2.7 million people), receiving income support. It is estimated that more than 80 per cent of all lone parents and around 30 per cent of 50 to 64 year olds[41] receive income support, with a large proportion of the former group of recipients spending an average of 12 years on welfare, switching from one form of working-age benefit to another. In the case of people claiming income support after the age of 50, few go off income support, with the majority moving into Age Pension support. Australia's participation rates for persons aged 55 and over are lower than the OECD average (Figure 4.6, Panel B).

The fast growth of Disability Support Pension[42] (DSP) programme is of particular concern. Despite the fact that people in general are leading longer lives, and are presumably healthier, the number of DSP recipients has tripled since the early 1980s, reaching 673 000 people in 2003, or 5 per cent per cent of the working age population. Australia has experienced one of the strongest increases in the disability recipiency rate among the advanced countries over the past two decades, narrowing the gap with the OECD average (Figure 4.7). As in many other OECD countries, the rate of disability benefit recipiency increases markedly with age, with individuals aged 55-59 years old being twice as likely to be on disability benefits than those aged 45-54. In addition, outflow rates from disability benefits are very low.[43] These possibly imply that the disability support pension programme is being used as a pathway to early retirement, especially by older males,[44] a view further supported by the statistic that the majority of customers (56.7 per cent) who were on DSP in June 2002, but no longer in June 2003, had moved on to the Age Pension.[45]

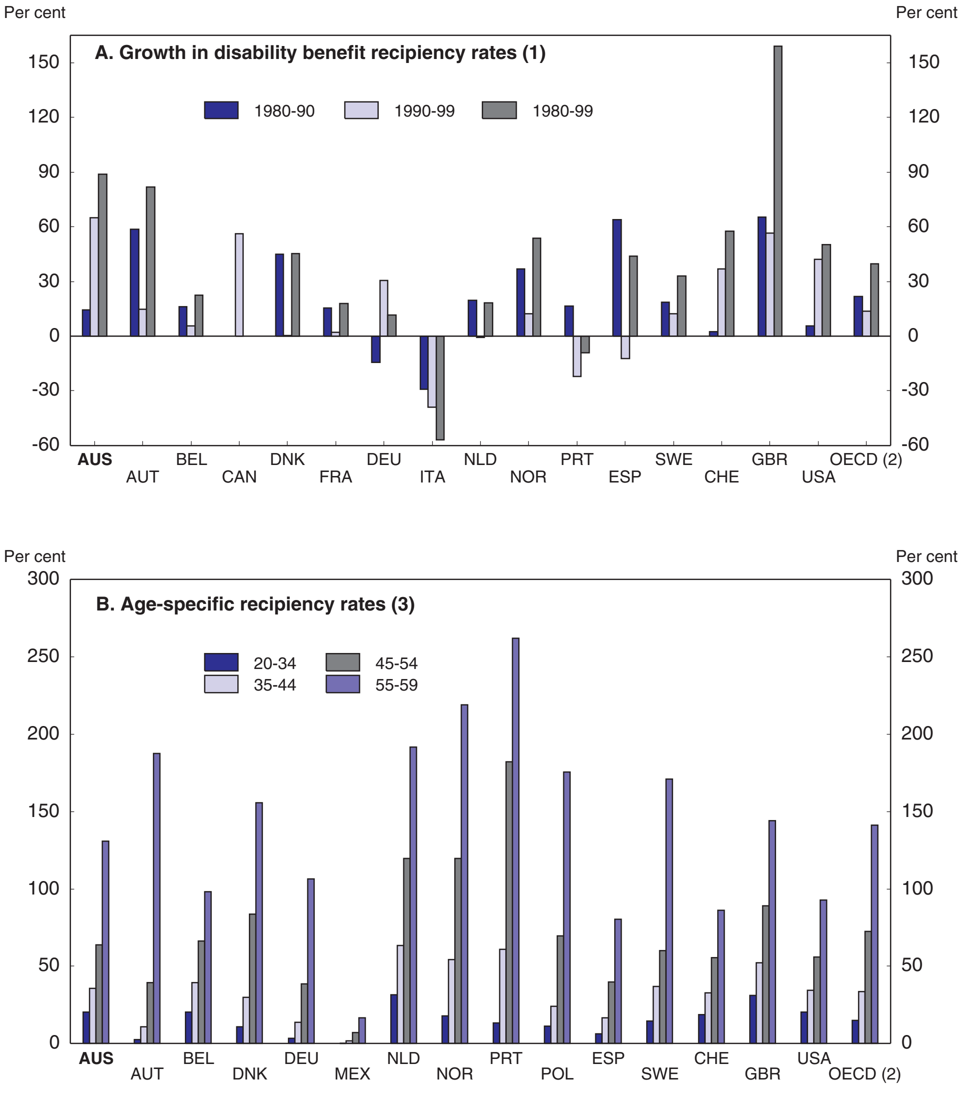
A range of factors might explain these developments over the past three decades, including reforms in public policy, most noticeably the introduction of the Disability Reform Package in 1991,[46] demographic changes (including population ageing), and structural changes in the labour market. Regarding the latter, Argyrous and Neale (2003) provide empirical evidence on the close association between employment conditions and the disability pension recipient rates, arguing that the DSP programme has acted as an "institutional mop" absorbing older males who have lost their jobs since the early 1970s.[47] There are currently more people receiving Disability Support Pension than unemployment benefits in Australia (Figure 4.8). This may also reflect the higher payments (similar in value to the old age pension) and more advantageous income and asset tests for disability

Figure 4.6. **Participation rates in OECD countries**
2003



Source: OECD, Employment Outlook database.

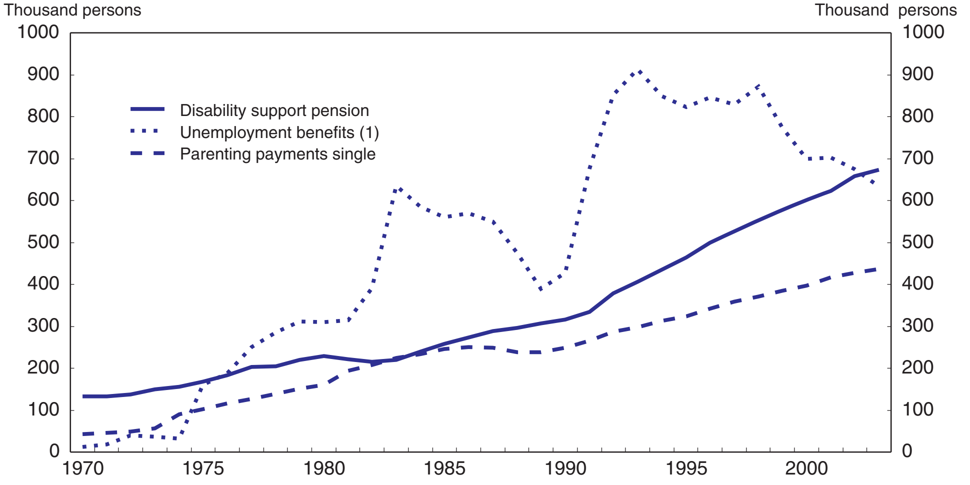
Figure 4.7. **Disability benefit recipiency rates: an international comparison**
Per cent



1. Recipients of disability benefits aged 20 to 64 as a percentage of the group's population.
2. OECD average is calculated on the basis of the covered countries.
3. Variation in age-specific disability benefit recipiency rate in 1999, per 1 000 in each age group.

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

Figure 4.8. **Developments of specific income support recipients**



1. Unemployment benefits include Newstart Allowance and Youth Allowance (non-students).
Source: Australian Treasury.

than for unemployment, as well the absence of mutual obligation requirements for the granting of DSP.[48] The cost of disability benefits has risen from 0.51 per cent of GDP in 1990 to 0.86 per cent in 1999, though remaining below the OECD average (OECD, 2003a).

The objective of ensuring an adequate level of income support for the disabled of working age is normal. However, this should be met while minimising work disincentives and sustaining attachment to the labour force for those concerned. The majority of working-age people on income support in Australia are not required to look for a job.[49] OECD estimates suggest that around one-third of people receiving disability benefit in OECD countries, for which data are available, do not consider that they have any disability at all (OECD 2003a). The relevant proportion in Australia stands at 15 per cent, probably reflecting – besides the potential impact of the fluidity of the disability status and definitional differences among countries – the fact that the Australian disability schemes are more effective than those in other OECD countries in assessing properly the disability status of a benefit applicant. In addition, social policies could play a more active role in "activating" lone parents, and more generally reducing the number of jobless families. International comparisons indicate that Australia has one of the highest levels of joblessness among households with children in the OECD area.[50] According to the Australian Bureau of Statistics, three quarters of jobless families (lone-headed and couple headed) with dependent children did not have a parent looking for work in mid-2000, with lone-parent families accounting for almost two-thirds of the total (Australian Government, 2002b). Developments over time are also disturbing. Despite continuing economic growth and falling unemployment, the proportion of Australian families with no parent in paid work continued to rise until 1998 and still remains at one family in six. The persistence of high rates of family joblessness is due to an underlying increase in the proportion of lone parent families and their low employment rate relative to couple families.[51] Based on these statistics, persons with disabilities and lone parents appear to be appropriate target groups for policies to boost participation and employment as well as targeted income support, although the disabled often have specific needs to be considered.[52] The challenge of reducing welfare dependency requires three policy levers: assistance, incentives and obligations. While the definition of an "appropriate balance" between these will vary across countries according to their institutions, policy settings and social values, the evidence favours a combination of policies and strategies to increase participation and self reliance (Kinnear *et al.* 2003).

Reforming the welfare system to raise participation

The Australian reform agenda mirrors the recommendations of the 1999 *McClure Report*, which specifies the ways in which welfare dependency could be reduced by assisting people out of work to move back into workforce (see Annex 4.A1). Following the publication of the McClure Report, successive budgets (See Annex 4.A2) have proposed measures along the recommended lines:

- 2001-2002: "*Australians Working Together*" (AWT)[53] introduced various "making work pay" measures, extended the mutual obligation requirement to 35-49 year olds, imposed activity requirements on individuals receiving parenting payments and closed access to two passive income support payments targeted to mature-age people (Mature Age Allowance and Partner Allowance).
- 2002-2003: More effective employment assistance,[54] development and improvement of the work capacity of people with disabilities, and especially a significant tightening of the rules governing access to disability pensions. The latter encountered strong political opposition and the amended legislation has not yet been passed by Parliament. However, new assessment measures were introduced in 2002 as part of the AWT.
- 2003-2004: Change to case-based funding for disability service providers plus financial assistance to employers of the disabled; additional caring help for parents of children with special needs.

Welfare policy reforms have also aimed at reducing effective marginal tax rates (EMTRs). The comprehensive targeting of the social security system in Australia can create significant employment disincentives, as transfer payments are withdrawn at relatively high rates and income tax is payable (Annex 4.A3). At the extreme, the tax and social security tax interactions may create "poverty traps", where the individuals receive little or no financial benefits from extra earnings because of the loss of means-tested payments. Moreover, means tests for different social security payments sometimes overlap, implying that individuals or families may face two or more tapers on different income support payments at any one time. Another disincentive highlighted by the McClure Report regards the treatment of people who have access to temporary jobs or work intermittently throughout the year, as income tests apply to earnings obtained at a certain point in time. In such cases, benefits may 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).

Some progress towards reducing EMTRs, and thereby strengthening incentives for participation, was made through the introduction of *A New Tax System* (ANTS) in July 2000.[55] ANTS reduced marginal income tax rates; increased the income thresholds; consolidated and simplified family-related payments; and eased income tests for pensions and family assistance (OECD, 2001a). Moreover, the AWT reform package introduced the Working Credit, which encourages people on income support to take up full-time, part-time or casual work.[56] The Working Credit increases a person's income "free area" before payment is reduced, and this indirectly reduces the (high) effective marginal tax rates (EMTRs) that welfare beneficiaries face when they move to paid employment. As a result, its impact on effective tax rates – marginal and average – is highly variable, depending on both the size of the Working Credit previously accrued and the amount of earnings reported in the relevant fortnight. Once the Working Credit has been used, tax rates revert to their usual level. Since its introduction in September 2003,[57] the financial initiative has been used by around 25 per cent of the Working-Credit eligible population.

The 2003-04 Budget raised personal income tax thresholds, and increased the low income tax offset and the income threshold at which the offset starts to phase out, thus improving work incentives. In keeping with Government's focus on increasing labour force participation, the 2004-05 Budget provided – under the *More Help for Families* package – for a reduction in the EMTRs for lower- and middle-income families, and an improvement in the incentives for a second earner in a family to take up part-time or casual work.[58] The new measures also provide additional assistance for women who wish to return to work after having children (Box 4.3). The May 2004 Budget further assists families by raising the thresholds at which the top two marginal tax rates apply, improving rewards from overtime work, seeking promotion, or acquiring skills.

In February 2004, the government released the policy statement *A More Flexible and Adaptable Retirement Income System*. To reduce incentives for early retire-

Box 4.3. Recent initiatives to assist families

The May 2004 Budget announced the *More Help for Families* package (amounting to A$ 37 billion over five years), including increased family assistance, personal income tax cuts, and incentives to save for retirement (through an enhanced superannuation co-contributions scheme and a reduction in the superannuation surcharge). The main initiatives (amounting to A$ 19.2 billion over five years) of the package to assist families include:

- an increase of A$ 600 a year in the maximum and base rates of Family Tax Benefit (A) for each dependent child (paid as a lump sum);
- a reduction in the withdrawal rate between the maximum and base rates of Family Tax Benefit (A) from 30 per cent to 20 per cent (with effect from 1 July 2004);
- a reduction in the Family Tax Benefit (B) income test withdrawal rate for the second earner from 30 to 20 per cent, with an increase in the income test threshold level from A$ 1 825 a year to A$ 4 000;
- the quarantining of Family Tax Benefit (B), from July 2005, for secondary earners returning to work. This implies that the income secondary earners receive from returning to work will not be counted against their benefit eligibility in that year prior to commencing work;
- a new maternity payment, from July 2004, paid as a lump sum, of A$ 3 000 for each new born child. The payment will be universal to all families, and it will gradually increase to A$ 5 000 in July 2008;
- an additional 44 000 child care places.

Source: Australian Government (2004b, c).

ment, the paper proposed to remove the restrictive rule that requires a person under age 65 who has reached their "preservation age" (the age until which the benefits must be preserved in a superannuation fund to qualify for concessional tax treatment) to retire or leave employment before they can access their superannuation benefits (as a lump sum or an income stream).[59] Instead, people who have reached their preservation age will be able to commence a non-commutable income[60] stream regardless whether they have ceased employment or not. The new arrangements – to take effect from 1 July 2005 – will allow individuals to reduce their hours of work and supplement their income with superannuation. As such, these arrangements are expected to foster participation of older workers, in addition to making the superannuation system more adaptable, and facilitating the transition process to retirement.

Further steps to improve participation

The government has undertaken a public consultation process in 2003 on the broad shape of, and priorities for, future reform of income support for working age people, based on the December 2002 discussion paper *Building a Simpler System to Help Jobless Families and Individuals*. The paper outlines issues in promoting participation and improving incentives to work. The main elements include: eligibility and coverage; structure of assistance; participation requirements; and means testing. Feedback on the consultation paper indicated a broad consensus that the income support and related systems require substantial reform to ensure that they work effectively to enhance self-reliance and reduce social exclusion, although there was less agreement as to the way this could be best achieved. The government is currently considering the outcomes of the consultation process with a view in determining the next steps of overhauling the welfare system. Overall, the authorities recognise the need for the income support system to be modernised in order to meet the goal of increased participation.[61]

In February 2004, the Government released a discussion paper *Australia's Demographic Challenges*, which outlined possible policy responses to address the looming fiscal challenge identified in the 2002-03 *Intergenerational Report*. The Government's preferred solution to this challenge is to implement policies designed to achieve higher economic growth *via* increases in labour force participation and productivity. The following opportunities to improve labour force participation have been identified:

- stronger incentives for work by modernising the income support system through better balance between assistance and obligations and addressing unintended early retirement incentives;
- supporting more flexible work options by extending people's working life through greater part-time work choice and having a sufficiently flexible industrial relations system that allows for individually tailored wages and conditions; and
- improvements in the capacity for work through better preventative health care and through enhanced education and skill levels.

Assessment

Rising welfare dependency has been a significant concern for many developed countries in recent decades, and Australia is not an exception. Persistent reliance on income support is seen as having adverse effects on both the community and on benefit recipients, as it is associated – at an aggregate level – with higher budgetary costs and lower participation and output growth rates, while – at the individual level – it usually results in long-term poverty and social exclusion. The problem is heightened by the prospect of population ageing which, as in most other advanced economies, is expected to result in a decline in the overall participation rate. In view of these considerations, the focus of the ongoing welfare reform process in Australia on economic and social participation is welcome. An indispensable challenge in this respect – as also highlighted by the government – is the achievement of an "appropriate balance" between three policy levers: assistance, incentives and obligations. The *Australians Working Together* reform package – providing more opportunities for training and work experience to assist groups with weak labour force participation attachment, and introducing new obligations for benefit recipients – is a step in the right direction, although its evaluation has not yet been completed.[62] The extension of full mutual obligation requirements to all recipients of unemployment benefits, including older unemployed workers, would be advisable, along with a close monitoring and strict enforceability of activity requirements to realise the objectives of the framework. Moreover, given the fast growth of the DSP programme – despite the fact that people in general are leading longer lives, and are presumably healthier – efforts should continue towards developing and improving the capacity of people with disabilities, and encouraging them to rejoin the labour force. Tailoring DSP eligibility rules to a person's level of ability to work is crucial for achieving the intended impact of the welfare reform on participation, while helping to keep the associated budgetary costs in line with the government's commitment to fiscal stability. The new work capacity assessment procedure, for people who are ill, injured or have a disability, along with changes to DSP policy guidelines and enhanced reviews arrangements are positive initiatives in this regard. While steps taken so far for reducing the EMTRs, are commendable, further reforms would be needed to provide people with better incentives to undertake part-time work or increase their working time. Efforts should also continue towards fostering female participation. While employment rates of women aged 45-64 are increasing strongly, primarily due to cohort effects, there has been little recent increase in the employment rates of prime-age women, including mothers. OECD estimates show, for example, that the participation gain for Australia from an increase of public childcare spending to the highest level among OECD countries would be 6.4 percentage points, while the favourable tax treatment of part-time would lead to an increase of 6.1 percentage points[63] (Burniaux *et al.* 2004). Finally, recent initiatives for promoting the participation of older workers – including changes to allow older workers to access their superannuation and continue working – are especially important faced with an ageing population, while their impact would be enhanced by an improvement in working conditions, to make them appropriate to older workers, and addressing age discrimination in employment.

Education and training

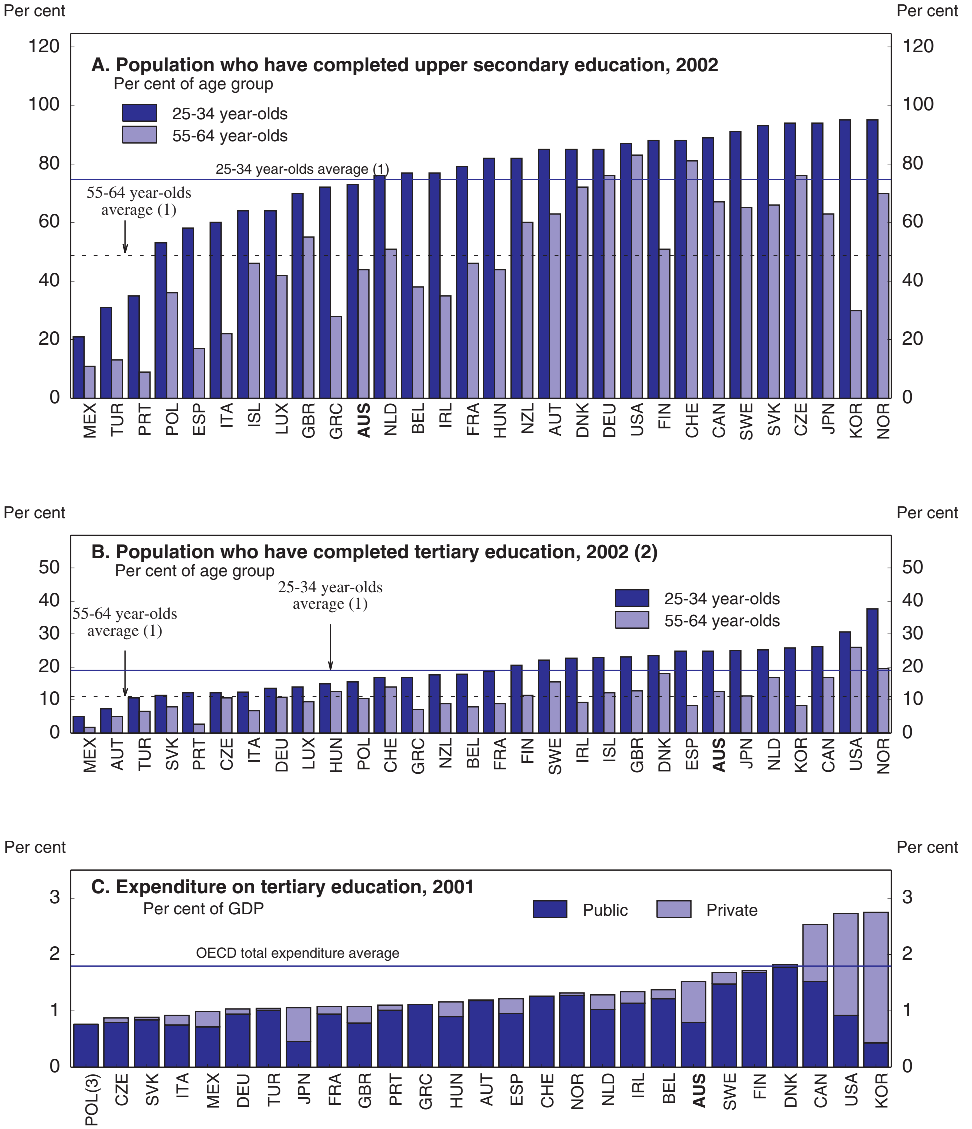
Raising labour force skills and competencies helps achieve higher levels of productivity, with the OECD Growth Project showing that a 10 per cent increase in the average number of years of education of the working-age population would increase *per capita* GDP between 4 and 7 per cent (OECD 2003b). Over the past 25 years, Australia has substantially increased its stock of human capital, as indicated by the difference in the educational attainment between younger and older groups (Figure 4.9). Moreover, international comparisons, based on the OECD *Programme for International Student Assessment* (PISA) study, show that 15 year-old students in Australia rank well above the OECD average in terms of reading, scientific and mathematical literacy. Nevertheless, around 12 per cent of the students in the PISA study had low reading literacy levels (Figure 4.10), and Australia exhibits above-average disparities in student reading performance, attributable, in large part, to within-schools differences.[64] Also, the share of 15-19 year olds enrolled in post-compulsory secondary education is lower than in many OECD countries. More and better training of the existing labour force is also desirable, to reap the benefits of globalisation and new technologies. Based on these considerations, policy attention should focus on the issues discussed below.

Enhancing the levels of achievement

High-school drop out rates have fallen markedly – and retention rates therefore risen – over the past two decades or so,[65] broadly stabilising since the mid-1990s (Figure 4.11). The increase in the apparent retention rates in the 1980s was associated with a decline in teenage full-time employment, starting during the 1982-83 recession. The subsequent improvement in the labour market, and the significant growth in New Apprenticeships and the non-apprenticeship vocational education and training (VET) sector were counteracted by the expansion of VET opportunities at school, and a continuing strong interest in university enrolment, leaving retention rates broadly constant.

Those who drop out of school before completing upper secondary school (or even entering it) raise important policy considerations, as this group of young people is typically vulnerable to changes in economic and social conditions. As shown in Figure 4.12, people with upper-secondary, and especially tertiary, education qualifications have a higher labour force participation than those who have not completed secondary school education. An assessment of the labour market outcomes of the early school leavers is relevant in this context, as many young people leave school to find a job, or enter an apprenticeship. However, other reasons, including student performance and motivation, socio-economic and personal characteristics, and school-system policies also contribute to this decision. Overall, non-completers are more likely than Year 12 graduates to experience extended periods of unemployment and to obtain part-time or casual jobs, or low-paying unskilled jobs with limited prospects for career advancement. Nevertheless, some young people make successful transitions to the labour market[66] and many return to education and training at a later stage.[67] The strong economic growth in Australia in recent years has contributed to the improved employment prospects for this category of young people, although

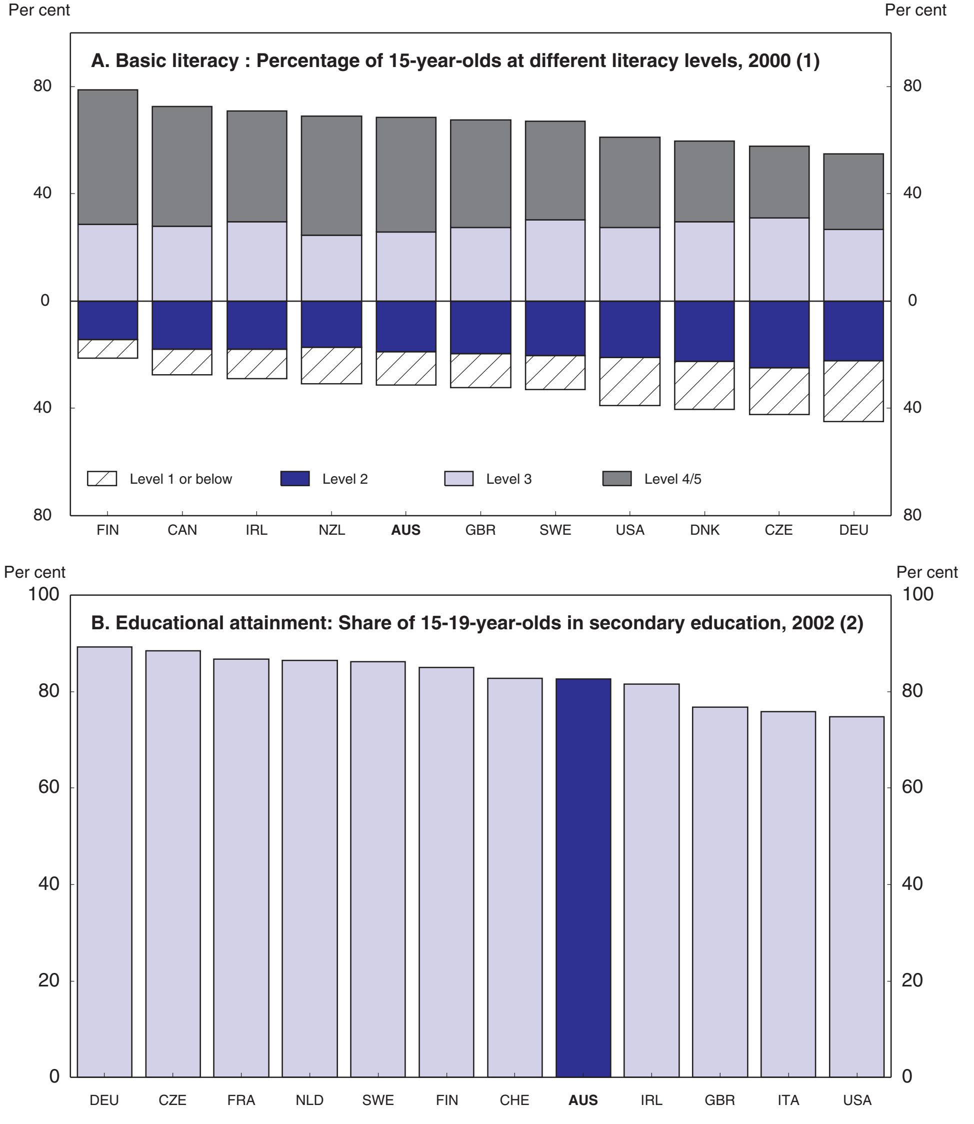
Figure 4.9. **Education indicators in comparison**



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

Source: OECD (2004), *Education at a Glance*.

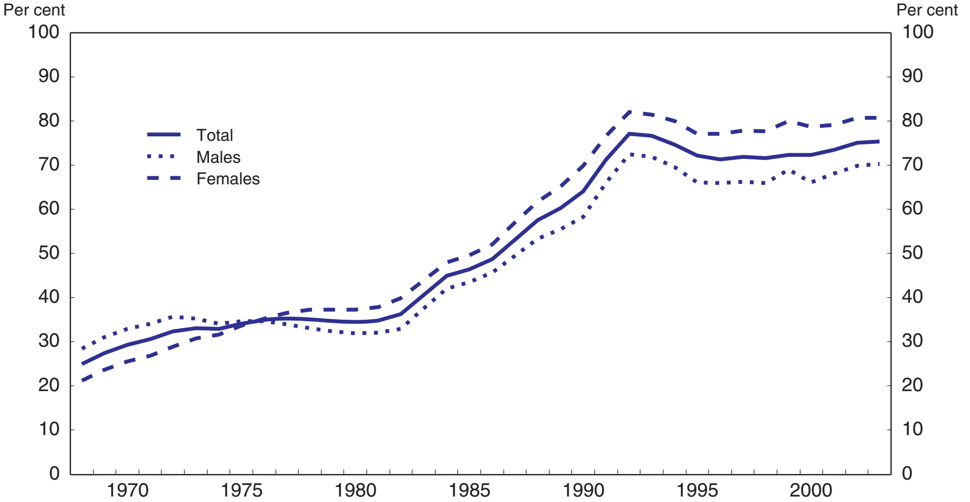
Figure 4.10. **Basic literacy and educational attainment of the young**



1. The figure shows the combined reading literacy, that is, the ability to retrieve information, interpret texts, reflect and evaluate.
2. The figures show the total number of full time and part time students in the age group as a share of the total population in the age group.

Source: OECD, *Programme for International Student Assessment* (PISA); *Education at a Glance* (2004).

Figure 4.11. **Apparent retention rates year 7/8 to year 12 by gender**



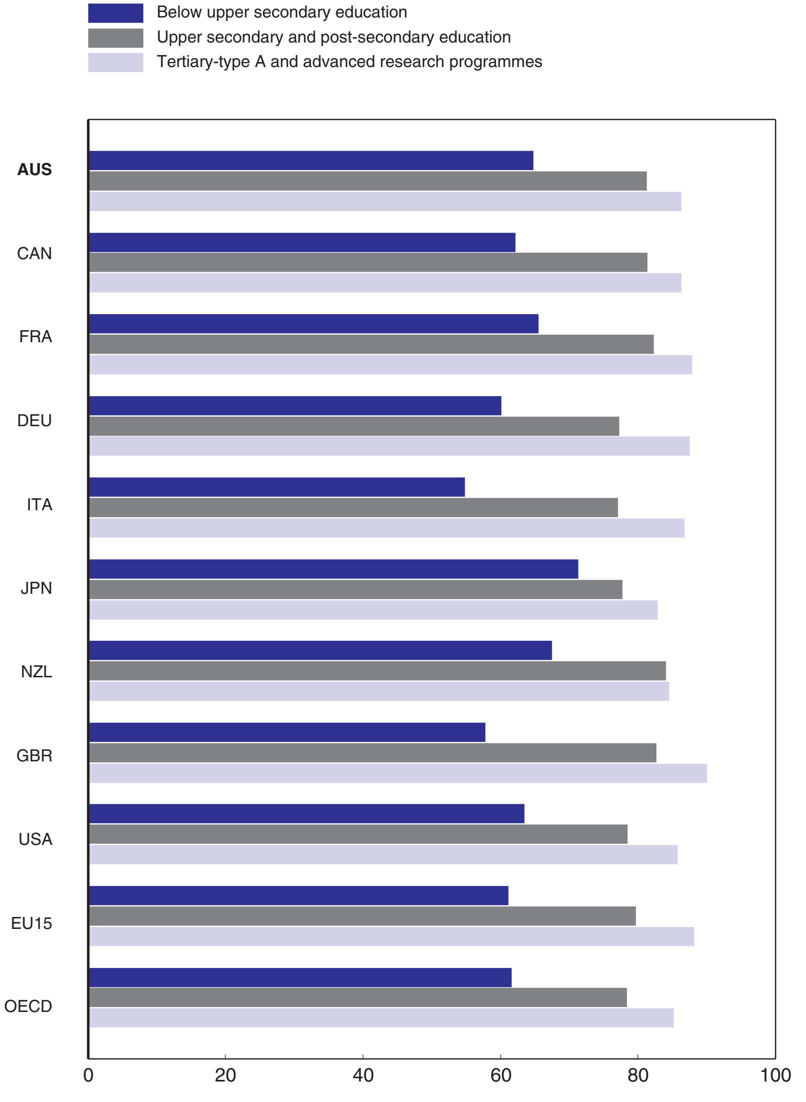
N*ote*: The apparent retention rate shows the percentage of students in a given age cohort who continue to a particular year of education.
Source: ABS Schools, Australia.

international comparisons of school-to-work transition outcomes for young people suggest that the employment disadvantage of poorly qualified school leavers, compared with their better educated counterparts, is somewhat above the OECD average.[68] Increasing demands for skills in Australia (and other OECD countries) have made qualifications at the upper secondary level of education (or an apprenticeship qualification) far more desirable for young people (OECD, 2002). The improvement in education achievement rates could also yield significant long-term economic benefits. Results from the Monash macroeconomic programme imply that raising the proportion of young people in Australia who obtain a Year 12 or equivalent education by 10 percentage points, would have a positive impact on GDP, real private consumption and economic welfare in the longer-term, outweighing its costs.[69]

Commendable progress has been made in broadening the curriculum in senior secondary years of schooling, so as to make it more attractive to students who do not wish to pursue tertiary education. The introduction of vocational education and training (VET) in schools (which permits senior secondary students also to follow VET programmes at school in tandem with their senior certificate studies), and school-based New Apprenticeships (full-time or part-time), are two important initiatives in this respect. It is important that these vocational pathways benefit young people by providing them with the necessary skills for their

Figure 4.12. **Labour participation rates by educational attainment**

Persons aged 25-64, percentages, 2002



Source: OECD (2004), *Employment Outlook*.

future learning and employment. Since 1996, the Australian Government has reinvigorated vocational education and training, with noticeable achievements in terms of numbers in training and New Apprenticeships, as well as increasing the labour-market responsiveness and flexibility of the VET system[70] and enhancing its national consistency (Box 4.4). Moreover, the government took steps to address skill shortages, through the introduction of incentives under the New Apprenticeships Incentive Programme, and the launching, in 2004, of the National Skill Shortages Strategy aiming to tackle many of the important disincentives which can turn young people away from choosing a career in the trades. The increased flexibility in traditional trade training provided by the strategy, along with the testing of the new approaches to apprenticeships it envisages, are welcome steps (Annex 4.A4).

Other important initiatives aim to help young people to improve their foundation skills, especially literacy and numeracy. To this end, arrangements are in place to measure and assess literacy and numeracy achievements in the early years of schooling education (Years 3, 5 and 7) in order to ensure that students meet minimum standards. Identifying and assisting people with poor foundation skills is an important step towards reducing the probabilities of both early school leaving and fragmented labour-force attachment thereafter. Low achievement in literacy and numeracy was found to be one of the most important factors explaining school drop out rates, especially for boys.[71] In addition to enhancing the foundation skills learned in school, recent policy initiatives further aimed at strengthening career education and information systems, experimenting with new ways of reconnecting young people with mainstream education.[72]

While the ranking of Australia in international comparisons by the OECD PISA study is high, disparities in student performance for reading literacy are also high, attributable, in large part, to within-schools differences. This implies the need to further reforms within schools that aim to close the gap between the students with the lowest and highest levels of performance and thus facilitate the move of youths from school to working life (OECD, 2001c). The government's national agenda for schooling includes measures *inter alia* to improve quality of teaching;[73] ensure national consistency in schooling; and improve career services in schools, as well as information and support services for school leavers.[74] These measures go in the right direction. Efforts should also continue in increasing curriculum diversity in upper secondary school to discourage early drop-outs. The better organisation and broadening of the VET-in-schools programmes is a priority in the government's policy agenda.[75] Two further policy options for expanding the range of subjects might be smaller class sizes and larger high schools, both permitting better careers advice to support the transition pathways of all young people, but the latter entailing different management structures. The further development of re-entry programmes for those early school leavers who wish to return to learning, constitutes another key step in enhancing transition outcomes of young people.[76]

Box 4.4. The New Apprenticeships Scheme: main aspects

The New Apprenticeships Scheme, introduced in 1998, established a unified framework for the traditional four-year apprenticeships and the relatively newer and shorter-duration traineeships.[1] The scheme provides training opportunities to new labour market entrants and existing workers, covering both young and mature age workers. Qualifications undertaken by New Apprentices meet nationally consistent standards under the Australian Qualifications Framework (AQF) and are portable across the country. New Apprenticeships cover a broad-number of occupations, enabling employers and New Apprentices to choose from over 1 500 national qualifications on offer. The User Choice arrangements allow employers and their New 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).

To ensure the quality and industry-relevance of the training provided under New Apprenticeships the government has introduced a number of mechanisms including, for example, legally binding training contracts.[2] Moreover, to encourage development of high level of skills, the government provides a "progression incentive" for New Apprentices moving to a higher level of Certificate.[3] The number of New Apprentices in-training has nearly doubled since 1995, reaching 406 900 persons by end-2003. 34 per cent of them fall into the trades and related occupations, which include occupations generally associated with traditional apprenticeships (such as construction and food trades) and experiencing skill shortages.

1. 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.
2. Under these contracts the employer agrees to provide facilities and expertise to assist the training of the New Apprentice in an agreed qualification.
3. At present, around 85 per cent of New Apprentices are undertaking qualifications at Certificate III or above.

Upgrading the skills of adults

To help counteract the negative impact on per capita GDP growth resulting from an ageing population, older workers should be encouraged both to remain in the workforce, and to become more productive. While educational attainment has improved markedly in Australia over the past two decades, it remains low by international comparison,[77] and about 40 per cent of 45-54 year olds have little or no formal qualifications beyond compulsory education (Figure 4.13). Research suggests a positive relationship between levels of formal schooling and later participation in adult education and training (Watson, 2003), highlighting the need to both improve education levels early in life and remove obstacles to participation in skills development during working life. Policy initiatives aiming at enhancing adult learning, such as the Basic IT Skills for Older Workers Programme,[78] and the New Apprenticeships Access Programme (providing unemployed of all ages with pre-vocational training and other forms of assistance) are steps in the right direction, as is making work-related training expenditure tax deductible. OECD data suggest that, as in other advanced countries, employers in Australia tend to be the most common financial sponsor of job-related training, providing funding for over two-thirds of those participating (Figure 4.14). This level of support, however, is relatively low by international comparison, as is the level of government support. On the other hand, Australia was found to have the third highest rate of self-financed participation in job-related training (O'Connell, 1999; Watson, 2003).

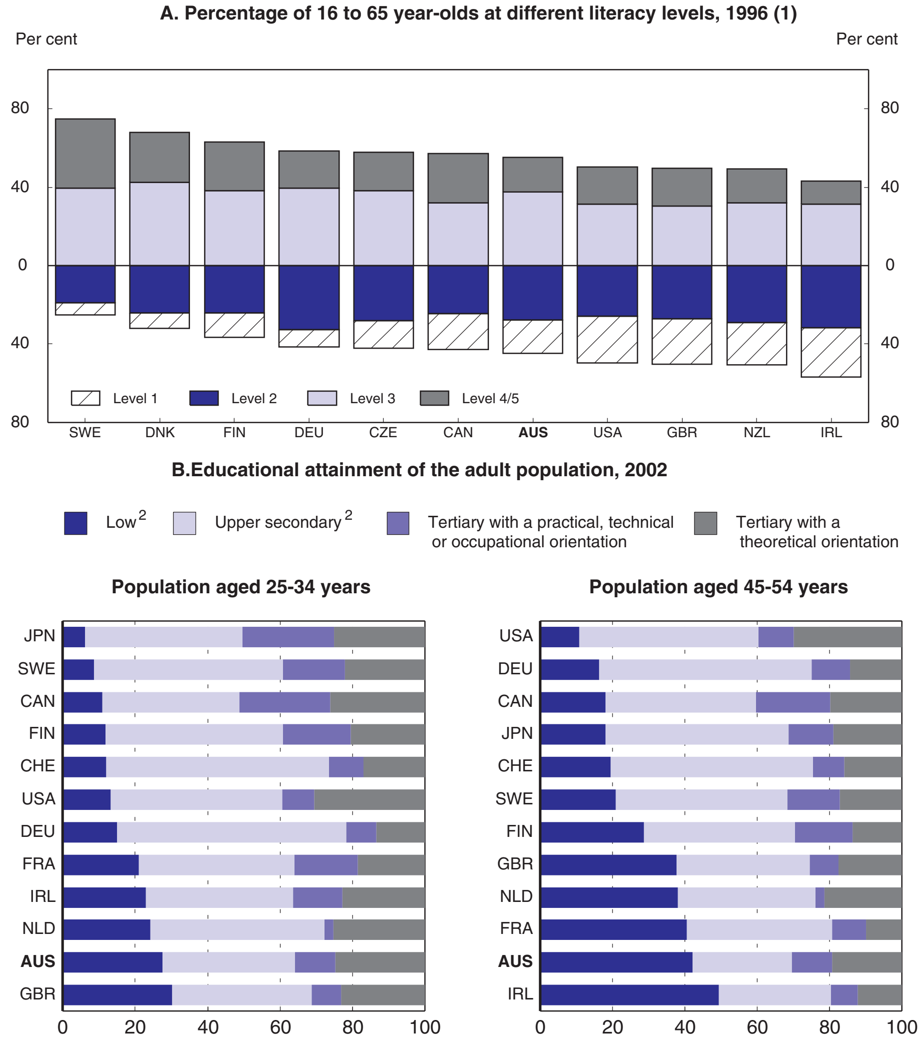
The Australian government conducted a consultation process – concluded in June 2004 – on a more coordinated approach to adult learning, aiming at further improving foundation and vocational skills, and a better integration of services to learners and provides, especially for those in non-metropolitan areas.[79] Policy initiatives should include programmes allowing adults to work part-time while undergoing training. To ensure that learning outcomes are sufficient to meet the costs they involve to individuals and their employers, the quality of the new programmes needs to be closely monitored and assessed.

Recent reforms of higher education sector

The government launched in early 2002 an extensive review with respect to the funding and other areas of the higher education sector.[80] The central finding of the public consultation process, namely that the present funding and policy arrangements for the sector have become "unwieldy, complex and inequitable", led to significant policy changes, announced in the 2003 May Budget.[81] Important initiatives included: a A$ 1½ billion increase in support to universities over four years; changes in commonwealth funding for higher institutions; greater flexibility for universities in setting course fees; and an extension of the operation of Higher Education Contribution Scheme (HECS)[82] (Box 4.5).

Overall, the reform package has the potential of leading to a higher education system that has more diversity, is more responsive to the labour market needs, and allows universities to have better access to funding. The proposed financing arrangements should ensure long-term vitality of the sector, given the constraints of raising large amounts of extra funding for universities *via* general taxation. Moreover, OECD findings indicate that the private internal rate of return to investment in tertiary education is well above the risk-free real interest rate,[83] suggesting that students benefiting from tertiary education should contribute to its cost, as is already the case in an increasing number of countries, among them Australia.[84] However,

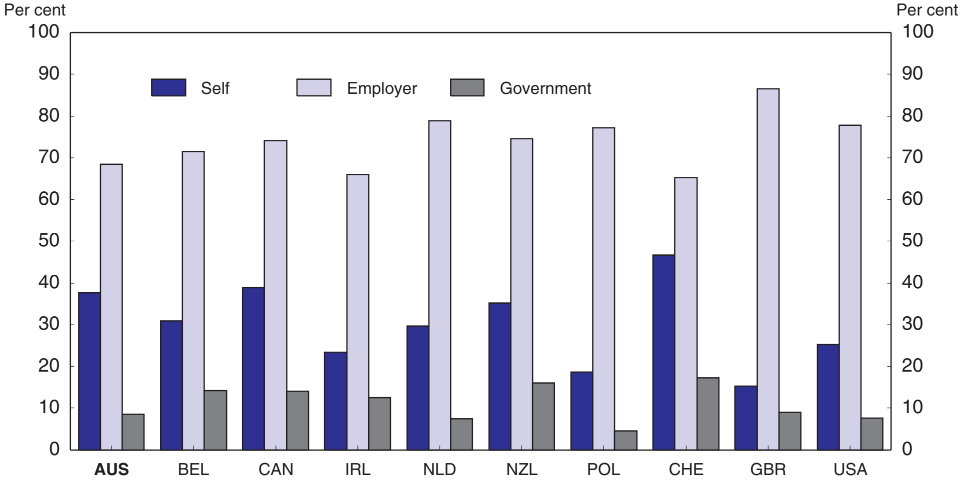
Figure 4.13. **Basic literacy and educational attainment of the adult population**



1. The figure shows so-called document literacy, that is, the ability to locate and use information contained in various formats.
2. Low comprises persons having primary school, lower secondary school or ISCED 3C short programmes as their only formal qualification; upper secondary includes also post-secondary-non-tertiary programmes.

Source: OECD (2004), *Education at a Glance*; OECD (2000), *Literacy in the Information Age: Final Report of the International Adult Literacy Survey*.

Figure 4.14. **Sources of financing of job related training for employed adults**
1994 to 1995



Source: O'Connell, P.J. (1999), "Adults in Training: An International Comparison of Continuing Education and Training", *OECD Centre for Education and Innovation*, CERI/WD(99)1.

concerns have been expressed that the existence of an A$ 50 000 loan ceiling means that some students will need to find resources to pay up-front fees to complete their course, and this will affect adversely the enrolment decision of relatively poor students.[85] The rationale for loan capping is to contain university charge increases for full-fee paying students, and to minimise the potential costs to the Australian Government of non-repayment of the loan. More flexible funding arrangements, while of major importance, are not the only factor contributing to a higher quality education system and enhanced educational outcomes. Other significant areas include: improved governance, less red tape in university administration, workplace relations in universities, quality of teaching and learning, and university research and cross sectoral collaboration – all canvassed by the consultation paper for higher education reform.

Assessment

Commendable progress has been made towards improving the school to work transition for young people, and the quality of education outcomes. Recent policy initiatives aiming at enhancing the foundation of skills learned in school, and strengthening career education and information systems, are steps in the right direction. Policies should be targeted at improving the performance of

Box 4.5. The main provisions of the higher education reform package

Changes in the commonwealth funding

In an effort to ensure that the discipline mix supported by the Australian Government meets the needs of the economy, the reform package introduced fundamental changes in commonwealth funding for higher institutions, with a new Commonwealth Grant Scheme (CGS) – delivering teaching and learning funds – replacing the traditional scheme of block operating grants to each university (covering the basic costs of teaching, administration and research). Under the CGS, the Commonwealth will provide a contribution, set by discipline, towards the cost of an agreed number of Commonwealth supported places offered by a university in a year, with institutions that consistently enrol non-full-fee paying students beyond a five per cent limit to be penalised. Moreover, under the new arrangements, annual increases in funding will be contingent on institution's adherence to the National Governance Protocols, requiring universities to specify the duties of their Council members and provide a formal programme for their professional developments.

Changes in funding arrangements for students

The government will introduce in 2005 a new set of loans – the Higher Education Loans Programme – which comprises the HECS scheme (HECS-HELP), and two new loan schemes, for full-fee paying students (FEE-HELP) and those who wish to study overseas Study HELP (OS-HELP). In particular:

In order to enhance the flexibility and diversity of the higher education system the Australian Government has proceeded to the partial deregulation of university fees. Specifically, with the exception of fees for nursing and education units of study (covering about 12 per cent of students), which remain as they are, universities will be able from 2005 to set their own student contributions for Commonwealth-supported places up to a ceiling determined by the Australian Government, which is no more than 25 per cent higher than HECS rates. It is expected that, the variation of student contribution levels between courses and institutions will lead to a competitive education sector in terms of cost and quality of courses provided. A key equity aspect of the HECS system retained in the new measures is the deferred payment arrangement, allowing all students to participate in higher education, even if they are unable to pay their contributions or fees up front. As a result, income contingent repayment arrangements will continue, ensuring that higher education remains free at the point of entry. The pricing reform, is accompanied by an increase in the repayment threshold to A$ 36 184 in 2005-06 (from A$ 25 348 in 2003-04).

Another major change to student funding regards the extension for 2005 of student loans scheme to cover full fee paying students in public and eligible private higher education institutions (FEE-HELP). Loans of this type will be capped at a level of A$ 50 000. Moreover, a new loan scheme will be developed to assist students wishing to study one or to semesters overseas (OS-HELP). To better accommodate student demand in particular areas and enhance the availability of educational opportunities and choices, the new arrangements further enable institutions to increase the maximum number of domestic full-fee paying student places in any undergraduate course from the current 25 per cent to 35 per cent, if students

Box 4.5. The main provisions of the higher education reform package (*cont.*)

want to take up these additional places. In 2003, less than 2 per cent of the undergraduate students were paying full-fees. This may reflect the absence of the income contingent loan facilities under the current system. It is expected that enrolments will increase under new arrangements, involving an extension, in 2005, of HECS-type loan to full-fee paying students.

Source: The paper draws on Australian Government (2003b) Our Universities: Backing Australia's Future.

weaker students, reducing existing disparities. Efforts should continue towards broadening the secondary school curriculum to meet a wider range of student aspirations and reduce the risk of early dropouts. A further integration of VET within the broader education sector would be desirable in this respect. Recent moves towards a coordinated strategy to adult learning are a welcome step forward. For lifelong learning outcomes to be sufficient to warrant the underlying costs, however, policy measures should provide flexibility, allowing adults to work part-time, and be closely tailored to the needs of mature workers. Finally, the 2003 comprehensive reform package in higher education incorporates important changes to student financing arrangements, including a move to a partial deregulation of university fees, which would allow universities to have greater access to funding and improve allocation of resources. The new arrangements also extend income contingent loans to full-fee paying students – compensating for the increase in full-fee paying quotas of enrolments per course – although concern has been raised regarding the capping of the loan. Overall, the reform package has the potential to further improve the functioning of the Australian higher education sector, enhancing its quality and competitiveness. However, the impact of the new measures should be monitored and evaluated in terms of increasing the responsiveness of higher education institutions to the labour market needs. Improvements in other areas, including that of governance, are also required.

Box 4.6. **Recommendations to lower unemployment and to raise labour force participation**

Industrial relations

Regulatory requirements for collective and individual agreements should be eased, to promote enterprise bargaining. A major step in this direction would be a reduction of the still high number of allowable award matters, and a further tightening of their definitions and specifications.

Federal and state industrial relations systems should be harmonised.

Industrial dispute regulations should be streamlined to minimise the incidence of unlawful industrial action.

"Safety Net" award wage increases should be guided by the productivity and thus employability of low-skilled workers.

The social partners should be encouraged to explore new approaches to reduce the cost of dismissal procedures, including for employees who have been with firms for only a short period, without substantial losses of the social and economic benefits of employment protection regulations.

Policies to raise labour force participation

High effective marginal tax rates should be reduced further, so as to provide firmer incentives for labour force participation, with the fiscal costs of the prospective changes being closely monitored.

Eligibility criteria for the Disability Support Pension should be tightened, aiming to encourage labour market engagement, or active participation in society, of people with substantial work capacity.

The extension of mutual obligation requirements to all working age income support recipients, including older workers, would be advisable, combined with a close monitoring and strict enforceability of activity tests.

Employers should be encouraged to provide training and re-training facilities for workers before they reach their mid-50s. Incentives should be strengthened for workers to enrol in such schemes.

Education and training

More should be undertaken to broaden the secondary school curriculum to reduce the risk of early school leaving; better integration of the vocational education and training sector with the broader education sector would be advisable.

The improvement of educational opportunities and outcomes to facilitate the school to work transition for young people should remain a policy priority.

Box 4.6. **Recommendations to lower unemployment and to raise labour force participation** (*cont.*)

Training and up-skilling of persons already in work should be given higher policy priority, with recent moves towards a coordinated strategy to adult learning representing a welcome step forward. Policies should be tailored to the needs of adult workers so that lifelong learning outcomes meet the costs of tuition and production losses from being out of work.

Efforts of improving the quality of higher education and keeping it internationally competitive should continue. These should include the quality of teaching and learning as well as governance and workplace relations in universities.

The impact of recently decided more flexible funding arrangements for universities should be monitored and evaluated in terms of increasing the responsiveness of higher institutions to the labour market needs.

Notes

1. The trend towards part-time employment was at least temporarily interrupted in 2004, when job creation was heavily concentrated in full-time employment.
2. Latest OECD estimates of the non-cyclical rate of unemployment are lower than that in Australia in Austria, Denmark, Iceland, Japan, Luxembourg, Korea, Mexico, the Netherlands, Norway, Portugal, Sweden, Switzerland and the United States.
3. In 2003, the overall employment-to-population ratio and the labour force participation rate were higher than in Australia in Canada, Denmark, the Netherlands, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. In Finland, the employment rate was lower but labour force participation somewhat higher than in Australia. See the Statistical Annex of the 2004 OECD *Employment Outlook*.
4. See ABS cat. No. 6203.0, 6105.0 and 6265.0.
5. There is also some evidence that there are full-time workers on overtime – both paid and unpaid – who wish to work fewer hours (Australian Government (2003c), p. 4-14).
6. See Russo and Headley (2004).
7. See also the 2003 OECD *Economic Survey of Australia*, Chapter III.
8. Awards are oriented towards occupations and industries rather than individual workplaces, and many firms are still covered by multiple awards. 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.
9. Of the 2 221 federal awards which were in operation on 30 April 2004, only 62 are yet to be simplified. In addition, the number of awards in force has been reduced substantially as more than 1 700 awards have been set aside or are deemed to have ceased operation.
10. This was achieved, inter alia, by removing the previous requirement to notify relevant trade unions that negotiations were being undertaken and by making non-union agreements subject to the same compliance tests as the union agreements.
11. Protected action means that it is exempt from civil liability. Unprotected industrial action is any action which occurs outside of a bargaining period.
12. Data for the year ending March 2004 indicate that only some 9 per cent of all current federal certified enterprise agreements were comprehensive, covering about 23 per cent of the employees under those agreements for fiscal year 2003-04.
13. The "allowable matters" set out in the Workplace Relations Act 1996 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; incentive-based payments (other than tallies in the meat industry), piece rates, 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; 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. Awards may also include; provisions incidental to the allowable matters and necessary for the effective operation of the award.

14. Leigh found a statistically significant elasticity of labour demand with respect to the Western Australian statutory minimum wage of –0.3, with the employment impact being most substantial among younger employees. This supports the theoretically expected downward slope of the labour demand curve, although the implied employment effect of minimum wage increases would be rather small. See also Watson's (2004) criticism of the methodology used, and Leigh's (2004) rejoinder.
15. Harding and Harding report a short-term elasticity of demand for minimum award wage workers with respect to minimum award wages of about –0.2. The bulk of the negative employment response to "safety-net" wage increases occurs through loss or non-creation of minimum award wage jobs.
16. In its "Safety Net Review" of 5 May 2004, the AIRC took note of the research by Leigh and Harding/Harding but decided not to take them into account in its decision on the grounds of doubts expressed by some academic commentators about the methodologies applied by the studies.
17. The federal system has always been the sole system in the Northern Territory and the Australian Capital Territory, while since the beginning of 1997, Victoria's system has been integrated in the federal system through a referral of most of its industrial relations powers by the Victorian government.
18. Examples of the compliance burden and costs on multi-state employers from the lack of jurisdictional uniformity in another area – the occupational health and safety and workers' compensation schemes – are given in Productivity Commission (2003).
19. For example, AIRC commissioners may be appointed to a State industrial relations commission and vice versa, an arrangement which is expected to improve mutual understanding across jurisdictions and increased consistency in approach and outcomes.
20. If accepted, the Workplace Relations Amendment (Termination of Employment) Bill 2002 would have extended the reach of the federal unfair dismissal legislation from around 50 per cent of the workforce to about 85 per cent, excluding only employees of state governments and some unincorporated businesses.
21. Workplace Relations Amendment (Secret Ballots for Protected Action) Bill 2002 [No. 2].
22. Workplace Relations Amendment (Improved Remedies for Unprotected Action) Act 2004.
23. For more details see OECD (2004), E*mployment* O*utlook*, Chapter 2.
24. The minimum severance pay standard in most awards provides for 8 weeks pay for individuals laid off after 4 year's service (lesser payments apply for shorter periods of service). Some awards and many agreements provide more.

25. During fiscal year 2002-03, 7 121 applications for relief in respect of termination of employment were lodged in the federal jurisdiction, which amount to about 1 per cent of layoffs. The number of applications has declined from 7 461 in 2001-02 and 8 109 in 2000-01. In the state jurisdictions, there were 8 435 unfair dismissal applications lodged in 2002-03, 9 148 in 2001-02 and 9102 in 2000-01. There are many out-of-court settlements, which are not covered by the statistics.
26. For references see the 2003 OECD *Economic Survey of Australia*, Chapter III. Doubts about the need of a special treatment of small firms with regard to unfair dismissal regulations are expressed by Barrett (2003).
27. The survey-based research of Harding (2002) concludes that the current unfair dismissal provisions have an adverse employment effect which shows in particular in higher unemployment of low skilled workers in the low-wage segment, a group among which the young are over-represented. From this follows that the negative employment effect from the legislation has the potential to last over a person's lifetime.
28. As a consequence of the recent AIRC ruling, small businesses are now required to make severance payments of a maximum of 8 weeks' pay in the case of more than four years of continuous service of a dismissed worker.
29. A typical pattern bargaining 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.
30. Among the potentially substantial social and economic benefits from employment protection legislation are reduced contracting costs by setting general rules and standards, encouraging increased investment in firm-specific human capital, and early notification of job loss to allow job search prior to being laid off. These are discussed in the OECD *Jobs Study* (1994), Part II, Chapter III.
31. Australia was thus among the first of the OECD countries to introduce contestability into the employment services framework.
32. Intensive Assistance provides individually tailored support to obtain employment for the most disadvantaged job-seekers and retains the job seekers' eligibility for income support.
33. See the evaluations by the OECD (2001a), the Department of Employment, Workplace Relations and Small Business (2000, 2001), the Department of Employment and Workplace Relations (2002), the Productivity Commission (2002), and the references to various other studies given there. A particular problem for assessments is that of "deadweight cost", *i.e.* the portion of job placements which would have occurred even without assistance.
34. Department of Employment and Workplace Relations (2003).
35. Referral impacts capture both compliance effects that occur where job seekers avoid participation in the programme by finding employment or declaring previously undeclared income, and the impacts that result from actual participation in a programme.
36. The impact from commencement captures both the improvement in employment prospects as a result of programme participation and attachment effects where participants reduce their job search activity while in a programme.
37. For Work for the Dole, for which no earlier equivalent exists, the cost per employment outcome was A$ 6 700.
38. See the 2003 OECD *Economic Survey of Australia*, Box 3.

39. Eardley (2002).

40. On the assumption of broadly unchanged behaviour over time with regard to labour force participation, the Commonwealth Government's Intergenerational Report (IGR) noted that recent participation trends, adjusted for demographic changes, would result in a significant reduction in the overall participation rate over time, from around 64 per cent in 2003-04 to slightly over 55 per cent in 2041-42 (Australian Government, 2002a).

41. See Australian Government (2002b and 2004a).

42. This type of payment is granted to people of working age, that is over 16 and under Age Pension age (currently 62 for women and 65 for men). Claimants must have an illness or injury (attracting 20 points or more under the Impairment Tables) that prevents them from undertaking work of at least 30 hours per week, or be re-trained for such work, for a period of at least two years. Permanently blind people are not required to demonstrate a continuing disability to work (Department of Family and Community Services, 2003).

43. On the basis of OECD estimates, only around half per cent of the disability benefit stock in Australia are leaving the rolls each year due to recovery or work resumption. This figure is among the lowest for the countries for which data are available (OECD, 2003a).

44. The number of male DSP recipients aged 50-59 increased by over 60 per cent between 1990 and 2000, while the population of the group increased by only 40 per cent (Australian Government, 2003c).

45. These data are published by the Australian Government's Department of Family and Community Services.

46. The 1991 Disability Reform Package replaced the invalid pension and the sheltered employment allowance by the DSP, with the corresponding restructuring adding 10 100 new claimants. The new scheme also broaden the eligibility criteria, permitting part-time workers to claim the pension while working up to 30 hours per week, as well enabling greater access to the DSP for people with psychiatric and drug and alcohol conditions. The increase, in the late 1990s, in female retirement age from 60 to 62 also influenced the number of DSP recipients (Australian Bureau of Statistics 2002; and Saunders 2004).

47. Argyrous and Neale (2003) used cross-sectional data to examine the relationship between the availability of work and the DSP rates of various age groups. Saunders (2004) notes, however, that the empirical analysis does not control for the impact of the socio-economic status of a region. Using the inflow-outflow framework, Cai and Gregory (2003), also conclude that the deterioration of labour market conditions has been the most important factor for DSP changes over the period 1971-99, the while the impact of population ageing was negligible.

48. Saunders (2004) argues that the financial attractiveness of the DSP, compared to unemployment benefit, and the absence of mutual obligation requirements, provide the incentive for unemployed people to get reclassified. On these grounds, Saunder argues that a large part of the increase in DSP numbers represents "hidden unemployment".

49. Under the current arrangements, only around one in three of all working-age recipients, and one in ten parents in jobless families receive an income support payment which is conditional on activity tests (Australian Government, 2004a). Only around one in six of working age recipients is required to actively seek work.

50. According to OECD (1998), workless households with children (single-adult and two-adult households) accounted around 30 per cent of total non employed households in 1996 compared to an OECD average for the countries for which data are available of 16 per cent.
51. Over the period 1982 to 1997-98 the rate of jobless households (lone-parent and couple) with children increased by 4.8 percentage points, to 14.6 per cent. The rise would have been much lower (2.1 percentage points) if the share of lone-parent families remained at the 1982 level (Bradbury, 2003).
52. For a discussion, see OECD (2003c).
53. The AWT announced in the May 2001 Budget but only passed by the Senate in 2003. The package provided new funding of around A$1.7 billion over four years. For a discussion, see Australian Government (2001), and OECD (2003d).
54. The Third Employment Services contract provided a high-degree of personalised assistance to the long-term unemployed and service guarantee to all job seekers (Australian Government, 2002c).
55. Another important initiative includes the reduction of the maximum rate of taper from 100 per cent to 70 per cent, as part of the "Working Nation" reforms to Newstart allowance in 1995. Empirical evidence related to the introduction of the measure suggest that, a reduction in income tests had a positive impact on labour force participate rates (Warburton *et al.* 1999).
56. Through Working Credits income support, recipients are able to build up working credits (up to a ceiling A$ 1 000) during fortnights when they have little or no income. On commencement of work by the welfare recipients, working credits increase the amount they can earn, before their income support payment is reduced.
57. 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. For more details on Working Credits, see Australian Government (2001) and OECD (2001b, 2003d).
58. The reduction in the withdrawal rates for Family Tax Benefits from 30 per cent to 20 per cent, under the package, will result in a reduction of the EMTRs for families on average earnings to 50 per cent in 2004, from 60 per cent in 2000, and 84 per cent in 1999 – the year before the introductions of ANTS (Australian Government, 2004c).
59. Other measures outlined in the government paper include: removal of work test for superannuation contributions under age 65 (from July 2004); simplification for work test for people aged 65 and 74; removal of the requirement for actuarial certificates for account based income streams (from 1 July 2004); and simplification of the superannuation guarantee earnings base (from 1 July 2010) (Australian Government, 2004d).
60. A "non-commutable income stream" is a product where once a person commences access to an income stream he or she is unable to access the associated capital as a lump sum. This is to ensure that the policy is not used by a person as a means of getting early access to his or her superannuation (*i.e.*, start an income stream then commute it the next day to a lump sum). The government is about to release a discussion paper on the rules applying to the non-commutable income stream.
61. See Australian Government (2002b and 2004a).
62. The final report is due to be completed by June 2006. The evaluation will assess the effectiveness of the programme in terms of participation outcomes for working age

income support recipients, particularly with regard to Indigenous Australians, mature age job seekers, parents with children and people with disabilities.

63. The OECD area-averages stand at 4.4 and 4.9 percentage points, respectively.
64. The findings of PISA 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) (OECD, 2001c).
65. School attendance in Australia is compulsory between the ages of 6 and 15 (16 in Tasmania). Formal schooling consists of six or seven years of primary school, followed by five to six years of secondary school, depending on the state (OECD, 2001c).
66. For a discussion see McMillan and Marks (2003).
67. Estimates from the Department of Education, Science and Training show that the probability of a young person undertaking some post-school education and training during their life stands at around 90 per cent.
68. See Figure 36 of OECD (2003d).
69. Business Council of Australia (2003a,b).
70. Regarding VET in Schools, in 2002, 95 per cent of all schools delivered such programmes, with the participation of senior secondary students exceeding 44 per cent.
71. See, for example, Rothman (2001).
72. Important initiatives – in response to the Prime Minister's Youth Pathways Action Plan Taskforce: Footprints to the Future – include online career exploration service; the Career and Transition Pilots; and the Partnership Outreach Education Model Pilot, testing the delivery of flexible education models. The Pilot initiatives are due to be completed by end-2005. Moreover, the government has developed a national framework – the Australian Blueprint for Career Development – to guide the development of career services from school to retirement.
73. The government announced, in August 2004, the appointment of 18 members of the Interim Board for the recently established National Institute for Quality Teaching and School Leadership (NIQTSL).
74. In February 2004, the Australian government circulated a public consultation paper underling the national agenda for schooling titled Taking Schools to the Next Level: The National Education Framework for Schools.
75. See OECD (2003d).
76. See Sweet (2001).
77. According to the Panel A of Figure 4.13, around 20 per cent of the adult population (16 to 64 years) lacks document literacy skills – that is the ability to locate and use information in various formats. This means for, example that they may be unable to determine the correct amount of medicine to take from information printed on the package. The shares are similar for prose literacy (understand and use information from texts) and quantitative literacy (apply arithmetic operations) (OECD: International Adult Literacy Survey 2000).
78. The programme provides basic IT skills – recognised at a national level – for low income earners aged 45 years and over in order to increase their labour market competitiveness (Australian Government, 2003a).
79. The underlying paper focused on issues such as: understanding the needs of adult learners; building relationships between service providers, employers, government

and the community; assisting mature age transitions; supporting learning in the workplace; and ensuring access to opportunities (Australian Government, 2003a).

80. For the outcomes of the consultation (completed in October 2002) and a discussion of the main reforms see Australian Government (2003b).
81. The announced measures passed by Senate, with modifications, at the end of 2003.
82. The HECS scheme provides a loan to students that is indexed to maintain its real value but is otherwise interest free, with deferred income contingent repayment.
83. 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 findings suggest that annual returns to successful students range from 6.5 per cent in Italy to 17.3 per cent in Britain. Australia was not covered by the sample (OECD 2002).
84. Recent research by Beer and Chapman (2004) on the impact of increasing the HECS fees by 25 per cent (coupled with new repayment threshold) on students who subsequently earn low, middle and high incomes concludes a reduction in effective charges, compared with the current system, for low-income graduates (especially women), while for graduates earning middle income and above the fee burden increased substantially.
85. See Chapman (2004).

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Annex 4.A1

The McClure Report recommendations

In 1999 the Australian Government commenced an extensive review of the social support system, aiming to prevent and reduce welfare dependency. To this end, the government appointed a Reference Group – chaired by Patrick McClure – to advise on options for changing the income support arrangements and the provision of related services (including employment, education and training). The terms of references focused particularly on the incentive effects of the design of social security payments for working-age population, a broader application of the Mutual Obligation principle, and international best practices.

The McClure Report,[1] noted that the existing income support system was not designed to deal with recent socio-economic and demographic changes, identifying four main shortcomings *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 Report also identified the costs of participation, including child care and transportation costs, as a barrier to social and economic participation.

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*) improved incentives and financial assistance to encourage and support participation; *iv*) a broader application of 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 recommended some "initial-step" measures, supplemented by some specific recommendations on research and evaluation to ensure that implementation is guided by solid information and analysis.

The government welcomed the McClure Report, emphasising that the welfare reform was seen as a "structural change" – rather than a cost cutting exercise – aiming at a more actively-managed social safety net that would encourage social and economic participation (Department of Family and Community Services, 2000). Such an investment has the potential of growth-enhancement, and social security expenditure savings over the longer term.

Annex 4.A2

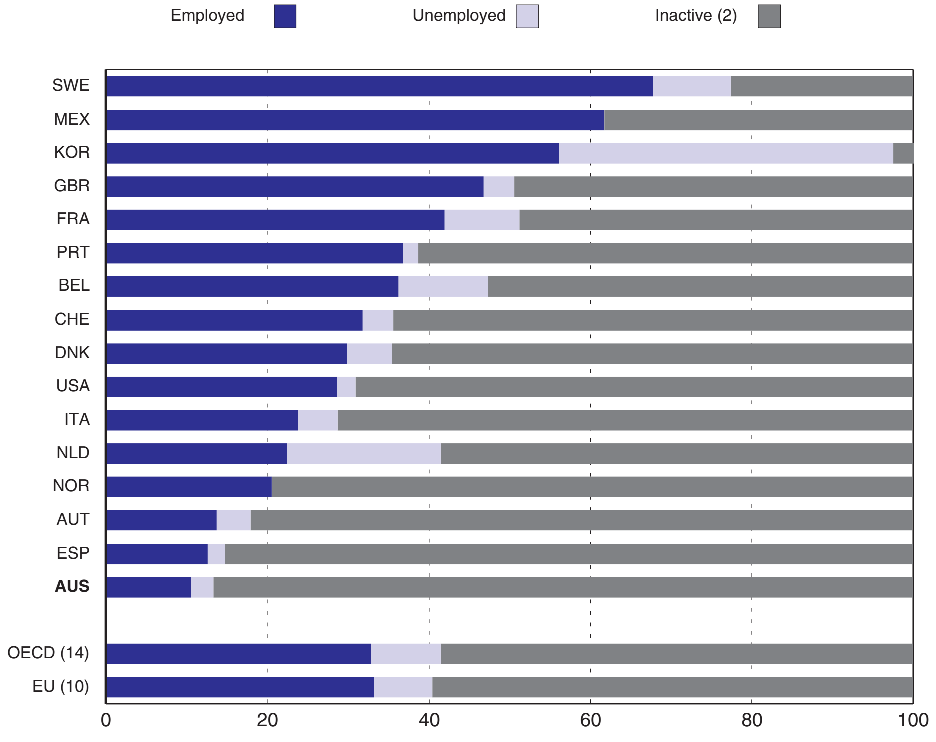
Welfare reforms: an overview

The Australian Government has already introduced measures to increase the participation rates of income support recipients, in line with the recommendations of the 1999 *McClure Report* of welfare reform (see Annex 4.A1). The *Australians Working Together* (AWT) package, announced in the 2001-02 Budget, was the first step towards a more responsive and personalised income support system. AWT provided for an expansion and improvement of employment assistance. It also improved financial incentives, through the introduction of a Working Credit, and training credits for job seekers undertaking community work activities. The package further sought to boost participation by extending the Mutual Obligation requirements for people receiving unemployment benefits to 34-49 years old.[2] In addition, AWT introduced the obligation for Parenting Payment recipients whose youngest child is aged between 6 and 12 to attend an annual interview with a Personal Adviser. Recipients with a youngest child aged between 13 and 15, must also undertake an activity every six months (an average of about six hours per week). This is less strict requirement than those applied in other OECD countries.[3] It constitutes, however, a significant move towards work-oriented welfare policies.

The next phase of welfare reform, detailed in the 2002-03 Budget, focused upon a more effective employment assistance to job seekers, through the Third Employment Services contract, and on the development and improvement of the work capacity of people with disabilities (Australian Government, 2002c). Based on OECD estimates, Australia has one of the lowest rates of employment for disability benefit recipients, with about one in nine recipients working (Figure 4.A2.1). As a positive step towards containing the flow of people into Disability Support Pension programme, the May 2002 Budget provided for a tightening of the DSP eligibility rules, and a revised Bill proposed that people able to work 15 hours or more per week at full award wages would be regarded capable for part-time employment, and be assisted as necessary to obtain this.[4] Both initiatives encountered strong political opposition. However, new assessment procedures (the *Better Assessment and Early Intervention Measure*) were introduced in September 2002, as part of the AWT package, focusing on the expert evaluation of work capacity for people who are ill, injured or have a disability, and the early identification of interventions and programmes that may assist them to improve their ability to work. Following the implementation of the *Better Assessment and Early Intervention Measure*, there was a fall in the growth of the DSP recipients to 2.2 per cent in 2002-03, from 5.4 per cent in the previous fiscal year.[5] Additional steps in containing the flow of people in the DSP programme, include changes to DSP policy guidelines (in effect as from September 2002) to improve Centrelink assessments of whether a person can work with mainstream re-training, and the introduction of enhanced reviews arrangements under the 2003-04 Budget.[6]

Figure 4.A2.1. **Work-status of disability benefit recipients: an international comparison**[1]

Percentage, late 1990s



1. Countries are ranked in decreasing order of the share of employed.
2. Inactive means not employed, for Mexico and Norway.

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

Measures announced in the May 2003 Budget complemented previous initiatives for the development and improvement of work capacity of people with disability. The budget included: a change in the funding for disability services providers from block grants to case-based funding (tailoring payments to service providers to the needs of their clients, the services provided, and outcomes achieved); financial assistance to organisations providing employment for people with disabilities; and more assistance – through the employment of additional carers – for parents of children with special needs, as a step in fostering their participation. Welfare policy reforms have also focused on reducing effective marginal tax rates (EMTRs), as discussed earlier, with the May 2004 Budget lowering EMTRs for families on average earnings to 50 per cent in 2004, from 60 per cent in 2000, and 84 per cent in 1999 – the year before the introduction of ANTS.

Annex 4.A3

The main features of the Australian income support system[7]

The Australian income support system is non-contributory and financed through general government revenue. Its primary objective is to provide protection against poverty, rather than income maintenance as is the case in most OECD countries. Benefits do not replace income but rather 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 student benefits.

There are three broad categories of income support payments: pensions, which include disability and lone parent 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. 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. In general, pensions have tapered asset tests, whereas allowances have a "sudden death" cut-out point, above which no income support payment is available.

Annex 4.A4

Measures to address skill deficiencies

Skill deficiencies are addressed through the New Apprenticeships Incentives Programme. To encourage employers in non-metropolitan areas to take a New Apprentice in identified skills shortage occupations, the programme provides a A$ 1 000 Rural and Regional Skills Shortage incentive.[8] Other incentives towards this end (also offered through the Programme) include the Innovation Incentive for New Apprenticeships in Innovation in both emerging and traditional industries, and the Women in Non-Traditional New Apprenticeships Incentive. Moreover, in 2004, the government launched the *National Skills Shortages Strategy* to tackle skill shortages in key industries throughout the country, especially in traditional trades. The new strategy incorporates a testing of new approaches to apprenticeships in critical skill shortage industries. These approaches include shorter apprenticeships and specialised apprenticeship pathways in industries such as building and construction. In addition, the new strategy will address skill shortages on a regional basis, and encourage and help industries to "adopt a school" to broaden the understanding and awareness of local career opportunities for young people. The testing of new apprenticeship approaches envisaged by the strategy is a welcome step towards monitoring and assessing their effectiveness in matching the supplied skills with those required by the industries.

Notes

1. The Final Report was issued in July 2000, following an Interim Report in March of the same year (RGWR, 2000a, b).
2. Job seekers aged 50 and over are not subject to the Mutual Obligation Programme but rather have obligations under the flexible Newstart Allowance activity requirements and a broader range of activities compared to job seekers aged 18 to 49, including Community work and caring responsibilities. The second phase of the Fair Go for Mature People (implemented in September 2003), provided for compulsory participation interviews and a more flexible activity test for Newstart Allowees aged 50 and over.
3. For example, in the United States, the age of child at which lone parents are excluded from work requirements was reduced in 1988 from 6 to 3 years, and since 1996 this has been left to individuals states to determine. In Nordic countries, sole parents are expected to actively search for a job once a child reaches three years of age, while in Germany and the Netherlands labour force participation requirements for lone parents have been extended to those with primary school age children (Saunders, 2003). See also OECD (2003c), and Dawkins and Kelly (2003).
4. Unlike the originally proposed gradual implementation of the changes in DSP, the revised Bill involved a change in the eligibility requirements for all new entrants to DSP (applying from 1 July 2003). People who claimed or received the DSP before 1 July 2003 would not be affected by the changes.
5. The number of Newstart/Youth Allowance incapacitated recipients has also declined, by around 33 per cent, since the introduction of the measure.
6. In particular, the new reviews, called "Service Update reviews", have the capacity to review medical details and income and assets at the same time. As such, they are better directed to people whose medical condition or capacity to work may have changed.
7. The Annex draws closely from the McClure Interim Report (RGWR, 2000b). For overview of the system see also, Whiteford and Angenent (2001); IMF (2001) and OECD (2001a).
8. Eligible New Apprenticeships include some of the traditional trades, as well as some non-trade New Apprenticeships such as computer support, agriculture and aged- and child-care.

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