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# AUSTRALIA

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# OECD Economic Surveys: Australia 2014

BETTER POLICIES FOR BETTER LIVES

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*The Secretariat's draft report was prepared for the Committee by Philip Hemmings and Vassiliki Koutsogeorgopoulou, under the supervision of Piritta Sorsa. Statistical research assistance was provided by Annamaria Tuske with general administrative assistance provided by Anthony Bolton.*

*The previous* Survey of Australia *was issued in December 2012. Information about the latest as well as previous Surveys and more information about how Surveys are prepared is available at* www.oecd.org/eco/surveys.

## BASIC STATISTICS OF AUSTRALIA

(Data refer to 2013 unless otherwise stated; numbers in parentheses refer to the OECD average)*

| | | | | | |
|---|---|---|---|---|---|
| **LAND, PEOPLE AND ELECTORAL CYCLE** | | | | | |
| Population (million) | 23.1 | | Population density per km$^2$ | 3.0 | (34.7) |
| Under 15 (%) | 18.9 | (18.3) | Life expectancy (years, 2012) | 82.1 | (80.2) |
| Over 65 (%) | 14.4 | (15.7) | Men | 79.9 | (77.5) |
| Foreign-born (%, 2011) | 27.0 | | Women | 84.3 | (82.9) |
| Latest 5-year average growth (%) | 1.7 | (0.6) | Latest general election | September 2013 | |
| **ECONOMY** | | | | | |
| Gross domestic product (GDP) | | | Value added shares (%) | | |
| In current prices (billion USD) | 1 505 | | Primary sector | 2.4 | (2.6) |
| In current prices (billion AUD) | 1 556 | | Industry including construction | 27.1 | (27.8) |
| Latest 5-year average real growth (%) | 2.5 | (0.8) | Services | 70.5 | (69.4) |
| Per capita (000 USD PPP) | 44.6 | (37.8) | | | |
| **GENERAL GOVERNMENT** Per cent of GDP | | | | | |
| Expenditure | 35.1 | (42.5) | Gross financial debt | 33.0 | (107.4) |
| Revenue | 33.7 | (36.7) | Net financial debt | -0.3 | (67.3) |
| **EXTERNAL ACCOUNTS** | | | | | |
| Exchange rate (AUD per USD) | 1.034 | | Main exports (% of total merchandise exports) | | |
| PPP exchange rate (USA = 1) | 1.510 | | Crude materials, inedible, except fuels | 38.3 | |
| In per cent of GDP | | | Mineral fuels, lubricants and related materials | 25.9 | |
| Exports of goods and services | 20.5 | (53.1) | Food and live animals | 10.4 | |
| Imports of goods and services | 21.1 | (49.1) | Main imports (% of total merchandise imports) | | |
| Current account balance | -3.3 | (-0.1) | Machinery and transport equipment | 38.1 | |
| Net international investment position | -49.4 | | Mineral fuels, lubricants and related materials | 17.5 | |
| | | | Miscellaneous manufactured articles | 12.9 | |
| **LABOUR MARKET, SKILLS AND INNOVATION** | | | | | |
| Employment rate for 15-64 year-olds (%) | 72.0 | (65.2) | Unemployment rate, Labour Force Survey (age 15 and over) (%) | 5.7 | (7.9) |
| Men | 77.6 | (73.1) | Youth (age 15-24, %) | 12.2 | (16.1) |
| Women | 66.4 | (57.4) | Long-term unemployed (1 year and over, %) | 1.1 | (2.7) |
| Participation rate for 15-64 year-olds (%) | 76.4 | (71.1) | Tertiary educational attainment 25-64 year-olds (%, 2011) | 38.3 | (31.5) |
| Average hours worked per year | 1 676 | (1 771) | Gross domestic expenditure on R&D (% of GDP, 2010) | 2.2 | (2.4) |
| **ENVIRONMENT** | | | | | |
| Total primary energy supply per capita (toe, 2012) | 5.9 | (4.2) | $CO_2$ emissions from fuel combustion per capita (tonnes, 2011) | 17.8 | (9.9) |
| Renewables (%, 2012) | 4.6 | (8.5) | Water abstractions per capita (1 000 m$^3$, 2010) | 0.6 | |
| Fine particulate matter concentration (urban, $PM_{10}$, µg/m$^3$, 2011) | 13.6 | (28.0) | Municipal waste per capita (tonnes, 2009) | 0.6 | (0.5) |
| **SOCIETY** | | | | | |
| Income inequality (Gini coefficient, 2012) | 0.324 | (0.308) | Education outcomes (PISA score, 2012) | | |
| Relative poverty rate (%, 2012) | 13.8 | (11.1) | Reading | 512 | (497) |
| Median equivalised household income (000 USD PPP, 2010) | 27.0 | (20.4) | Mathematics | 504 | (494) |
| Public and private spending (% of GDP) | | | Science | 521 | (501) |
| Health care (2011) | 9.1 | (9.2) | Share of women in parliament (%, August 2014) | 30.1 | (26.7) |
| Pensions (2009) | 2.5 | (8.7) | Net official development assistance (% of GNI) | 0.34 | (0.37) |
| Education (primary, secondary, post sec. non tertiary, 2011) | 4.1 | (3.9) | | | |

Better life index: *www.oecdbetterlifeindex.org*

* Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

*Source:* Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

# Executive summary

- *Main findings*
- *Key recommendations*

## Main findings

Australia's material living standards and well-being compare well internationally, reflecting a well-managed and successful economy. The economy is slowing as the prolonged mining boom recedes. Output growth of about 3% is expected for 2014 and 2.5% in 2015. Macroeconomic policies are appropriate for the current conjuncture while long-term prosperity depends on ensuring that structural settings help all forms of economic activity and promote broad-based productivity growth.

**Ensuring price and financial stability.** Inflationary pressure is contained. Low interest rates are supporting activity and the rebalancing of growth. House prices have grown by about 10% over the past year, prompting construction activity but also attracting some speculative demand. Strong prudential regulation and a concentrated financial sector have supported financial stability, but the latter has also created concerns about competition and credit supply in some segments.

**Pursuing fiscal consolidation and ensuring efficient tax and public spending.** Gross public debt has risen from below 20% of GDP to over 30% since the global financial crisis. The budget faces significant volatility from movements in global prices for natural resources, and past spending commitments have created a medium-term structural fiscal challenge. Australia's heavy reliance on inbound investment and exposure to resource-market fluctuations provide strong arguments for fiscal discipline and low public indebtedness. The country has a comparatively light tax burden overall, but the heavy reliance on direct taxation is not ideal. Public-spending efficiency in some services is adversely affected by overlapping responsibilities and complex funding arrangements between federal and state governments.

**Improving framework conditions for business.** Improvements in productivity growth will require reforms across a wide range of structural policy areas including taxation, competition and deregulation. Government plans to ramp up infrastructure investment make sense, but only if funds are spent efficiently. Targeted business support needs to be judicious as it can be a short step from value-for-money subsidy to outlays on corporate welfare.

**Encouraging employment, deepening skill, and addressing inequality.** The importance of raising participation, combined with budgetary concerns, means effective welfare-to-work policies remain a priority. The government plans to incentivise unemployed youth, including lengthening the benefit waiting period. A proposed liberalisation of higher-education tuition fees and reforms to student support aim to improve competition, access and choice. It will be important to monitor the impact of these reforms, particularly for students from disadvantaged backgrounds.

**Tackling environmental challenges.** The government is fundamentally changing Australia's environmental policy, replacing a carbon tax with a suite of planned new measures, including a mechanism to provide incentives to businesses for reducing emissions. Ramping up road building provides opportunities to extend road pricing. Ensuring efficient supply chains for water is important.

## Key recommendations

### *Ensuring price and financial stability*

- **Continue intensive monitoring of the housing market**; maintain deep micro-prudential oversight and consider using macro-prudential tools to bolster credit safeguards and signal concern.
- **Examine credit and competition issues in the financial sector**; consider reducing banks' implicit guarantees, tackling risk-weighting advantages in mortgage lending, improving credit databases.

### *Pursuing fiscal consolidation and ensuring efficient tax and public spending*

- **Prioritise medium-term fiscal consolidation** to rebuild fiscal buffers in light of Australia's exposure to external risk and consider establishing a stabilisation fund.
- **Rebalance the tax mix**; shift away from income and transaction taxes, make greater use of efficient tax bases such as the Goods and Services Tax and land tax.
- **Reform federal-state financial relations**; reduce grant conditionality further, instigate state-level tax reforms to enhance funding autonomy, and increase state-level responsibilities and accountabilities.
- **Address federal-state shared responsibilities to improve efficiency**; improve co-ordination and co-operation and in some cases, health care in particular, consider a reallocation of responsibilities.
- **Strengthen capacity for assessing and comparing state-level public services**; further develop performance indicators; and continue enhancing the availability and quality of data.

### *Improving framework conditions for business*

- **Ensure infrastructure delivers value for money** through robust and transparent cost-benefit analysis both to ensure economic use of the existing stock and appropriate selection of new infrastructure projects.
- **Concentrate on broad support for business**; prioritise corporate-tax rate cuts, reduce regulatory burdens and continue to be tough on corporate welfare and tax avoidance.
- **Strengthen competition;** continue adjusting network-industry regulation and improve the competitive environment more generally in light of the review currently underway.

### *Encouraging employment, deepening skills and addressing inequality*

- **Monitor the proposed welfare reforms** to ensure they raise work-force participation cost effectively without adverse social outcomes. Better target superannuation (pension) tax concessions.
- **Monitor the proposed higher education reforms** to ensure that choice and quality is enhanced and access is not compromised.

### *Tackling environmental challenges*

- **Achieve greenhouse-gas emission targets**; ensure the proposed Emission Reduction Fund is efficient through: i) robust measurement and verification methods; and ii) implementation of a safeguard mechanism that prevents offsetting emissions elsewhere in the economy.
- **Make transport policy greener**; enact the proposal to index excise duty on retail fuel, expand other use-based vehicle charges and extend public transport.
- **Continue strong commitment to water reform** including the Murray-Darling Plan.

# Assessment and recommendations

- *Post-boom adjustment is underway*
- *Long-term economic, social and environmental challenges*
- *Ensuring price and financial stability*
- *Pursuing fiscal consolidation and ensuring efficient tax and public spending*
- *Improving framework conditions for business*
- *Encouraging employment, deepening skills and addressing inequality*
- *Tackling environmental challenges*

Australia's material living standards and well-being compare well internationally. However, continued progress will require adjusting towards broad-based growth in the wake of the peak in the mining boom, coping with population aging and dealing with socio-economic and environmental challenges. The current government, elected in September 2013, is focussing on addressing the structural budget deficit through reducing the pace of spending increases and aims to improve productivity performance through deregulation, infrastructure investment and structural reform (see Box 1). Prominent initial items on the government's agenda have been the scrapping of a supernormal profit tax on mining companies and the repeal of a carbon tax with proposals to replace this with subsidies to firms for reducing greenhouse gas emissions.

### Box 1. **Economic policies of the current government**

The current government, elected in September 2013, aims to raise living standards through its *Economic Action Strategy*, the key goals of which are as follows:

- Fiscal consolidation. Budget proposals aim to bring the budget back to surplus without damaging growth prospects. Reducing government's share of the economy is a core element of the approach.
- Financial-sector reform. A broad review of the sector is underway via the Financial System Inquiry which is due for completion by November 2014.
- Promotion of competition. The Competition Policy Review's investigation of competition policies is due for completion by the end of March 2015.
- Tax reform. Options for reform are being considered via a white paper, which will be completed by the end of 2015.
- Federation reform. Exploration of reform options is underway in collaboration with state governments via a white paper, which is due for completion by the end of 2015.
- Reduced regulatory burdens. A target of reducing red and green tape worth AUD 1 billion each year has been set.
- Promotion of competitiveness and productivity. The Industry Innovation and Competitiveness Agenda was released in October 2014. It includes mechanisms to promote innovation (for instance, adjustments to encourage employee share schemes and support for research and development) and economy-wide incentive mechanisms to boost investment.
- An alternative approach to climate change. Notably, abolition of the carbon tax and replacement with incentives to reduce emissions under the Emissions Reduction Fund.
- Removal of the Mineral Resource Rent Tax. This tax on supernormal profits of the iron ore and coal sectors, was regarded by the government as imposing a significant regulatory and compliance burden on these industries, and as damaging business confidence.
- Commitment to maintain the Fair Work framework and work to improve it, including by initiating a review of the Fair Work laws.

This assessment examines macroeconomic and structural policy in light of these developments and is augmented by the conclusions from in-depth reviews of taxes and transfers (Chapter 1) and federal-state relations (Chapter 2).

## Post-boom adjustment is underway

Australia's economy passed through the global financial crisis comparatively well. Few serious dysfunctionalities in domestic credit systems emerged in 2008/09 and exposure to foreign toxic debt was insignificant. Also, the global financial crisis caused only a short-lived dip in the commodities boom (Figure 1); the latter being characterised by rising export volumes, high prices (Figure 2) and massive investment in capacity.

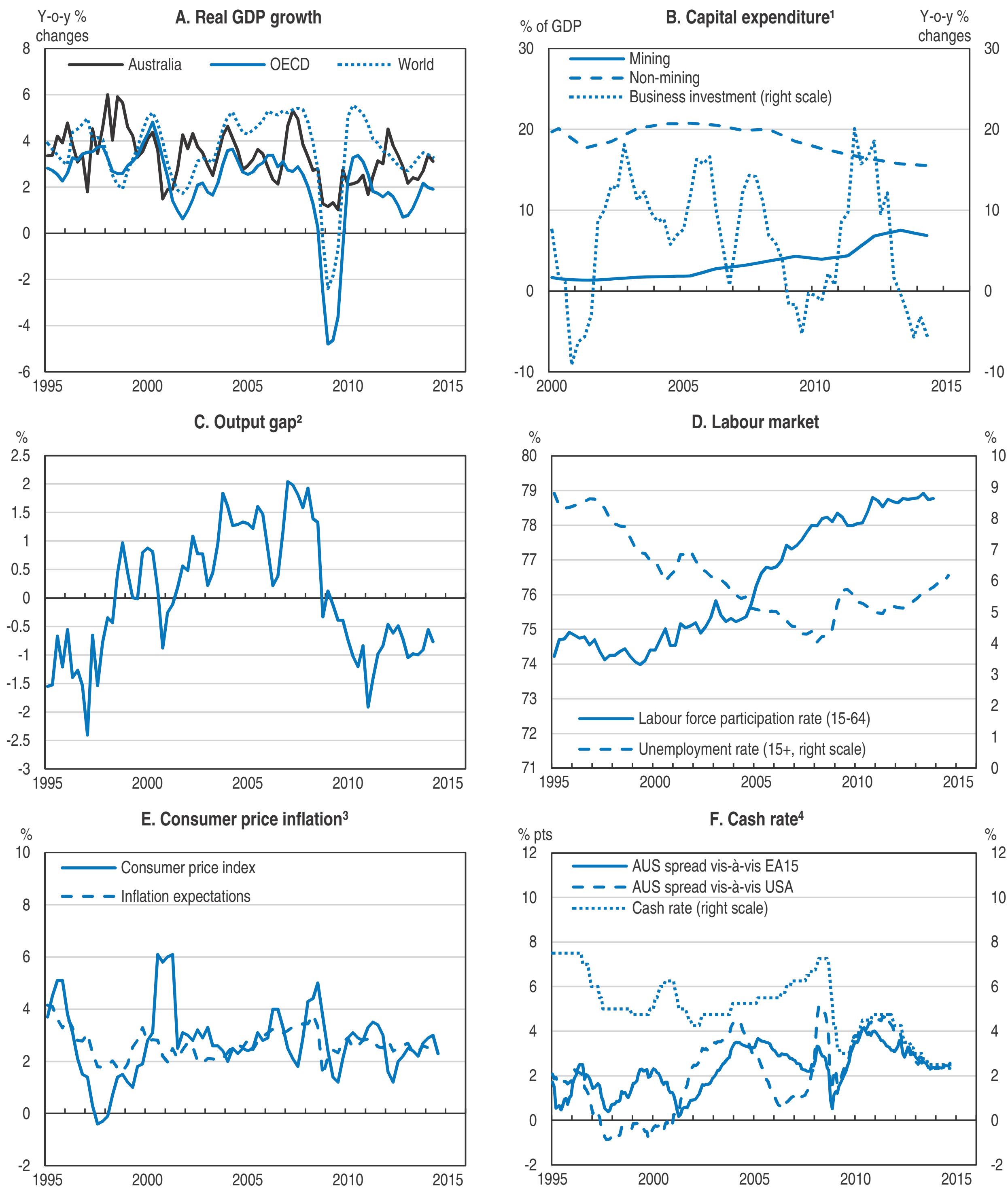
However, the economy now faces a potentially difficult rebalancing process. Commodity prices and the terms of trade have softened, and may have further to go. Australian commodity exports are dominated by coal and iron ore, which in 2013 accounted for nearly 45% of total goods and services exports in nominal terms (and nearly 10% of GDP); therefore market developments in these sectors are particularly significant. In addition, net of import content (about one-third to one-half of gross mining investment is reckoned to comprise imports), total mining investment is already falling and is expected to decline by several percentage points of GDP in the coming years. Partly reflecting these forces, annual (calendar year) output growth dropped from 3.6% in 2012 to 2.4% in 2013, and the unemployment rate rose from 5.2% to 5.7% over the same period. The "textbook" rebalancing scenario envisages market signals from further softening in the terms of trade and exchange rate depreciation inducing a sufficiently timely and substantial growth in non-resource exports and investment so as to prevent a large dip in the growth of demand, employment and activity. Without such offsetting adjustment the impact of falling terms of trade on national income, living standards and overall macroeconomic stability may be substantial.

Despite the slowdown in output growth and increased unemployment, house prices in some cities have resumed their strong upward path (Figure 3) and indicators are showing a pick-up in house building. Contributory factors include a comparatively high rate of population growth, low borrowing costs, a search for return by investors and a market untarnished by a credit crisis. The housing-market's buoyancy has to a degree been a blessing with wealth effects from rising prices helping support consumption demand, and the pick-up in house building countering decline in resource-sector investment. However, there are increasing concerns that prices, at least in some segments of the market, have become too high.

Price increases elsewhere in the economy have been contained. During the mining boom years, exchange-rate appreciation helped counter inflationary pressures. At present, comparatively weak demand, as manifest in the output gap and other indicators, is keeping growth in the prices of most goods and services low, notwithstanding some exchange-rate depreciation.

Output growth is projected to be around 2.5% in 2015, but then to pick up somewhat in 2016, in particular through strengthening domestic demand (Table 1) and despite weakening mining investment. The pick-up in housing construction will play a role too, and there will be additional exports from the expansion in mining capacity from the investment boom, in fact some export boost is contractually assured, such as that from liquid-natural-gas production. The unemployment rate is projected to peak a little above 6% and the recovery's modest pace will mean a continued absence of strong inflationary pressure. Further devaluation of the Australian dollar seems likely. As of end-2013, the IMF

Figure 1. **Output, employment and prices**




1. Capital expenditure refers to private gross fixed capital formation. Mining and Non-mining sector investment refers to financial years. Business investment covers private non-residential gross fixed capital formation, in volume terms.
2. Output gap refers to the deviation from potential GDP. The OECD calculation of output gap is based on a production-function approach. For more details, see Johansson (2013), "Long-term growth scenarios", *OECD Economics Department Working Papers*, No. 1000.
3. Inflation expectations are based on the "Break-even 10-year inflation rate", which is measured by the Reserve Bank using Commonwealth government securities; end-quarter observations are shown.
4. The cash rates denote the interest rate paid or received on unsecured overnight funds in the interbank market.

*Source:* Reserve Bank of Australia (2014); Australian Bureau of Statistics (2014), Cat. No. 5204.0 and 5206.0; OECD (2014), *OECD Economic Outlook 96 Database*.

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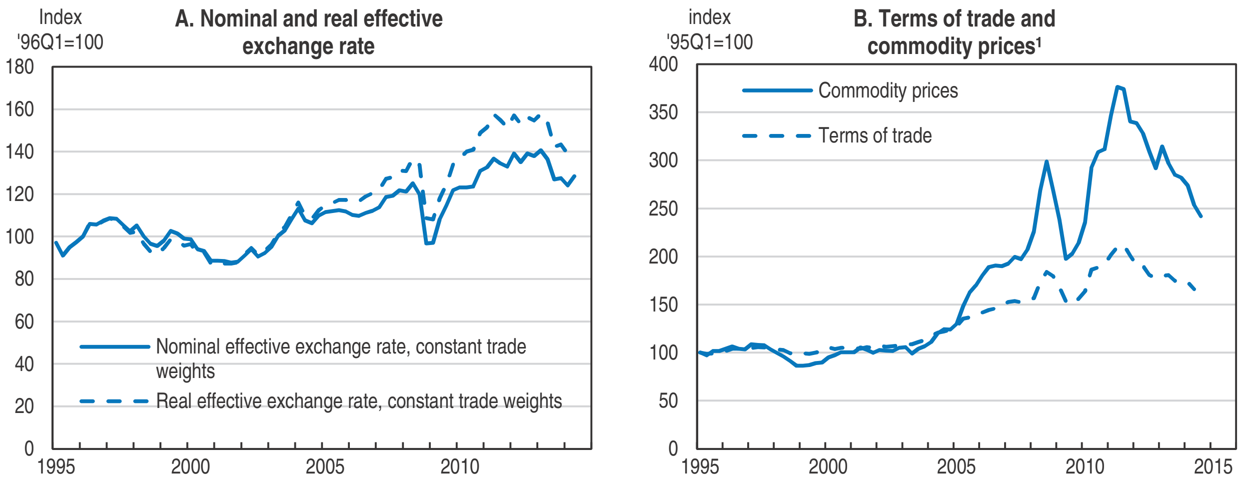
Figure 2. **External developments**




1. Terms of trade is the ratio of export and import prices.

*Source:* Reserve Bank of Australia (2014); Australian Bureau of Statistics (2014), Cat. No. 5204.0 and 5206.0; OECD (2014), *OECD Economic Outlook 96 Database*.

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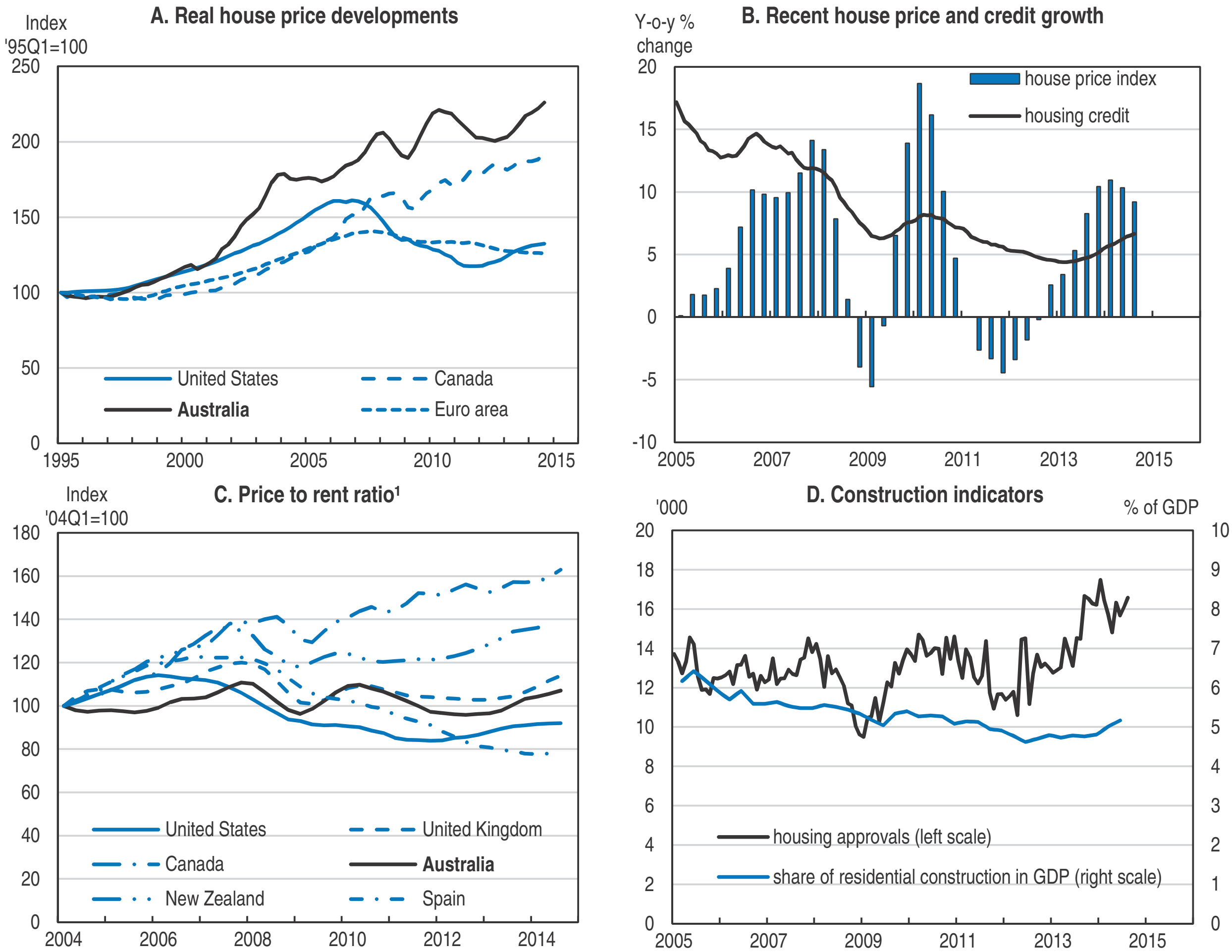
estimated that the real exchange rate was overvalued by 5-10 per cent, and it is widely believed it remains higher than market fundamentals would suggest. For instance, for some time the RBA has noted that it believes the currency is overvalued, particularly in light of falling commodity prices.

Broadly speaking, the balance of risks facing the Australian economy contains more substantial downside than upside uncertainties. External risks, chiefly from commodity markets, combined with speculative activity in the housing sector and uncertainties in the responsiveness of non-resource sectors, could conspire to generate a period of weak macroeconomic activity. Within the range of possible outcomes the most difficult scenarios are likely to be triggered by an external development. For instance, a slower-than-expected growth in China could weaken demand for Australia's mineral exports, which could lead to a further fall in the terms of trade. This could be accompanied by a depreciation of the exchange rate, which would ease conditions in the export-oriented and import-competing parts of the economy, but also weaken real consumer income in the short term and dampen household consumption growth. This difficult situation might then be prolonged by a slow reaction of non-resource sectors to the favourable conditions created by the lower exchange rate – either because of low price responsiveness of demand for non-resource exports or because of sluggish supply response. On the flipside, with the conditions in place for a pick-up in investment outside the resources sector, the rebalancing of growth could be sooner and stronger than currently anticipated.

## Long-term economic, social and environmental challenges

Australia has a well-managed and successful economy supported by strong macroeconomic frameworks and institutions. In the early 1990s, material living standards already ranked well in international comparison, with GDP per capita around 10% below the average of the top half of the OECD economies, and that gap has since been closed (Figure 4). However, maintaining growth in incomes and even "standing still" in terms of international competitiveness requires effort.

Figure 3. **Housing market developments**




1. Nominal house prices to rent prices, index based in 2004 Q1.

*Source:* Australian Bureau of Statistics (2014), Cat. No. 5302.0; Reserve Bank of Australia (2014); OECD (2014), *OECD Economic Outlook 96 Database*.

StatLink http://dx.doi.org/10.1787/888933176411

Ensuring a smooth economic transition in the wake of the mining boom and raising average living standards over the long run primarily requires broad-based shifts up the productivity ladder with policy helping through strong macroeconomic and structural framework conditions for business, improvements in workforce skills, and attention to public-service efficiency. The resources sector presents important policy challenges of its own in terms of guiding the exploitation of mineral and energy wealth to allow for a healthy rate of return and to ensure a fair distribution of the benefits. In addition, coping with the macroeconomic consequences of the ebb and flow of commodity demand and prices will remain a challenge for the foreseeable future.

However, raising average living standards is not sufficient to ensure inclusive growth. Inequality and relative poverty levels in Australia are middle ranking (Figure 4) and gaps between employment rates and earnings of men and women remain large. Furthermore, despite several decades of policy attention, Australia's widest socio-economic gaps remain those between its indigenous peoples and the rest of the population. Indigenous Australians represent about 3% of the population (Australian Bureau of Statistics, 2014) and have average life expectancy about a decade below that of the country as a whole and an employment rate more than 25 percentage points lower (Figure 4).

Table 1. **Macroeconomic indicators and projections**
Annual percentage change, volume (2005 prices)

| | 2011 Current prices (AUD billion) | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **GDP** | **1 452.8** | **3.6** | **2.4** | **3.1** | **2.5** | **3.0** |
| Private consumption | 779.7 | 2.5 | 2.1 | 2.5 | 2.9 | 3.6 |
| Government consumption | 256.6 | 2.9 | 1.2 | 1.7 | 2.0 | 1.9 |
| Gross fixed capital formation | 395.9 | 8.6 | -1.5 | -0.5 | -0.5 | 0.6 |
| Housing | 73.0 | -3.4 | 2.1 | 9.1 | 4.7 | 5.6 |
| Business | 271.3 | 14.0 | -1.8 | -4.2 | -2.5 | -1.1 |
| Government | 51.5 | -3.2 | -5.2 | 9.2 | 3.2 | 2.4 |
| Final domestic demand | 1 432.1 | 4.3 | 0.9 | 1.5 | 1.8 | 2.5 |
| Stockbuilding[1] | 9.0 | -0.1 | -0.5 | 0.2 | 0.2 | 0.0 |
| Total domestic demand | 1 441.2 | 4.1 | 0.4 | 1.7 | 2.1 | 2.5 |
| Exports of goods and services | 313.1 | 6.3 | 6.7 | 6.5 | 4.6 | 6.9 |
| Imports of goods and services | 301.4 | 6.5 | -2.1 | 0.4 | 2.5 | 4.4 |
| Net exports[1] | 11.7 | 0.0 | 1.8 | 1.2 | 0.4 | 0.4 |
| **Other indicators (growth rates, unless specified)** | | | | | | |
| Potential GDP | .. | 2.9 | 2.8 | 2.9 | 2.9 | 3.0 |
| Output gap[2] | .. | -0.6 | -1.0 | -0.8 | -1.2 | -1.2 |
| Employment | .. | 1.2 | 1.0 | 1.0 | 1.1 | 1.7 |
| Unemployment rate | .. | 5.2 | 5.7 | 6.1 | 6.2 | 5.9 |
| GDP deflator | .. | -0.2 | 1.2 | 0.0 | 1.0 | 2.5 |
| Consumer price index | .. | 1.7 | 2.4 | 2.6 | 2.3 | 2.6 |
| Core consumer prices | .. | 2.2 | 2.5 | 2.7 | 2.4 | 2.6 |
| Household saving ratio, net[3] | .. | 11.0 | 9.9 | 9.6 | 9.3 | 8.2 |
| Trade balance[4] | .. | -0.8 | -0.3 | .. | .. | .. |
| Current account balance[4] | .. | -4.4 | -3.3 | -3.6 | -4.1 | -3.6 |
| General government fiscal balance[4] | .. | -3.0 | -1.3 | -3.3 | -2.0 | -1.5 |
| Underlying general government fiscal balance[2] | .. | -2.8 | -1.3 | -1.5 | -1.5 | -1.1 |
| Underlying government primary fiscal balance[2] | .. | -2.3 | -0.8 | -0.9 | -0.8 | -0.4 |
| General government gross debt financial liabilities[4] | .. | 31.8 | 33.0 | 36.2 | 38.1 | 39.3 |
| General government net debt[4] | .. | -0.4 | -0.3 | 3.0 | 4.9 | 6.1 |
| Three-month money market rate, average | .. | 3.7 | 2.8 | 2.7 | 2.9 | 3.4 |
| Ten-year government bond yield, average | .. | 3.4 | 3.7 | 3.7 | 3.5 | 3.7 |

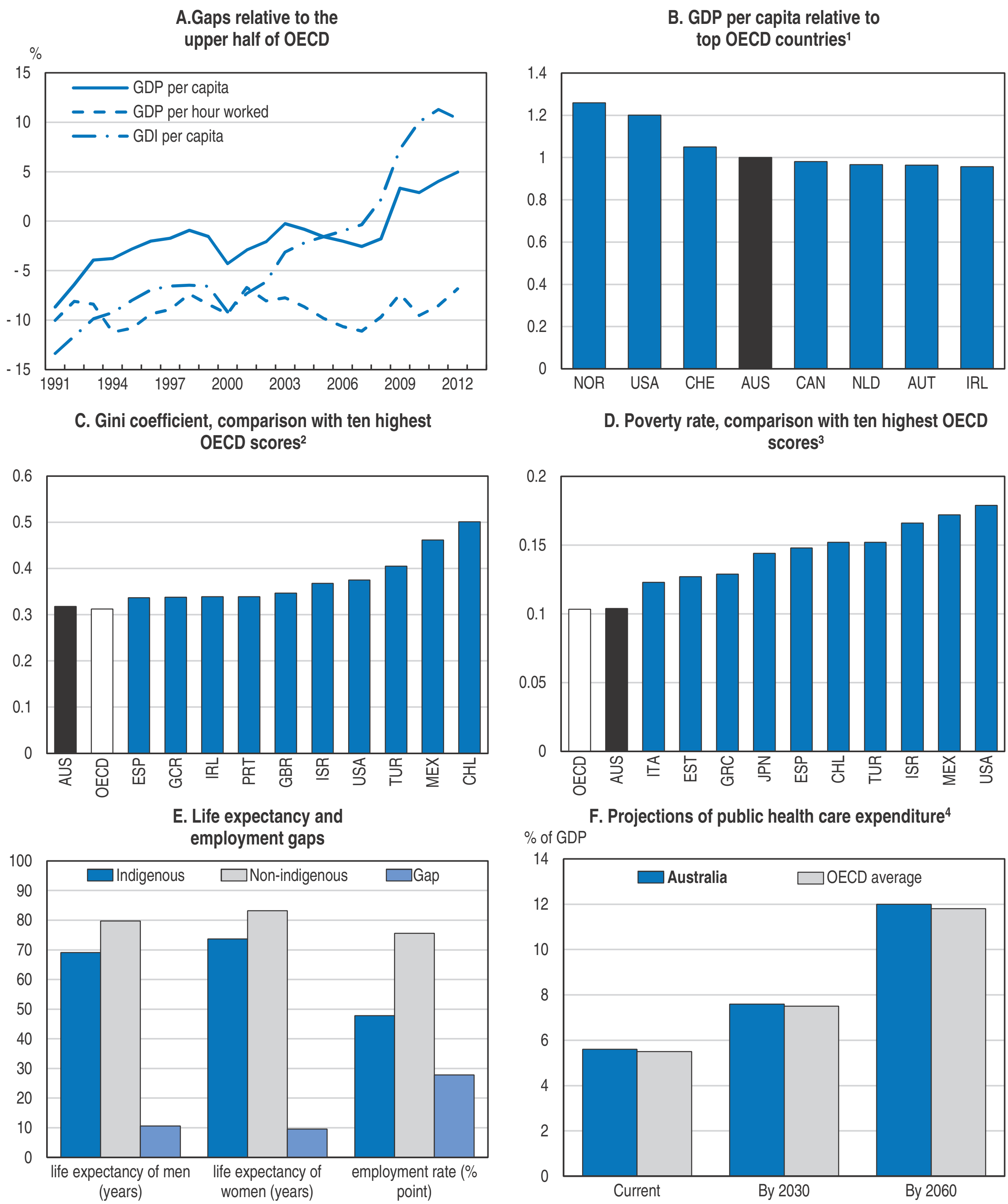
1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of household disposable income.
4. As a percentage of GDP.

*Source:* OECD (2014), *OECD Economic Outlook 95: Statistics and Projections* (database), September.

Although population ageing is not as rapid in Australia as in some other OECD countries ensuring retirement-income adequacy and appropriate retirement-age incentives is nevertheless challenging. Also, population aging and ever-expanding treatment possibilities are putting pressure on the health-care system (Figure 4). In addition, ageing requires shifts in the composition of services, and the increase in demand is sharpening the challenges of funding and co-ordinating federal and state health care.

Australia faces several environmental issues (Figure 5) and policy challenges; in particular a replacement mechanism for the repealed carbon tax is not yet in place. Much of the population lives in urban areas planned around car-based transport, resulting in traffic congestion and local air pollution. In addition, there are economic challenges in the supply chain for water and risks of drought. Cataloguing and preserving the ecosystems in

Figure 4. **Long-term challenges**




1. GDP is measured as per head, USD, constant prices, constant PPPs, OECD base year 2005. "1" indicates the same GDP per capita as the average of the top half of the OECD distribution. Ranking is based on the 2012 performance.
2. This Gini coefficient is calculated using disposable income after taxation and transfers. The coefficient ranges between zero and 1; a zero would indicate that everyone has the same income and a 1 implies one person has all the income.
3. This measure of relative poverty that indicates the share of individuals receiving less than 50% of the median income.
4. The projection is based on a scenario accounting for cost pressure.

*Source:* OECD (2014), *Going for Growth Database*; OECD (2014), *National Accounts Database*; Australia, Closing the Gap, Prime Minister's Report 2014; *Economics Department Working Paper*, No. 1048.

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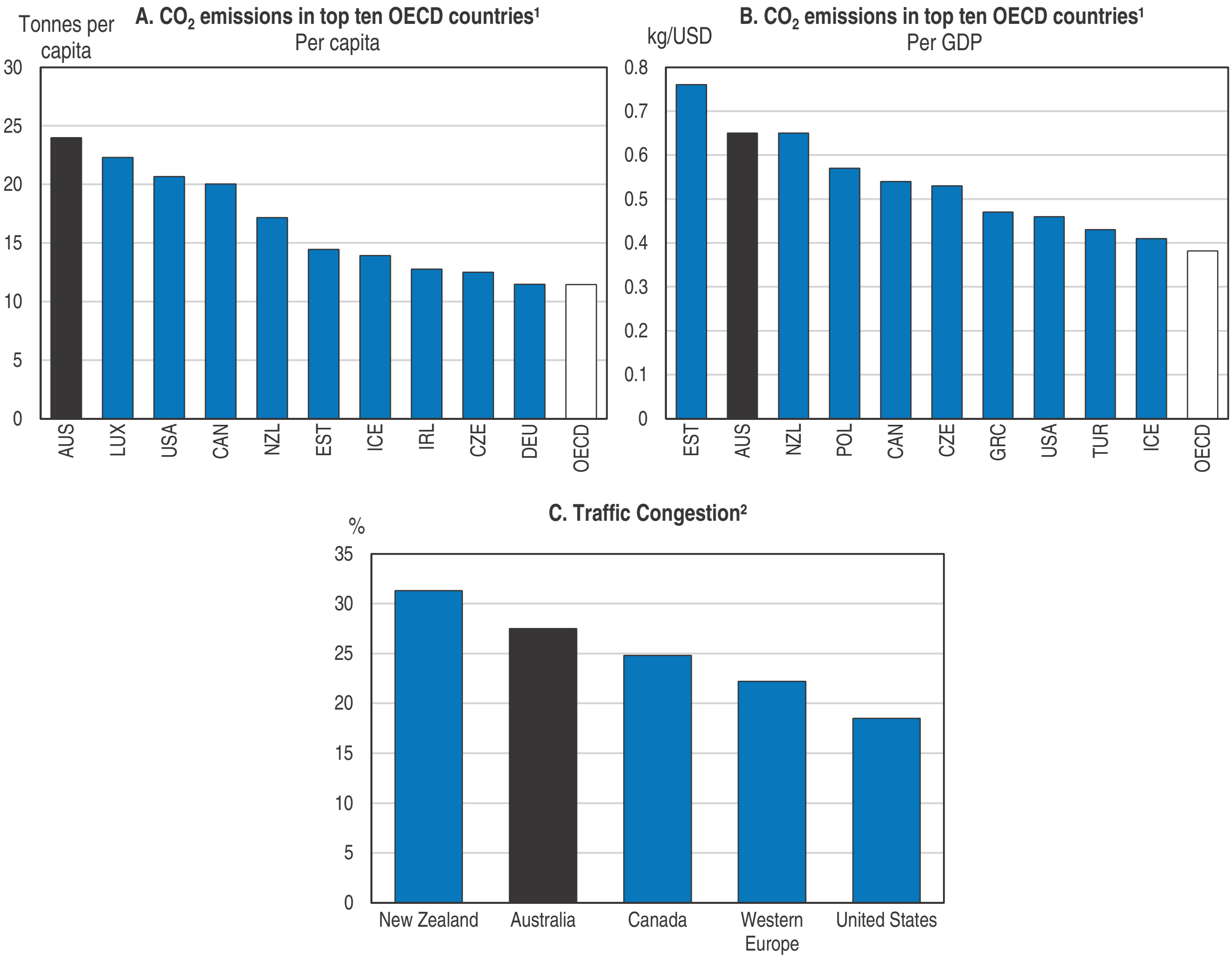
Figure 5. **Environmental challenges**




1. $CO_2$ emissions refer to greenhouse gases emissions equivalent to tonnes of $CO_2$ and to the year 2012. OECD refers to a simple average of 30 OECD member countries.
2. Traffic congestion is measured as excess travel time due to congestion, i.e. the average trip takes 27.5 per cent longer in Australia because of traffic congestion, compared to the average trip without congestion as calculated by GPS devices.

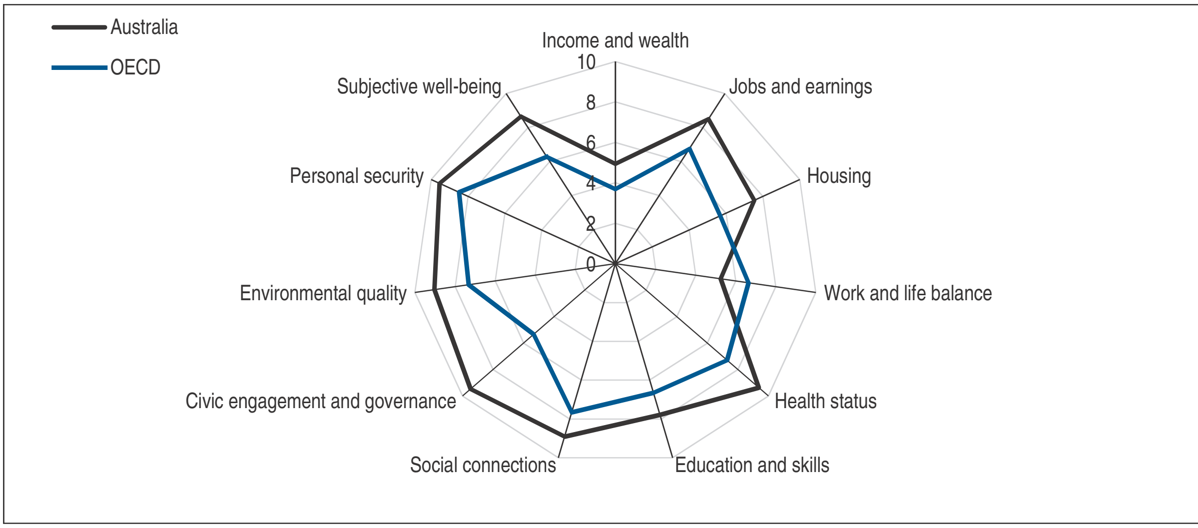
*Source:* OECD (2014), *Environment Statistics Database*; *Tom Tom Traffic Index*, 2013 Q2.

StatLink http://dx.doi.org/10.1787/888933176437

Australia's vast tracts of land and offshore marine habitats is challenging too. Difficult issues sometimes arise in accommodating mining and environmental concerns, as exemplified by the recent debate over the expansion of coal export facilities at Abbot Point in Queensland. Climate change impacts are of particular significance, because of threats to Australian plant and animal life and risks to agricultural production. On a per capita basis Australia's economy generates more greenhouse gases than most other OECD countries. Abundant supplies of low-cost fossil fuels favour GHG-intensive electricity production and have created opportunities for energy-intensive export-based processing (notably aluminium smelting).

Many of Australia's strengths are echoed in the OECD's Better Life Index (Figure 6). The country's score in indicators of factors driving material well-being (such as the Income and Wealth, Jobs and Earnings and Education and Skills data) are above the OECD average and the country also ranks highly in health status (the data largely reflects high life-expectancy), subjective well-being, personal security and the environment (water and air quality). Australia's below-average score in the Work and Life Balance indicator is mainly

Figure 6. **Australia's score in the Better Life Index**




How to read this figure: Each well-being dimension is measured using one to three indications from the OECD Better Life Indicator set with equal weights. Indicators are normalised by re-scaling to be from 0 (worst) to 10 (best).

*Source:* OECD (2014), *Better Life Index 2014 Database*.

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driven by a labour-force-survey statistic showing that a comparatively high proportion of employees work more than 50 hours per week.

## Ensuring price and financial stability

### *Inflation targeting continues to work well*

Australia's flexible monetary policy approach has effectively contained inflation and inflation expectations within the 2-3% target range. As in a number of other OECD economies, recovery from the global financial crisis has reached a point where the normalisation of monetary conditions is on the horizon. However, the appropriate moment for this process to begin, and its pace thereafter, remain uncertain and subject to debate. The RBA's policy rate has remained at 2.5% since August 2013. Reserve Bank statements indicate a period of stability in interest rates is likely to continue; for instance the projection shown in Table 1 assumes the start of interest-rate increases in the first half of 2015.

### *The composition of Australia's large and mostly private external debt has improved*

In aggregate, Australia remains a fairly substantial "external debtor nation". A long history of current-account deficits has generated net foreign debt of about 55% of GDP (Table 2). This has principally been generated by inbound private-sector investment; although in recent times private savings have increased significantly (buttressing Australia's already high national saving rate) and foreign investment has largely flowed to the resources sector in the form of equity rather than debt. Some aspects of the debt mitigate the potential risk. Most foreign liabilities are denominated in Australian dollars while the foreign assets are mainly in foreign currency (ABS, 2013). Hence, exchange-rate depreciation reduces net external debt, rather than propelling it into territory that may risk financial stability. In addition, since the global financial crisis the banks have reduced short-term offshore funding, which has lengthened the maturity of external debt (Debelle, 2014; IMF, 2013). However, these considerations do not entirely remove the risk.

Table 2. **Selected balance-sheet indicators**

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| **Balance-of-payments account** | | | | | |
| Gross foreign liabilities | 147 | 145 | 152 | 162 | 163 |
| Gross foreign assets | 94 | 90 | 96 | 109 | 109 |
| Net foreign liabilities | 53 | 55 | 55 | 53 | 54 |
| **Household account** | | | | | |
| Gross household assets | 545 | 505 | 532 | 556 | 569 |
| *Of which:* Non-financial (mainly dwellings) | 329 | 301 | 304 | 317 | 326 |
| *Of which:* Financial | 215 | 204 | 228 | 239 | 243 |
| Gross household liabilities | 111 | 112 | 114 | 115 | 119 |
| Net household worth | 433 | 393 | 418 | 441 | 450 |
| **Business account** | | | | | |
| Total liabilities | 166 | 151 | 156 | 163 | 163 |
| *Of which:* Loans | 40 | 40 | 41 | 43 | 44 |
| *Of which:* Equity | 96 | 81 | 85 | 89 | 89 |

*Note:* The data shown are for the final quarter of each year, except 2014 where the data are for the second quarter.
*Source:* Reserve Bank of Australia.

### *Prudential oversight is focusing on the housing market*

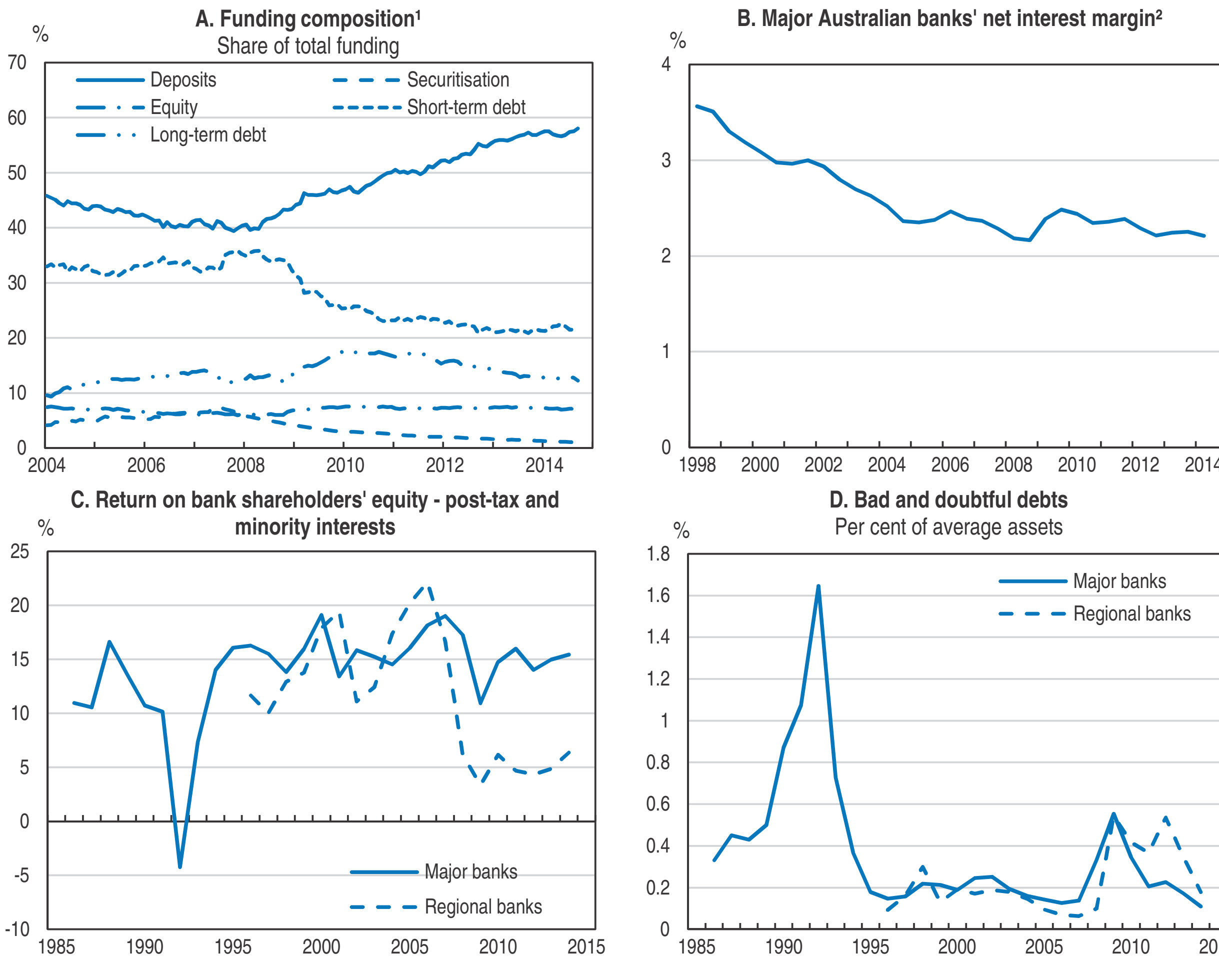
Strong prudential regulation and oversight undoubtedly helped Australia weather the global financial crisis. Various rules dissuading high-risk lending played a key role. In particular, conservative capital adequacy rules and reduced leverage protected the system and encouraged banks to focus portfolios on domestic and low-risk credit. Indicators show that the banking sector is currently in a strong prudential position; return on equity remains high as do capital adequacy ratios and there remains relatively little problematic debt (Figure 7).

Given the recent rapid increase in house prices, the Australian Prudential Regulation Authority's (APRA's) circulation of new draft guidelines on residential mortgage lending in May 2014 (APRA, 2014a) has been a sound move. For instance, the guidance outlines prudent practices in addressing housing credit risk for deposit taking institution's (ADI's), such as guidance on loan origination criteria, security valuation methods, the management of hardship loans and stress-testing. These guidelines are in addition to a review in 2013 on the loan serviceability standards. Also micro-prudential scrutiny (i.e. scrutiny on an institution-by-institution basis) has intensified, its effectiveness helped by the fact that the four major banks represent the bulk of the banking sector. This said, macro-prudential measures may become appropriate if a general slowing in lending is needed, and as a means of signalling concern and willingness to act to stabilise the financial system as a whole (i.e. announcement effects). Accordingly, the Council of Financial Regulators is continuing to monitor developments in the housing market (particularly in relation to investment housing) and is actively considering additional steps in order to reinforce appropriate lending practices.

### *Banks are strong, but the degree of concentration raises issues*

Australia's financial sector is in good health from a prudential perspective but there are concerns, particularly relating to the degree of concentration in banking. The global financial crisis strengthened the already dominant position of the four main banks, as two of them took over smaller banks over this period (Figure 7). Nevertheless, according to

Figure 7. **Banking sector indicators**




1. Short-term debt and long-term debt are adjusted for movements in foreign exchange rates. Short-term debt includes deposits and intragroup funding from non-residents.
2. The data refer to the major banks' public reports on net interest margins, excluding St. George Bank and Bankwest prior to the first half of 2009.

*Source:* Reserve Bank of Australia (2014), *Banks' Financial Reports*; Australian Prudential Regulation Authority (2014).

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available indicators it would appear that competition is robust. Indeed, net interest margins are near thirty-year lows and measures of consumer satisfaction are near record highs. However, the concentrated structure of the banking sector leaves no room for complacency for the Australian authorities in ensuring prudence is maintained and that there is strong competition in financial markets. A recent interim report from an inquiry of the financial system contains welcome discussion of these issues alongside suggestions for reform (Murray Report, 2014). It elaborates on avenues to reduce the problem that the four major banks are perceived as too-big-to-fail and, linked to this, that they benefit from a substantial implicit guarantee. For instance, the interim report suggests increasing powers to impose losses on creditors in the event of bank failure. As regards retail markets, the interim report identifies banks as benefitting from differences in risk-weighing systems in mortgage lending and is critical of the degree of competition in superannuation (i.e. pension fund) administrative fees. As regards business financing, the report notably suggests the creation of a credit registry to facilitate lending to small and medium-sized enterprises, and proposes facilitating bond financing by making it easier for companies to raise money using vanilla (i.e. simple) bonds. Follow-up on these suggestions for reform will await the final recommendations of the inquiry (which are due in November 2014).

**Recommendations on ensuring price and financial stability**

- **Continue intensive monitoring of the housing market**; Maintain deep micro-prudential oversight and consider using macro-prudential tools to bolster credit safeguards and signal concern.
- **Examine credit and competition issues in the financial sector**; Consider reducing banks' implicit guarantees, tackling risk-weighting advantages in mortgage lending, improving credit databases.

## Pursuing fiscal consolidation and ensuring efficient tax and public spending

### *A structural budget problem has emerged*

Compared with many OECD economies, particularly those in Europe, the scale of government spending and revenues in Australia have long been low and public debt light (Figure 8). Many policy approaches have involved a comparatively small fiscal commitment. These include, for example, the important role of mandatory saving into private pension funds ("superannuation") to ensure adequate incomes in retirement; the use of public-private partnerships for infrastructure development; and, extensive use of means testing in welfare assistance.

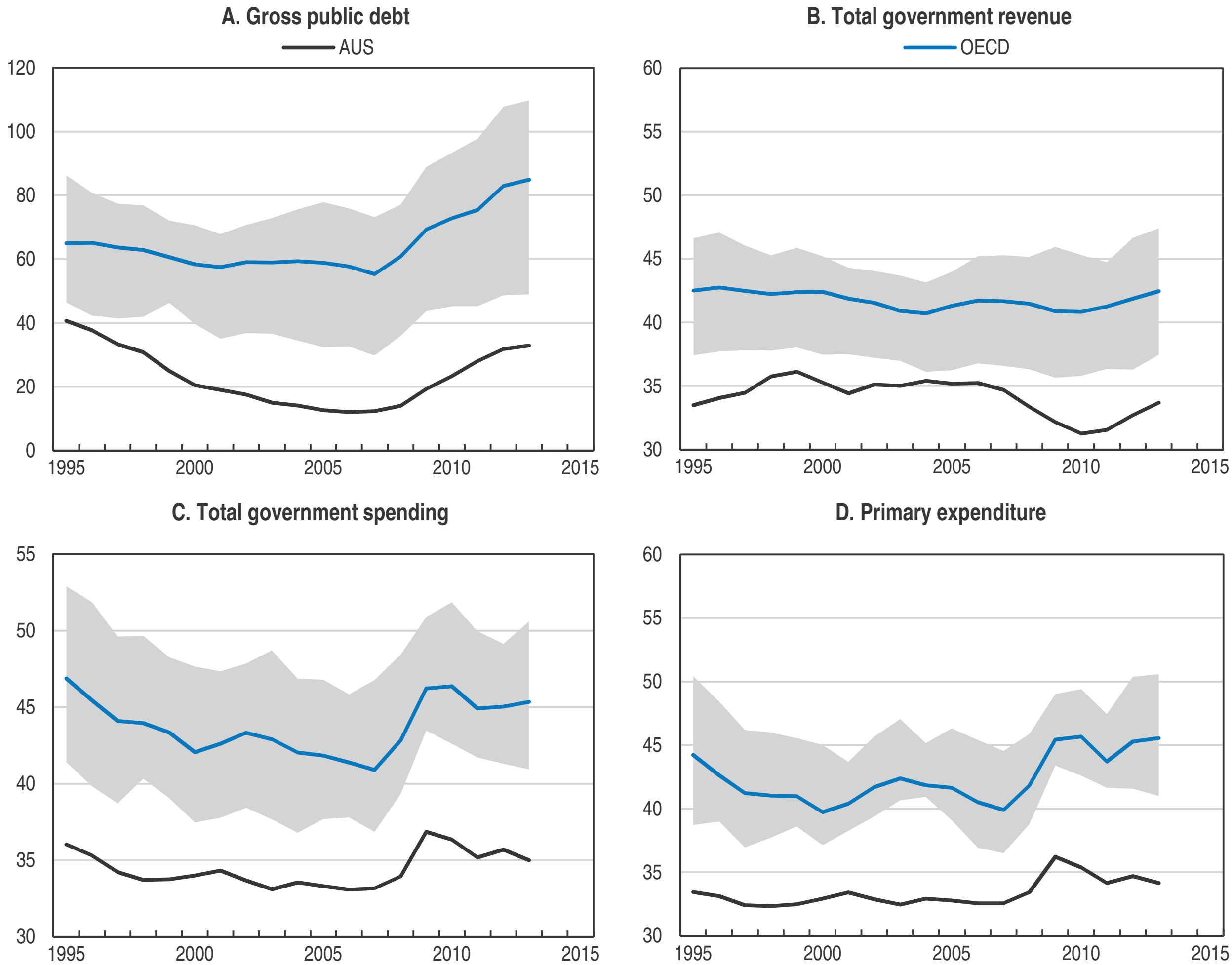
However, unusually for Australia, the general-government balance has been in deficit for the past six years and gross public debt has increased from 20 to 30% of GDP (Figure 9). Furthermore, in the absence of active fiscal consolidation measures, such as those presented in the government's budget, progress in deficit reduction is projected to be slow and somewhat bumpy (Figure 10, top left panel, "with budget measures"), even with the help of fiscal drag (notably, personal income tax thresholds are not indexed). The global economic crisis and associated fiscal stimulus, and more recently, the tailing off of resource-sector investment provide a partial explanation for the deficit situation. However, there has also been an over-commitment to costly spending initiatives and tax cuts (OECD, 2012a). Linkage between the boom and a ramping up of active spending measures (in the form of outgoings or tax expenditures) is illustrated in calculations of the cumulative value of such measures based on budget documents (Figure 11).

A conservative approach to public debt is important for Australia. Exposure to external risk, particularly from resource markets, implies possible shocks that would require substantial fiscal fire-power to offset. In addition, the substantial private sector debt, despite mitigating factors, also highlights the importance of a strong public sector balance sheet.

Australian fiscal policy is guided by a general principle of achieving a balanced budget (or surpluses) "over the cycle". Following this framework, the government aims for a budget surplus of over 1% of GDP by 2023-24 (Figure 12) through its "budget repair strategy". This strategy includes a commitment to more than offset new spending measures with reductions in spending elsewhere and a commitment to bank positive variations in receipts and payments from favourable economic conditions to the budget bottom-line. In the near term, the accounting impact of a one-off government grant to the RBA in 2013-14

Figure 8. **General government revenues, expenditures and debt**[1]

As a percentage of GDP




1. Data represent general-government accounts (i.e. including sub-national government accounts). The shaded area denotes the 25th to 75th percentile range of available data for OECD countries. OECD is a simple average of data for available countries.

*Source:* OECD (2014), *OECD Economic Outlook 96 Database* and OECD (2014), *Annual National Accounts Database*.

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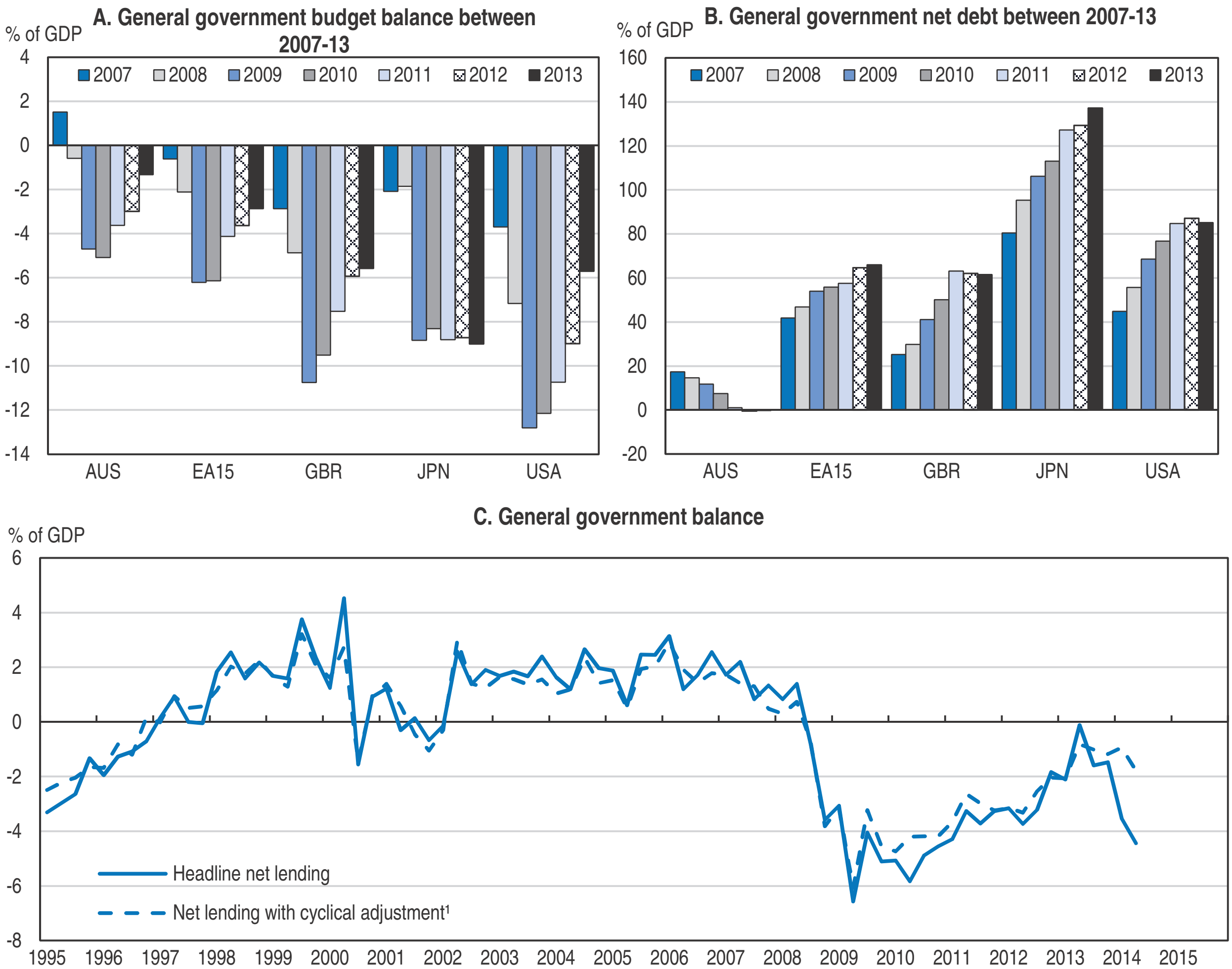
will technically generate consolidation of 0.6% of GDP in 2014-15 (Figure 12) and other factors will reduce the deficit too. Given this, new measures in the government's budget commendably do not add much to the consolidation between 2013-14 and 2014-15; the "new" measures on net only add about 0.1 percentage points to previously mandated consolidation. However, consolidation measures have a larger impact in the remaining years of the 4-year budget horizon, especially in 2017-18.

In terms of spending and tax measures, the 2014-15 Budget reflects a "small government", pro-business philosophy. It creates fiscal room for additional public spending on infrastructure, on the basis that this will boost jobs and productivity (as well as bring benefits for households). Other spending initiatives include a large increase in the generosity of paid parental leave and the establishment of a sizeable fund for medical research (Table 3). The fiscal savings for reaching the deficit targets and funding the new spending initiatives concentrate on economies in spending (in particular, welfare transfers) rather than on revenue-raising measures (Table 3). Some of the latter are temporary, in particular a new top-

Figure 9. **General government balance and net debt**




1. Adjusted for one offs.

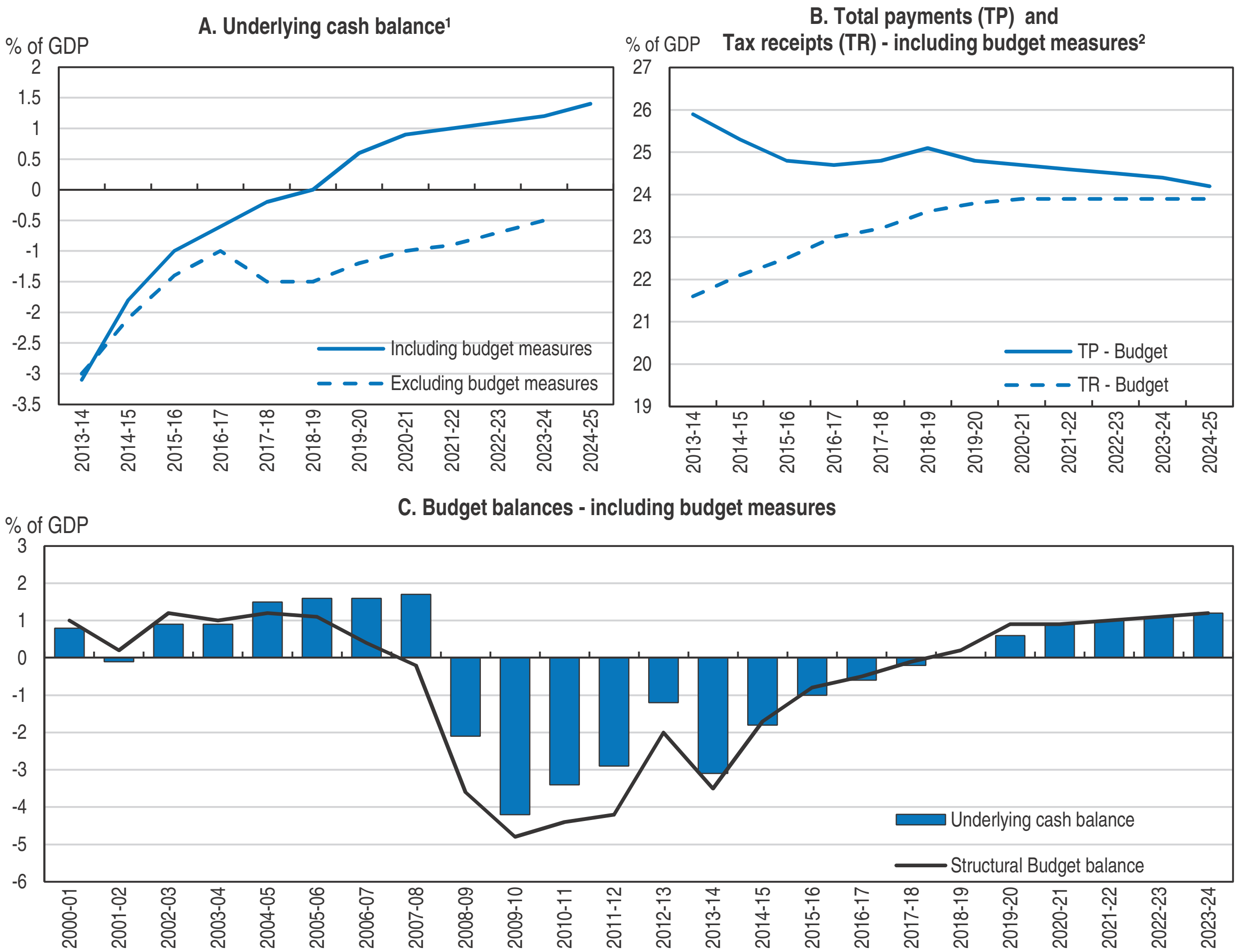
*Source:* OECD (2014), *OECD Economic Outlook 96 Database*.

StatLink http://dx.doi.org/10.1787/888933176471

end personal-income tax (the Temporary Budget Repair Levy) will be applied for only three years. Among the measures intended as permanent, the proposal to re-introduce indexing of excise on retail gasoline is a particularly commendable move.

Pursuit of budget surpluses should remain faithful to the cyclical tolerance embodied in the guiding principle of Australia's fiscal policy. In particular, policy should allow automatic stabilisers to cushion unanticipated shocks. For the longer term, policymakers should be mindful that in the Australian context there is no obvious virtue in accumulating a large war chest of net public assets, which could happen in the absence of downturns or if budget surpluses are pursued at all costs. True, there are future liabilities in pension and health spending, but Australia's challenges are not extraordinary on these fronts. In addition, considerable mineral wealth remains in the ground, the public component of which (for instance, that accumulated from royalties) is not included in estimates of general government assets.

Figure 10. **The Commonwealth government's medium-term fiscal outlook**




1. The underlying cash balance excludes Future Fund earnings and cash flows for investments for policy purposes. The "Business as usual series" notably assumes fiscal drag is allowed to operate throughout the time period. The series "Including budget measures" includes the fiscal impact of measures detailed in the 2014-15 Budget and imposes a revenue cap from 2021-22 onwards, which can be interpreted as a scenario in which the authorities decide to stop fiscal drag by, for instance, increasing thresholds in personal income tax.
2. Including the imposition of a tax cap.

*Source:* Australian Government (2014), *Budget Paper No. 1: Budget Strategy and Outlook 2014-15.*

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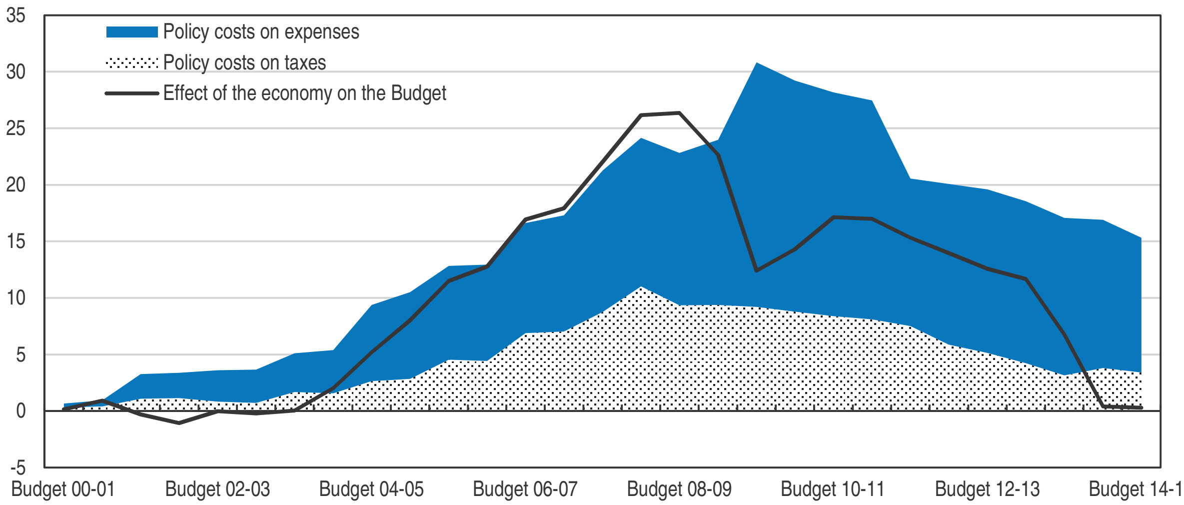
### *Options for embedding more disciplining mechanisms into federal-budget processes*

Avoiding inappropriate commitment of windfall natural-resource revenues could be helped by ring-fencing them through the establishment of a stabilisation fund, as recommended by previous *Economic Surveys*; or through greater use of existing funds, such as the Future Fund (OECD, 2010, 2012a). Such measures could insulate the budget from fluctuations in the resource-based revenues and, thereby de-link government spending decisions from revenue changes caused by shifting terms of trade.

On other fronts, the recent experience with reforms involving additional spending commitments over a prolonged period (such as the disability support reform), suggests strengthening the reporting requirements for spending commitments beyond the four-year budgeting horizon may be worthwhile. Also, some suggest stricter rules for when expenditures in a specific portfolio of the budget exceeds their target during the budget year (IMF, 2014). At

Figure 11. **The impact of policy decisions and the economy on the Commonwealth Budget**[1]

Cumulative totals from the 2000-01 budget onwards, as a percentage of GDP




1. These calculations are based on Commonwealth government budget documentation that identifies the amount of federal budget spending (and revenue) that is linked to policy measures, the remainder being driven by other factors that can be broadly be interpreted as influence of the economy on the budget. The data do not reflect the impact of the 2014-15 Budget.

*Source:* Deloitte Access Economics (2014), *Budget Monitor*, Issue No. 85, May 2014.

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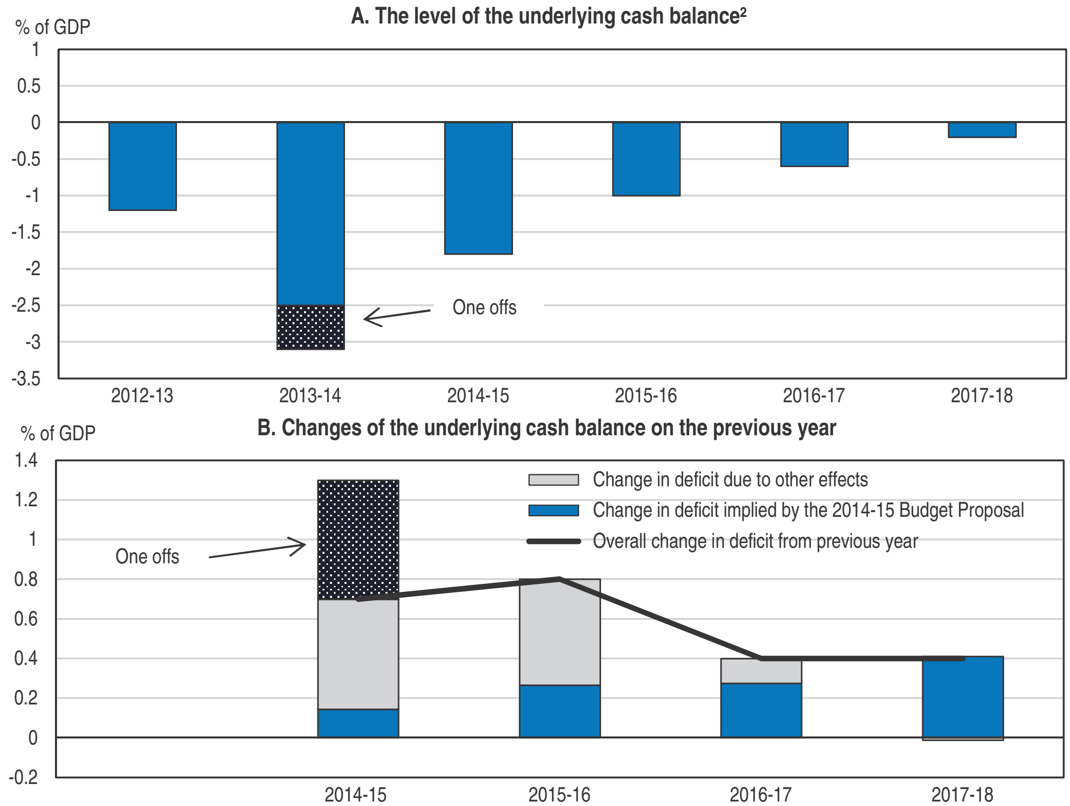
present the rules require submission of a supplementary budget but do not specify, for instance, whether this must be expenditure neutral. In addition, the Parliamentary Budget Office could play a stronger role, in particular: by reporting progress against the medium-term fiscal strategy in the Commonwealth budget (NCA, 2014); by extending the Treasury's Intergenerational Report to all governments; and, by examining shared federal and state responsibilities in areas such as health and education (see below and OECD, 2012a).

### *There is room for a more growth-friendly tax mix*

The government has initiated a review of taxation, which provides an opportunity to improve the efficiency of the existing system, including the tax mix where Australia has a lower component of indirect taxation (Chapter 1 and Figure 13) and a larger contribution from income tax on households and businesses compared with many other OECD countries. In principle, maintaining a low share of taxes that directly affect business costs and margins (with correspondingly greater weight for indirect taxation) is better for economic growth (Johansson et al., 2008). As recommended in previous OECD surveys, shifting the tax mix could include broadening the base and raising the rate of the Goods and Services Tax (GST) and increasing the use of land taxes, combined with (fiscal conditions permitting), a reduction in the rate of corporate tax, and rate cuts and threshold increases in personal-income tax.

With a rate of only 10% and fairly widespread exemptions, GST raises only half the revenues (as a share of GDP) compared with the OECD average and significantly less than the countries making the most use of such tax (Figure 13). Consequently, the tax burden falls more on other taxes, including those on labour and business. Raising GST revenues by raising the rate or removing exemptions can prompt concerns, as the exemptions in particular typically originate from distributional considerations. However, the efficiency of exemptions in VAT-type taxation as a redistributive mechanism is low (as all households

Figure 12. **Deficit reduction according to the 2014-15 budget**[1]




1. The Commonwealth deficit in 2013-14 has been increased by a government grant to the RBA for restocking a buffer fund which is equivalent to 0.6 per cent of GDP.
2. The deficit refers to the underlying cash balance which excludes Future Funds earnings and payments.

*Source:* Australian Government (2014), *Budget Paper No. 1: Budget Strategy and Outlook 2014-15*; and OECD calculations based on Statement 3, Table 5 of this publication.

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benefit from them) and such concerns can anyway be addressed through welfare policies. Any changes to the current GST rate or base would require the agreement of both state and federal levels of government under existing legislative settings.

### *Reforming state-level financing – raising autonomy and responsibility*

Australia's federal system is currently under the spotlight not only in this review but also by the government that has committed to a white paper on the federation. Over time the Australian federal system has gradually become more centralised (see Chapter 2). States have wide-ranging spending responsibilities, including public schools and hospitals, public housing, and transport, but federal influence over resource allocation and policy has tended to increase. Compared to other federal OECD countries, sub-national spending (as a share of total government spending) is similar to that in the United States and Spain, but less than in Switzerland or Canada (Figure 14). Australian states' "own revenues" account for only about half of their total revenue, the remainder being covered by federal transfers, i.e. there is a large vertical fiscal imbalance (Figure 15). These transfers include various types of "tied" grant plus the transfer of all GST revenues. GST is governed by national legislation and administered centrally. It is distributed across the states according to a system of full horizontal equalisation, which some argue is overly sophisticated (Kirchner, 2013).

Table 3. **Notable measures proposed in the 2014-15 budget, impact on the fiscal balance, AUD billions**

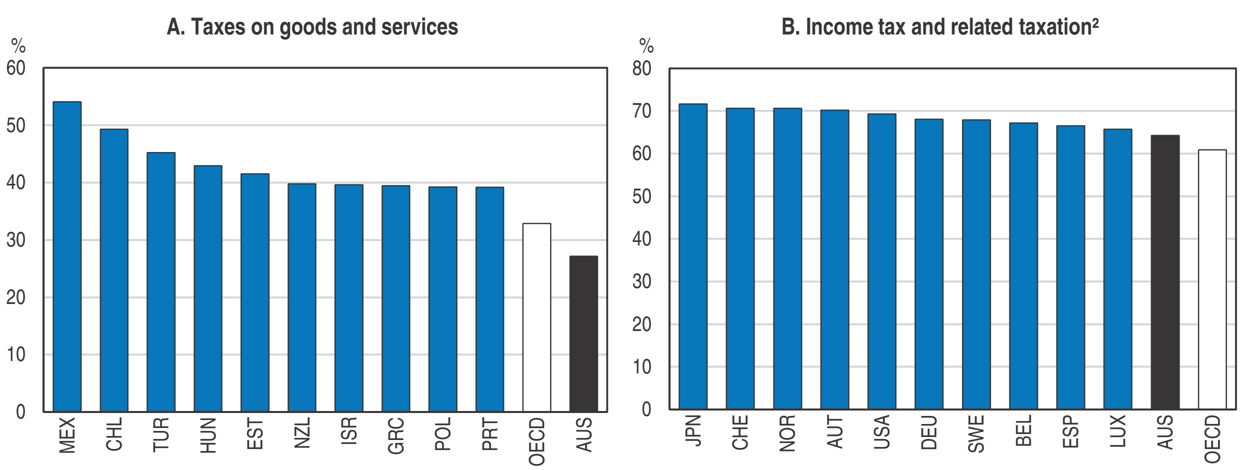
| Measure | Budgeted value of major items 2014-15[1] | … over the budget horizon 2014-15 to 2017-18 |
|---|---|---|
| **New spending initiatives[2]** | **-140** | **-15.0** |
| Increased infrastructure spending ("Infrastructure Growth Package") | -0.6 | -8.5 |
| Subsidies for taking on older workers ("Restart") | -0.2 | -0.5 |
| Establishment of a medical research fund | 0 | -0.3 |
| **Revenue-increasing measures** | **0.8** | **6.6** |
| Re-introduction of indexing on gasoline excise | 0.2 | 2.2 |
| A temporary additional top-end personal income tax (the "Temporary Budget Repair Levy") | 0.6 | 3.1 |
| **Savings in public spending: welfare, education, healthcare** | **2.6** | **27.1** |
| Welfare pay-outs for working-age households: threshold freezes, reduced indexing, reduced scope of Family Tax Benefit B, tougher benefit eligibility for under 30s | 1.0 | 10.7 |
| Support for the elderly including less generous indexing on pension pay-outs | 0.6 | 3.0 |
| Health care, including new co-payments and reduced rebates for some Medicare services and a freeze to the indexation of income thresholds for theprivate health insurance rebates | 0.5 | 8.1 |
| Education, including reduced generosity of commonwealth supported student loans | 0.5 | 5.2 |
| Economies in transfers to the States for hospital care and education[3] | | |
| **Savings in public spending: Other** | **0.7** | **8.0** |
| Reduced foreign aid commitments | 0.6 | 7.0 |

1. Totals underestimate the total budgeted amounts because numerous smaller items are not included.
2. Expansion of parental leave is also a major initiative but detailed estimates were not included in the 2014-15 budget documentation.
3. Scheduled to start only in the final year of the budget horizon or beyond it.

*Source:* Based on Australian Government, 2014, Budget 2014-15, Overview, Annex C, Major Initiatives; and Annex D, Major Savings.

Figure 13. **Tax revenue by sector relative to top OECD countries[1]**

As a share of total taxation, 2011




1. Panels A and B show national accounts general government data (i.e. including sub-national government) on a calendar year basis and using a standardised international classification. OECD refers to a simple average based on 32 OECD countries.
2. Income tax and related taxation comprise taxes on income, profits and capital gains, social security constributions and taxes on payroll and workforce.

*Source:* OECD (2014), *Revenue Statistics Database*.

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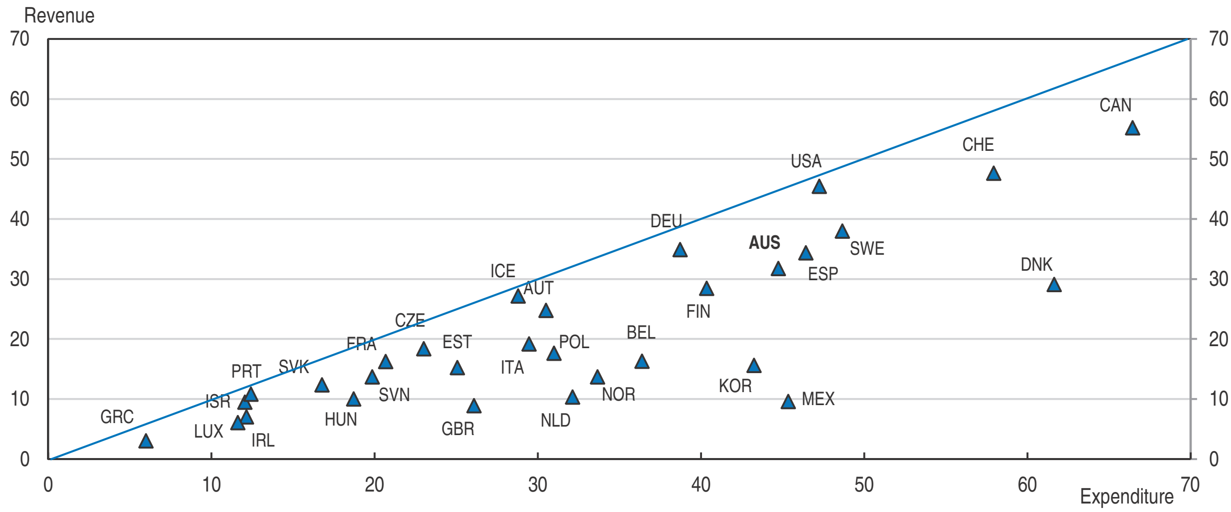
Figure 14. **Fiscal decentralisation**

Sub-national shares of revenue and expenditure in per cent of total general government, 2012 or latest year[1]

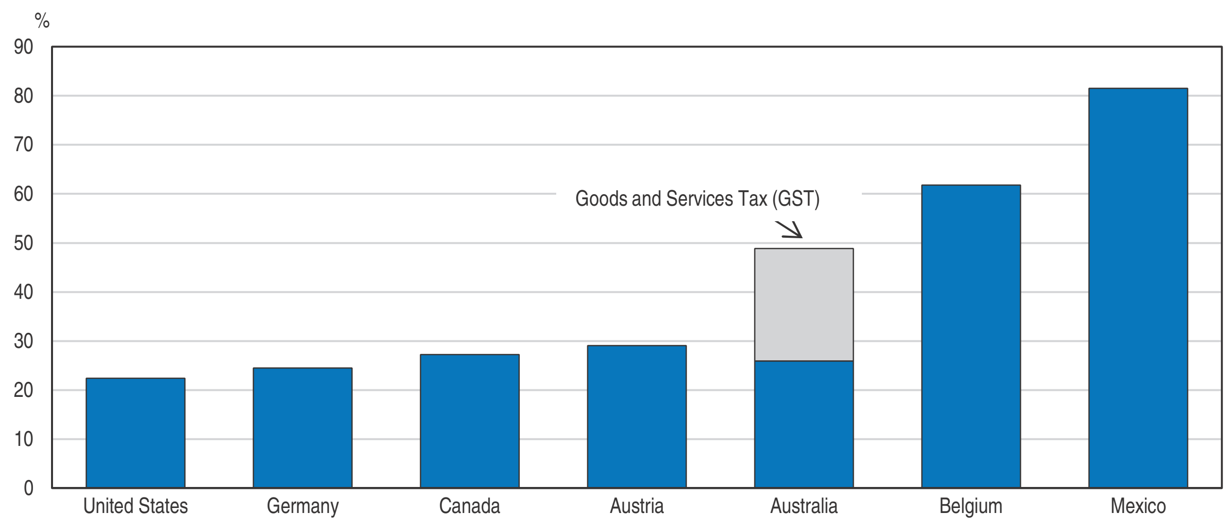



1. Data refer to 2011 for Korea and Mexico and to 2010 for Canada. Revenue does not include intergovernmental transfers. For Australia, data refer to the financial year 2011-12.

*Source:* OECD (2014), *Fiscal Decentralisation Database*; ABS, *Government Finance Statistics 2011-12* (Cat. No. 5512.0).

StatLink http://dx.doi.org/10.1787/888933176526

Figure 15. **Vertical fiscal imbalance: A comparison with other federations**




1. The vertical fiscal imbalance (VFI) is defined as the total of federal payments to total sub-national revenue. For Australia, VFI is the share of Commonwealth payments in total state revenue. Data refer to 2011 and in the case of Canada to 2010.

*Source:* International Monetary Fund (2013), *Government Finance Statistics Yearbook*; Australian National Authorities.

StatLink http://dx.doi.org/10.1787/888933176539

Broadly speaking, federal fiscal relations would be improved by less central government steerage, giving states more financing autonomy but also more responsibility. The government has recognised this including through statements that state governments should be sovereign within their own sphere. One route is to reduce the strings attached to Commonwealth grants ("conditionality"). There have been attempts to do so in reforms that also sought to reduce complexity and administration costs (Warren, 2006; Ward, 2009; Ramamurty, 2012). In particular, a major reform in 2008, the Intergovernmental Agreement on Federal Financial Relations, replaced the numerous tied grants with a small number of much less prescriptive transfers (National Specific Purpose Payments).

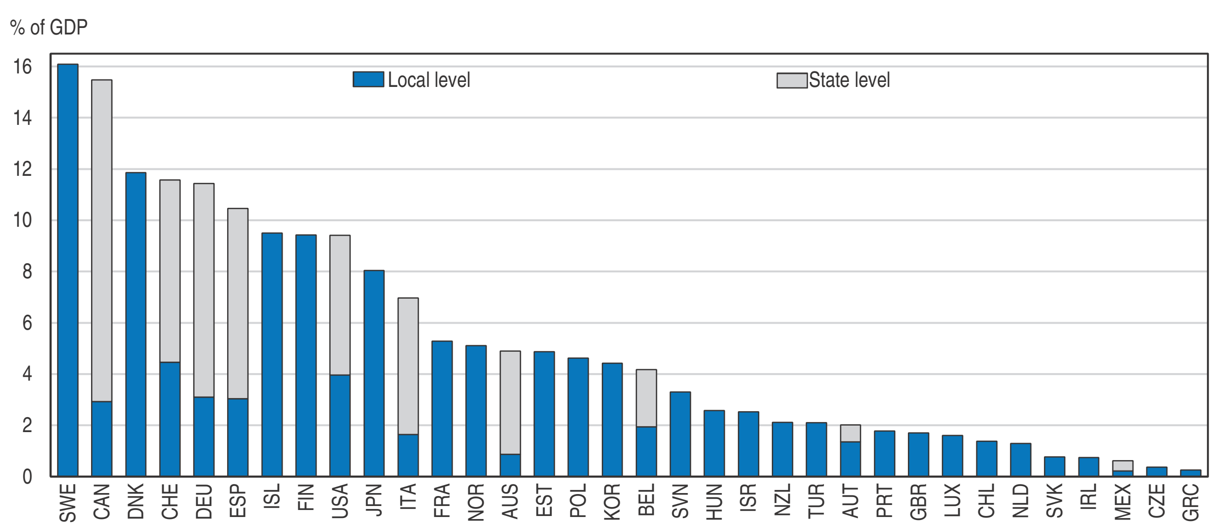
However the 2008 reform was weakened by rapid growth in a new form of grant via National Partnership Agreements. Designed to deliver national reforms, these agreements are funded by grants containing conditionality clauses. As of mid-2013, there were over 140 such agreements with the corresponding payments (National Partnership Payments) accounting for about a third of all tied grants. In addition, the growing number of partnerships has increased administrative and reporting costs, according to a recent monitoring report (CRC, 2013a). Encouragingly, the current government intends to reduce the role of these agreements. However, reform could go further by converting some types of National Partnership Payments into National Specific Purpose Payments (OECD, 2012b).

Reducing the vertical fiscal imbalance by increasing states' own revenues and reducing the role of grants in state funding potentially increases accountability and reduces "blame-shifting" between levels of government, consequently improving the efficiency of public-service delivery (see Chapter 2 and BCA, 2013; NCA, 2014). Indeed, recent OECD work concludes, using Canada as a benchmark, that tax decentralisation could have a positive impact on Australian growth (OECD, 2013a). However, such gains would most likely only arise if incentives on each level of government for efficient revenue raising and service provision were improved.

There is considerable room to improve the efficiency of sub-national taxation. Total sub-national tax revenue is equivalent to about 5% of GDP (Figure 16). A significant share of state taxation is from distortionary transaction taxes (for instance stamp duties on real-estate transactions). Furthermore, tax bases that have some merit economically have significant exemptions and concessions. For instance, only about 5% of businesses are liable for state payroll tax. In addition, the state land-tax base should be broadened to include owner-occupied housing and other exempted assets. There is also scope to

Figure 16. **Sub-central tax revenue**[1]

2008




1. Taxes where sub-central governments have power to set the tax base and/or the tax rates, as a percentage of GDP. Local governments in the United States have a wide variety of taxing powers but it is not possible to identify the share of each.

*Source:* OECD (2014), *Fiscal Decentralisation Database*.

StatLink http://dx.doi.org/10.1787/888933176544

increase the utilisation of the rates base by sub-national governments (Figure 16). Municipal rates are applied broadly across all residential land, with few exemptions, and are based usually on the unimproved capital value of land. They are considered to be an efficient tax base (see, for example, Australian Government, 2009; and Lambert, 2011). One sub-national government (the Australian Capital Territory) had announced a plan for a 20 year transition from transaction taxes to general municipal rates. The abolition of distortionary state taxes could also be facilitated by a broadening of the efficient tax bases and/or an increase in the GST (following an adjustment in its base and/or rates, see Chapter 1). This could also contribute to a shift towards lower vertical imbalance, in addition to increasing efficiency.

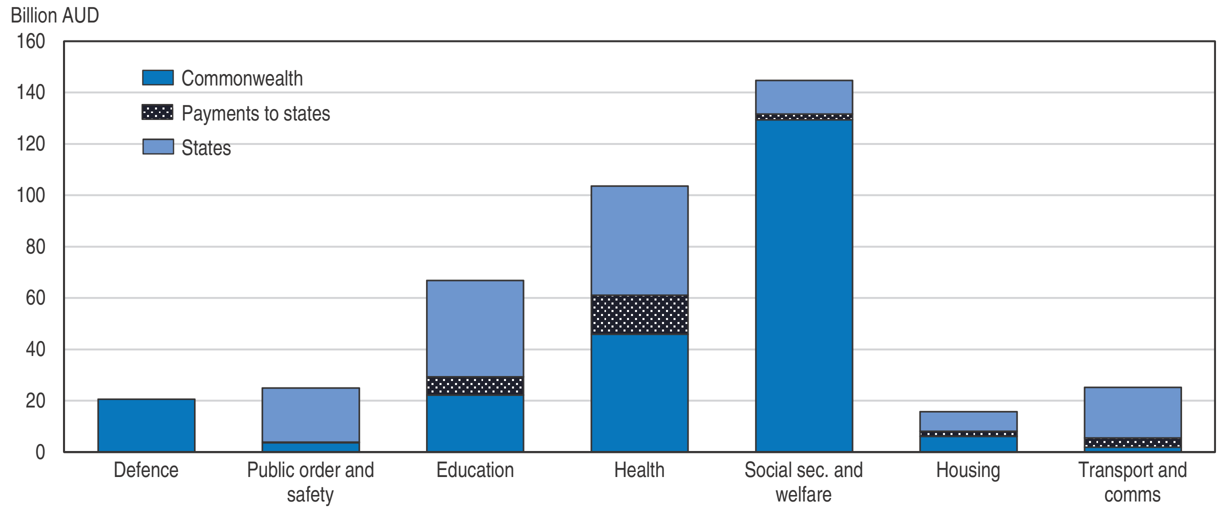
Better utilisation of relatively efficient existing sub-national tax bases should be a priority, but if additional "own-revenue" is warranted to reduce vertical fiscal imbalance as part of a broad reform of the federation, a state-level personal income tax (PIT) could be considered. The reform should also dovetail with the recommendations made elsewhere in this *Survey* for a shift towards less reliance on direct taxation at the national level. This could imply that the federal government "makes room" by lowering its personal income tax to accommodate both state-level PIT and national tax reform (OECD, 2006; Australian Government, 2009; NCA, 2014). Various approaches to state-level PIT can be taken, such as a system where states are allowed to set their rate while keeping a unified base throughout the country (a so-called "piggyback" system). This is likely to involve some economic costs, such as the erosion of the base assigned to states due to horizontal competition and efficiency loss, particularly if multiple rates are applied across jurisdictions. Moreover, state-level PIT might make future reform of the income tax base more difficult, given the involvement of more government levels in its determination. However, vertical tax competition (i.e. competition of different levels of government for the same tax base) could partly offset the impact of horizontal competition, according to recent OECD analysis (OECD, 2013a). To reduce complexity and potential inefficiencies from different PIT tax rates across states, individual rates could be set within a nationally agreed band. Moreover, piggybacking state-level PIT on national taxation would limit significantly administration costs, since such tax would be centrally administrated and collected (Fedelino and Ter-Minassian, 2010), although there could be increased red-tape and compliance costs around determining the state in which income is earned. Sub-central income taxes features in many advanced economies, but international experience varies. In Canada, for example, most provinces impose their tax rates on the federal income tax base (modified slightly by provincial and credits rebates), which is collected and administrated centrally (except for Québec). Meanwhile, the Nordic countries apply flat, locally set tax rates, imposed on a common tax base and collected centrally (Bird and Smart, 2010). Furthermore, in the United States and Switzerland, the federal and state levels set PIT rates and bases separately. Any increased revenue powers must go hand in hand with increased responsibility and accountability such that states have strong incentives for maintaining wide tax bases.

### *Some shared federal-state service provision does not work as well as it could*

Responsibilities for most public services are divided between state and federal governments (Figure 17) and in some cases this creates wasteful duplication and cost- and blame-shifting. The 2008 Intergovernmental Agreement clarified roles and responsibilities to a point, but the recent National Commission of Audit indicates continuing difficulties (NCA, 2014). Health care suffers from the greatest challenges in this regard. The Commonwealth

Figure 17. **Decomposition of government expenditure by function**

2012-13




*Source:* Australian Bureau of Statistics (2014), *Government Finance Statistics* 5512.0; Commonwealth Final Budget Outcome 2012-13; Australian National Authorities.

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government is responsible for funding most primary care (notably general practitioners) while the states manage public hospitals. This is a more complex mix of funding arrangements than in, for instance, Belgium or Switzerland (see Chapter 2 and Warren, 2006). Cost-sharing risks feature prominently; for instance, public hospitals can refer discharged patients to general practitioners, rather than providing post-operative services themselves (OECD, 2006; Anderson, 2012). In education, shared responsibilities in schools give rise to complex and opaque funding arrangements, with concerns about the efficiency of service provision. Considerable state-Commonwealth overlap is also found in the regulation and funding of vocational education and training, leading possibly to weak outcomes relative to the public money spent, as assessed by the National Commission of Audit (NCA, 2014).

Further efforts to clarify roles and encourage co-ordination should continue, not only in health care and education but in other sectors such as housing and infrastructure. For example, on the basis of existing reports, success has been limited, so far, in addressing homelessness, and especially improving housing affordability outcomes (CRC, 2012, 2013b; NCA, 2014). However, for some public services clarifying roles and better co-ordination may not prove enough and re-allocating responsibilities between the federal and state governments may be best. For example, the National Commission of Audit report makes a case for states managing the allocation of funding for all schools, so as to remove the current fragmentation across the different segments of the school system on this front (NCA, 2014). The scale of federal-state co-ordination problems in health care also suggests that a reallocation of responsibilities may be the best route. The government's commitment to produce by the end of 2015 a White Paper on reforming federation with consultation with the states in this process is welcome.

### *There is room to further improve state-level performance indicators*

Enabling quantifiable comparison across states in outcomes in public services is an important channel for detecting inefficiency and poor service quality, helping states learn from each other, and increasing public accountability. Since 1993, an annual Report on Government Services has monitored the effectiveness and efficiency in public service provision, publishing performance information on key areas such as health and education (SCRGSP, 2014). The 2008 Intergovernmental Agreement sought to make additional progress through its focus on "outcomes and outputs" monitoring and increasing requirements for performance reporting (Chapter 2). However, data-quality still varies widely with outdated or unavailable data in a number of areas; a greater focus on outcomes is required (CRC, 2013a); simple and easy-to-quantify audit targets are essential if operational efficiency is to be enhanced (OECD, 2006).

**Recommendations on pursuing fiscal consolidation and ensuring efficient tax and public spending**

- **Prioritise medium-term fiscal consolidation** to rebuild fiscal buffers in light of Australia's exposure to external risk. Consider establishing a stabilisation fund.
- **Rebalance the tax mix**; Shift away from income and transaction taxes, make greater use of efficient tax bases such as the Goods and Services Tax and land tax.
- **Reform federal-state financial relations**; Reduce grant conditionality further, instigate state-level tax reforms to enhance funding autonomy, and increase state-level responsibilities and accountabilities.
- **Address federal-state shared responsibilities to improve efficiency**; Improve co-ordination and co-operation and in some cases, health care in particular, consider a reallocation of responsibilities.
- **Strengthen capacity for assessing and comparing state-level public services**; Further develop performance indicators; and continue enhancing the availability and quality of data.

## Improving framework conditions for business

Recent decades have seen large improvements in the structure and tone of policies that shape the business sector and its capacity for productivity growth and its capacity to adjustment, which is particularly relevant in the wake of the mining boom. The relatively light overall tax burden, a low inflation environment, flexibility in labour regulation and a welfare-to-work approach in social policy have all helped. Nevertheless, there remains work to be done. The following sections assess the immediate operational challenges. However, establishing good "higher level" processes for identifying and analysing structural weak spots matter too. While Australia's institutional framework on this front is good, there may be ways of ensuring it is used to maximum effect. For instance, the Productivity Commission could be tasked with producing a regular review of structural policy that focuses on identifying new areas for reform.

### *Infrastructure is receiving much attention*

There are several avenues for significant improvement in Australia's infrastructure, progress on which can potentially make business operations easier, improve firms' capacities for productivity growth, and raise households' material living standards. Shortfalls in transport infrastructure are prominent and the 2014-15 budget proposed to address these with the AUD 11.6 billion Infrastructure Growth Package, taking total Commonwealth expenditure to AUD 50 billion by 2020. Some of this additional funding will go to states that sell assets to help fund new infrastructure (the Asset Recycling Initiative). As regards telecommunications, the government is committed to continuing rolling out a major upgrade of physical infrastructure (the National Broadband Network). Meanwhile in the energy sector, some aspects of regulation are believed to generate uneconomic infrastructure commitments, and a white paper is due to report on this (and other issues for the sector) at the end of 2014. Similarly, the authorities are pressing on with implementation of the Murray-Darling Basin Plan (see section on environmental policy below). The government advisory body, Infrastructure Australia, is undertaking two audits, a Northern Australia Audit and a National Audit; the latter will be used to develop a 15-year infrastructure plan.

As underscored in a previous *Survey* (OECD, 2010), ensuring efficient use of existing infrastructure and sound choices about new investment requires clear objectives, good co-ordination between federal and state governments, and extensive application of economic analysis. Infrastructure Australia's stocktake of infrastructure and the development of a 15-year plan mentioned above will help in this regard. In addition, new governance arrangements have been introduced for the advisory body Infrastructure Australia that aim to increase independence and transparency. Also, the Productivity Commission has recently completed a review into public infrastructure project costs and funding arrangements. Good practice has to extend in particular to public-private partnerships. Past experience on this front has been mixed. A recent report (Productivity Commission, 2014a) concludes that successful examples include Melbourne's Citylink and Sydney's Eastern Distributor road networks. By contrast, the Victoria government's contract with Latrobe Regional hospital and the Sydney Airport link are cited as cases where the contract worked out badly for government finances and the Clem7 motorway in Queensland a case where the private-sector partner experienced difficulties.

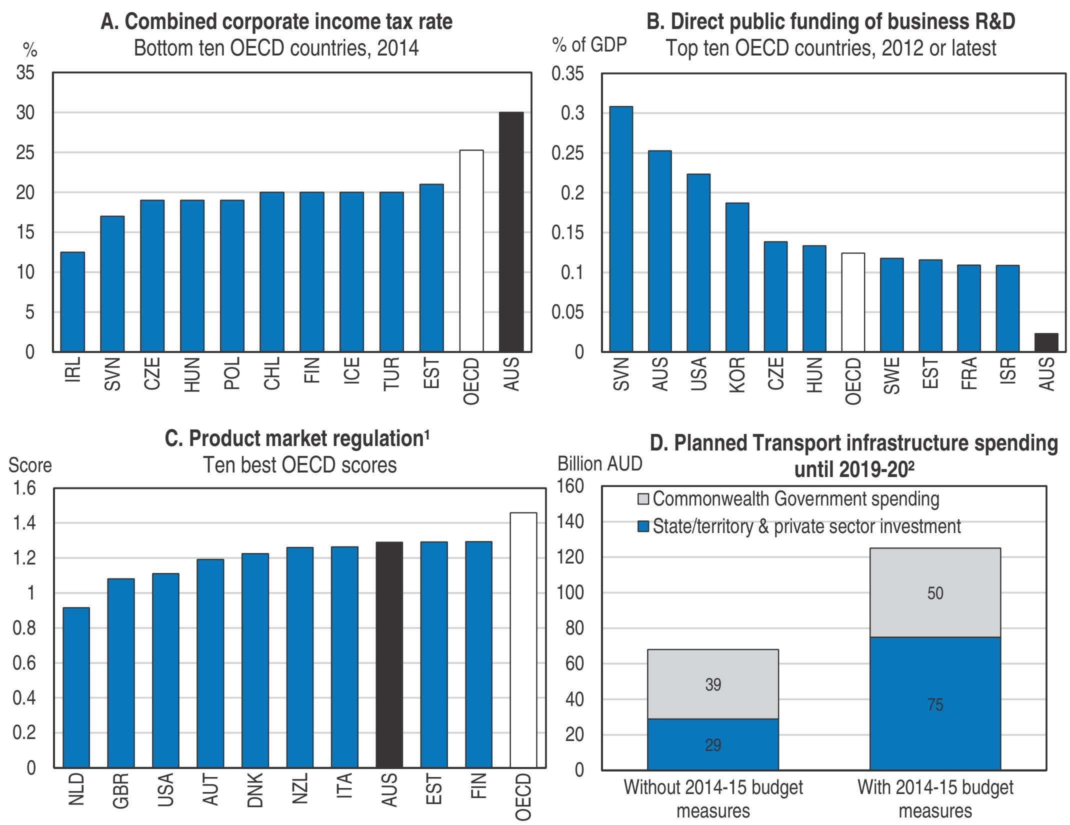
### *A new campaign to cut red tape is underway*

Australia's international ranking in red-tape indicators has long been favourable. For instance in the World Bank's Ease of Doing Business composite measure, Australia ranks 11th out of nearly 190 countries and scores well in the OECD's product-market-regulation index too (Figure 18). Seeking further improvement, the government's plans to remove redundant regulation and legislation can only be applauded in principle, and in practice as long as sufficient care is taken to ensure axed items are genuinely superfluous. In addition, the government has set a AUD 1 billion per annum compliance cost reduction target, toward which the Australian Tax Office has announced measures expected to provide savings exceeding AUD 250 million each year (Chapter 1). In addition, a large number of legislative acts and instruments have been submitted for abolition and two "repeal days" per year in the parliamentary calendar are planned. Furthermore, the government is following through on a programme of simplification in tax and superannuation regulation that was initiated by the previous administration.

### *There is room to rebalance business taxation and support schemes*

As discussed above, Australia's economy would benefit from a shift away from direct to indirect taxation (Chapter 1). Under such reform, and as previous *Surveys* have suggested, reducing the headline corporate-income tax rate should have a high priority (Figure 18). The government intends to cut the corporate-tax rate by 1.5 percentage points to 28.5% from July 2015. However an offsetting levy of 1.5% will be imposed on taxable

Figure 18. **Indicators on business policy**




1. A higher score indicates higher barriers. OECD is a simple average of the OECD member countries.
2. Commonwealth Government Budget 2014-15, *Budget Overview*, p. 15. The data do not include other potential sources of investment in transport, for instance the private-sector funding stimulated by the Asset Recycling Initiative.

*Source:* OECD (2014), *Tax Database 2014*; OECD, *Main Science and Technology Indicators* (MSTI) *Database*; OECD (2014), *Product Market Regulation Database 2013*; and Australia, Budget 2014-15.

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corporate income above a threshold of AUD 5 million, which implies that broadly speaking the effective rate of corporate tax will be lower for small and medium-sized enterprises (the levy is nominally linked to funding paid parental leave, see below). The implicit support this provides for smaller enterprises may not be appropriate. Support for small-and-medium enterprise is perhaps better delivered through existing programs that address shortfalls in expertise and specialisation for handling regulation and administrative processes and in conducting marketing campaigns for exports.

However, tax policy should not be a one-way street favouring immediate business interests. There have been difficulties in bringing in an effective operational tax on supernormal profits in the mineral sector, even though such a tax operates in the petroleum sector (Chapter 1). Indeed, the current government has abolished the recently introduced Mineral Resource Rent Tax. A tax on supernormal profit (as previously recommended) would be less dissuasive to investment and exploration compared with royalties as it is only imposed if profits surpass a level compatible with that of a competitive market. However, royalties can fulfil a useful role as they deliver a more regular and predictable revenue stream. On other fronts, campaigns against tax evasion and aggressive avoidance should continue. Furthermore, policies need to shape business incentives and behaviour in the environmental sphere (see environment section below) as well.

Between late 2013 and early 2014 closures of Australia's remaining three automobile assembly plants were announced by the respective companies, marking the end of an era and reflecting healthy resistance to appeals for further support for the industry. Also, the present government has proposed cutbacks or resisted further claims for support in other sectors. This firm line should continue with other inefficient business support (Chapter 1). In particular, the states should consider reintroducing a pact to avoid uneconomic inter-state bidding wars for mobile capital. Furthermore, the bodies involved in setting up state-level agreements with mining companies should ensure a co-ordinated and common front in negotiation on tax and other issues.

### *Ensuring strong competition will require continual attention*

In telecommunications and energy sectors, market-oriented systems have been operating for some time and the scores in these sectors in the OECD's product-market-regulation data are reasonable. However, as mentioned above, challenges remain as regards infrastructure. In addition, the inherently complex nature of network industry regulation and oversight requires ongoing attention with a view to further improvement. As regards the electricity sector and echoing previous *Surveys* (for instance, OECD, 2010), a recent report (Productivity Commission, 2013) recommends, inter alia, expediting the installation of smart meters, re-examining provision requirements and greater benchmarking between providers. The white paper on the energy sector mentioned above will also cover these issues.

As regards ensuring healthy competition in the economy more generally, the government has commendably initiated a review of competition laws and policy. It is the first major review since 1993 and therefore an opportunity to realign institutional frameworks and legislation to reflect the changes in the Australian economy since that time. The final report is due for completion by the end of March 2015.

**Recommendations on improving framework conditions for business**

- **Ensure infrastructure delivers value for money** through robust and transparent cost-benefit analysis both to ensure economic use of the existing stock and appropriate selection of new infrastructure projects.
- **Concentrate on broad support for business**; Prioritise corporate-tax rate cuts, reduce regulatory burdens and continue to be tough on corporate welfare and tax avoidance.
- **Strengthen competition**; Continue adjusting network-industry regulation and improve the competitive environment more generally in light of the review currently underway.

## Encouraging employment, deepening skills and addressing inequality

### *Mixed progress in improving households' tax-benefit situation*

Australia's tax-benefit system features light fiscal revenue demands compared to many other countries and correspondingly low tax wedges on labour, which are a plus for employment and competitiveness (Chapter 1). Also, there has long been an emphasis on "welfare-to-work" incentives and activation schemes. Fixed-rate, means-tested unemployment benefits are modest (indeed, past *Surveys* have recommended increasing payments in the initial months of unemployment). Unemployment benefits are accompanied by activity testing and activation programmes through privately run jobs centres operating under contract with the federal government. Means testing, which exists throughout the benefit system, results in more tightly targeted welfare spending compared with many countries.

One of the government's flagship reforms proposes a substantial increase in publically funded paid parental leave. Currently, 18 weeks' pay out at the minimum wage is provided; the proposal is for a benefit providing up to 26 weeks' pay at previous earnings or the minimum wage (whichever is greater) and superannuation contributions will also be paid. Under current proposals the pay-out will be capped at AUD 50 000 in total for the six months, which is equivalent to a little over the average full-time wage. Linking paid parental leave to previous earnings will bring Australian policy closer to practice elsewhere and such financial support during the early days of parenting broadly encourages labour supply and facilitates greater parental involvement in the first months after children are born. Also, the provision of superannuation contributions will help improve the retirement savings of women. However, as for any substantial increase in funding on a specific mechanism, there should be careful impact assessment to check that the move stacks up favourably against a more diversified strategy given there may be diminishing marginal returns. In this vein, a recent draft report of child-care issues (Productivity Commission, 2014b) does question whether the scale of parental leave expansion is appropriate; suggesting the diversion of some funding for the proposed scheme to other aspects of family policy.

Plans to continue implementation of the National Disability Insurance Scheme will ensure much-needed roll-out of improved disability services and will increase capacity for coping with population ageing. Dealing with the latter will also be helped if, as intended by the current administration, further increases in the Age Pension age are scheduled (see Table 2). Elsewhere in the pension system, overly generous tax treatment of the second-pillar pension in particular needs tackling, as this especially benefits middle- and upper-income households where concerns about savings incentives and pension adequacy are not paramount (Chapter 1). In terms of encouraging employment among older cohorts, the government's proposal to give employers up to AUD 10 000 over a two-year period for taking on long-term unemployed aged over 50 years can potentially be a useful addition to activation policy. However, careful attention to the scheme's design is needed to avoid deadweight loss and to prevent employers from gaming the programme, with this in mind the authorities intend to implement a monitoring and compliance strategy to mitigate and treat these risks.

The merits of the welfare reforms proposed by the government must be evaluated on a case by case basis. Information so far available on proposals for unemployment-benefit reform indicates significant tightening of eligibility for those unemployed aged under 30. These include substantially longer benefit waiting periods (although with a number of exemptions), during which jobseekers will receive job search support from employment-service providers. The proposals will certainly motivate some to seek and take up work (or go into further education). However, the precise impact of such reform is difficult to predict; close monitoring, and adjustment as appropriate, is important.

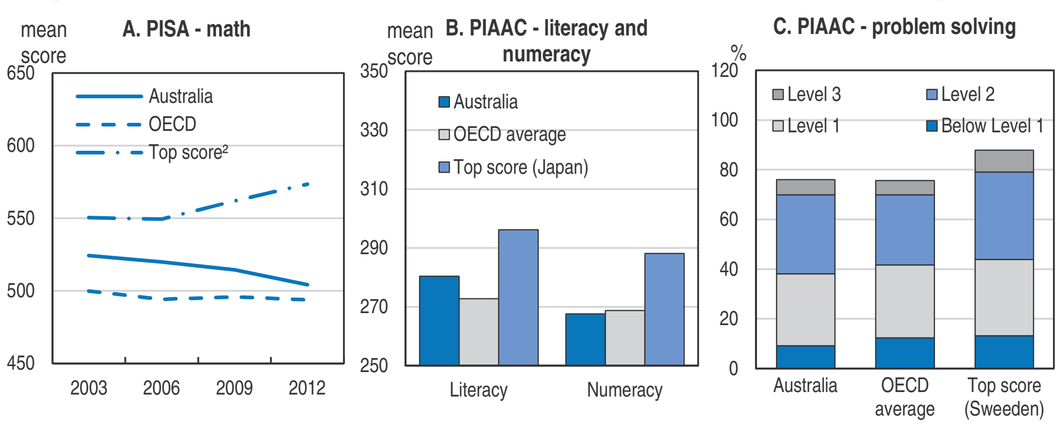
In addition, some of the savings proposed via reduced generosity in indexing will likely become unsustainable over the long term. This particularly applies to the Age Pension which is a means-tested benefit intended as a safety net for older households. The net replacement rate from this benefit is a little under 60% (the OECD average is 67% for similar benefits; OECD, 2013b) at half average earnings and less than half this at average earnings. The Age Pension is not the only form of support for the elderly (which include, notably, access to universal health care, concessions on pharmaceutical and other government services, tax concessions and aged care services), and high levels of home ownership and increasingly private savings through superannuation contribute to retirees' material well-being. Nevertheless, the Age Pension plays an important safety net role, providing significant share of income for many pensioner households. The government's Intergenerational Reports, that are published every five years and examine demographic challenges, provide a mechanism for parametric adjustment of the Age Pension, including indexation. However, constant change to pension indexing is not optimal, given the importance of stability in pension-system parameter settings to help households plan for the future. Narrowing the focus of the Age Pension for instance through increased benefit tapering rates or revision of asset tests or increased superannuation contributions (which implies lower pay outs on the Age Pension) may provide alternative avenues for managing the fiscal pressure from the Age Pension.

Simplification of the tax and benefit system should be pursued further. For instance, past reviews by the Australian authorities suggested merging family benefits and child-care allowances. Simplification should also aim to reduce the difficulties arising from high marginal net tax rates generated by benefit withdrawal; for instance reduction in the number of benefits will reduce instances of multiple and cascading benefit withdrawal schedules (Chapter 1). The welfare review is also likely to consider a number of these issues.

### *In education, the government is headlining tertiary-sector liberalisation*

Improving education and skills needs to remain a key ingredient in ensuring Australia remains internationally competitive, and is vital for productivity gains over the longer term. Furthermore, low academic achievement and weak workplace skills are central drivers of poverty and socio-economic vulnerability. Therefore, education reform can bring gains on multiple fronts. Certainly, indicators such as the OECD's PISA and PIACC tests, suggest room for improving core skills (Figure 19).

Figure 19. **Student and adult performance in international competency tests**[1]




1. PISA refers to the Programme for International Student Assessment of the OECD and PIAAC refers to the Survey of Adult Skills of the OECD.
2. Top scores for the PISA math section were recorded in Hong Kong, China, for 2003; in Chinese Taipei for 2006; and in Singapore for 2009 and 2012.

*Source:* OECD (2014), *PISA 2012 Database* and *PIAAC 2012 Database*.

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The involvement of both the federal and state governments in education adds further complexities and challenges to implementing reform (Chapter 2). As regards primary and secondary education the present administration will continue the reform agreement with the states (the "Gonski" reform, Australian Government, 2011) that, amongst other things, changes the funding formula for federal transfers by giving greater weight to socio-economic variables. The government has signalled intention to reform the system when the agreement terminates.

In tertiary education, the government plans a major liberalisation by removing tuition-fee caps currently imposed on providers. In addition it intends to reduce the generosity of support by lowering the subsidies given directly to the providers that partially cover tuition-fees costs, and by charging a higher rate of interest for the government-backed income-contingent loans available to students for paying their contribution to the fees. Reform proposals however also aim to widen the scope of support. With a view to increasing access for students from a wider range of socio-economic backgrounds, tuition-fee subsidies, which are currently only available for institutions providing bachelor degree-level courses, will also be provided to those offering accredited sub-bachelor degree courses (including private universities and Technical and Further Education (TAFE) colleges). In addition loan fees that are charged for some types of course will be scrapped with a view to further encouraging competition between providers (by promoting funding neutrality).

These reforms will allow market signals to operate more strongly and more fully recognise the large private gains from education, but there are risks. Success depends crucially on whether strong tuition-fee competition develops and how effectively the fees reflect genuine differences in the quality of education between providers and between courses. In this regard, it is worth noting that the fees for international and post graduate students are already liberalised and exhibit high levels of price differentiation and competition between providers. As a check against the reforms compromising access to education for those from poorer backgrounds, it is proposed tertiary providers channel a portion of tuition-fee revenue towards scholarships. Further, students will continue to be able to defer the costs of their studies via the income-contingent student loans. However this may well not be sufficient. Monitoring of the reforms will be important to ensure access to higher education is not compromised, particularly for students from disadvantaged backgrounds.

### *Efforts are underway to better integrate support for Indigenous Australians*

According to government plans, the 150 programmes and activities supporting Indigenous Australians that currently operate under the Department of Prime Minister and Cabinet will be streamlined into a new strategy (the Indigenous Advancement Strategy) with five core themes. Programmes in the Health portfolio have been similarly rationalised (into the Indigenous Australians' Health programme). Certainly, judging by the sheer number of programmes currently in operation, consolidation makes sense. However, sorting out which elements of the system are worth preserving and which should be scrapped in the interests of improving efficiency will be challenging.

**Recommendations on encouraging employment, deepening skills and addressing inequality**

- **Monitor the proposed welfare reforms** to ensure they raise work-force participation cost effectively without adverse social outcomes. Better target superannuation (pension) tax concessions.
- **Monitor the proposed higher education reforms** to ensure that choice and quality is enhanced and access is not compromised.

## Tackling environmental challenges

As in some other areas of policy, the current government is altering environmental-policy frameworks and settings with a view to reducing the burden for business. This does not necessarily mean diminishing environmental objectives, as there can be opportunity for increased policy efficiency. The government's one-stop shop policy for environmental approvals, for instance aims to reduce the regulatory burden on business while maintaining environmental standards. Recent OECD cross-country comparisons examining the impact of (economy wide) environmental policy tightening on productivity find no empirical support for permanent effects either positive or negative. This suggests that any direct negative effects are either trivial or washed out by offsetting second-round effects (Albrzio et al., 2014). Nevertheless there are likely to be specific instances in which pro-business measures can mean reduced ambitions and increased risks in environmental terms.

### *Alternative approaches to reducing greenhouse gas emissions are planned*

The government has retained an unconditional commitment to reduce GHG emissions by 5 per cent below 2000 levels by 2020. In 2015, it intends to review its international targets in light of upcoming negotiations on a new global climate change agreement that will apply to all countries from 2020. The review will focus on the extent to which other nations are taking actions to reduce emissions.

The present government has dramatically changed the policy approach to mechanisms for reducing emissions (Chapter 1). In July 2014, it delivered on its election commitment to repeal a carbon credit and purchasing system (dubbed the "carbon tax", as its initial phase involved companies buying carbon credits from government as a first step towards a cap and trade system). By way of replacement, the government has proposed a suite of new measures called the Direct Action Plan.

The Direct Action Plan centres on the Emissions Reduction Fund which is a mechanism for crediting emissions reductions. Emission-reduction projects will be selected via a sealed bid auction and the government will then enter into contracts with successful bidders which specify that it will purchase a specific quantity of emission reductions on delivery. To sell emissions reductions to the government or into the secondary market, participants must first have the reductions verified and be issued with tradable carbon credits. In principle, such a scheme can have the appropriate incentive effects – indeed it can have the same effects as a carbon tax at the margin, providing difficulties in establishing baseline emissions and checking the achievement of emissions reductions are overcome. Unlike a carbon tax or cap and trade system, the Direct Action Plan will involve a net fiscal cost to the government.

However, there are avenues for enhancing the Emission Reduction Fund. Encouraging the development of a secondary market for the credits would help deepen efficient allocation through market forces. Also, in a sound move to address the risk of offsetting increases the government intends to implement a safeguard mechanism in which large industrial facilities will be encouraged not to exceed an established historical baseline. As of October 2014, legislation establishing the fund was in the final stages of parliamentary process while the safeguard mechanism was still at the consultation stage.

***There are opportunities to make transport policy greener***

Incorporating environmental considerations in regulation and taxation relating to private and commercial vehicle use is particularly important in the Australian context given road-based transport's dominance. As mentioned above, the government's proposal to bring back indexing on retail-fuel excise is welcome. In addition, the planned ramp-up in spending on road infrastructure provides an opportunity to expand road charging. Indeed, developing charges for car use rather than car ownership should be a central pillar of policy, and would usefully provide further reason to scrap the various state-level taxes relating to car ownership (see Chapter 1).

At the same time, the government should ensure that public transport plays a central role. Federal funding is focused on road transport. There was no new funding specifically announced for rail in the 2014-15 budget, although the government's Asset Recycling Initiative is likely to result in federal incentives being provided for state public transport projects (Australian Government, 2014b). If state governments indeed engage in substantial public-transport infrastructure projects, this near-term focus on road development by federal government may indeed be providing the right mix of transport investment overall. However, consideration should nevertheless be given to increasing federal-level backing for public transport.

***Economic incentives in water supply are being improved***

Major reform of water management in the Murray-Darling Basin, one of the country's main sources of fresh water, took place through the commencement of the Basin Plan in 2012. The Plan provides a long-term framework for the management of water resources and includes Sustainable Diversion Limits, which are a mechanism for ensuring the use of fresh water supply for agricultural, domestic and industrial use is environmentally sustainable. Successful implementation of the Basin Plan requires collaboration between the federal and the relevant state and territory governments (South Australia, Victoria, New South Wales, Queensland and Australian Capital Territory) and needs to be implemented consistently with the Intergovernmental Agreement on Implementing Water Reform in the Murray-Darling Basin.

Implementation of wide ranging infrastructure improvements are funded through the infrastructure component of the Sustainable Rural Water Use and Infrastructure Program, which invests in rural water use, management and efficiency, including improved water knowledge and market reform, and water purchase for the environment. It is the key mechanism to bridge the gap to the sustainable diversion limits under the Murray Darling Basin Plan. Infrastructure works are well advanced and scheduled for completion by 2019, when the sustainable diversion limits set out in the Murray-Darling Basin Plan ("Basin Plan") will come into effect.

**Recommendations on tackling environmental challenges**

- **Achieve greenhouse-gas emission targets**; Ensure the proposed Emission Reduction Fund is efficient through: i) robust measurement and verification methods; and ii) implementation of a safeguard mechanism that prevents offsetting emissions elsewhere in the economy.
- **Make transport policy greener**; Enact the proposal to index excise duty on retail fuel, expand other use-based vehicle charges and extend public transport.
- **Continue strong commitment to water reform** including the Murray-Darling Basin Plan.

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ANNEX

# Follow-up to previous OECD policy recommendations

*This annex reviews action taken on recommendations from previous Surveys. They cover macroeconomic and structural policy priorities. Each recommendation is followed by a note of actions taken since the December 2012 Survey. Recommendations that are new in this Survey are listed in the relevant chapter.*

## Ensuring price and financial stability

### Improve the functioning of the housing market

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| State and Territory governments should: | |
| Adopt more transparent, harmonised and less restrictive zoning and planning regulations and consider fast-track administrative processes in areas of high housing demand. | There are ongoing state-level reforms. The Victorian government, for example, has, increased the range of zones (e.g. three new residential zones were introduced) and amended existing ones. |
| Phase out subsidies to housing demand benefiting first-home buyers. | All states (except Western Australia) have abolished First Home Owners Grants for the purchase of existing dwellings, targeting the First Home Owners Scheme at newly constructed dwellings. |

## Maintaining fiscal prudence and ensuring efficient tax and public spending

### Strengthen mechanisms that aid fiscal discipline and press on with tax reform

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Consider creating a stabilisation fund to better insulate public spending decisions from revenue changes caused by volatile terms of trade | No action taken. |
| Consider raising the yield for the GST by increasing its rate and broadening its base. | No action taken. |
| Reduce the rate of corporate tax. | A 1.5 percentage-point cut in the corporate tax rate is in the pipeline but the intention is to partially offset this by a new 1.5% levy on taxable income over AUD 5 million. |
| Broaden the scope of the Mineral Resource Rent Tax. Consider replacing state royalties by a mining rent tax modelled on the federal approach, allowing states to set their tax rates. | Policy has moved in the opposite direction; the Mineral Resource Rent Tax, which applied to coal and iron ore, was repealed in September 2014. |
| Streamline and reform state taxation, including through reducing or removing, insurance levies and conveyancing duties broadening land tax by ending existing exemptions on owner-occupied housing and reduce progressivity. | The Australian Capital Territory has commenced reforms to reduce gradually stamp duty on residential conveyance (with an aim to abolish it by 2032) and replace the foregone revenue with higher land tax. |
| Review the tax-treatment of investment property that allows "negative gearing". | No action taken. |

## Improving business conditions: Competition, red-tape and innovation

### Promote competitive markets and cut red tape

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Apply to other countries the lighter screening procedures granted to the United States. Involve specialist agencies (e.g. national security) in the screening procedure to enhance transparency. | Lighter procedures have applied to New Zealand since March 2013 and are in the pipeline for Korea and Japan. |
| Continue to pursue reform campaigns in structural reforms towards stronger competition. | According to the COAG Reform Council's assessment of the National Partnership Agreement to Deliver a Seamless National Economy (2013 CRC Report), nine further competition and regulatory reforms have been completed in 2012-13. In total, over the five years to 2012-13, 31 of the 45 components of National Partnership have been completed, with a further 11 reforms partially completed. |
| Reduce red tape through a faster harmonisation of regulations between the states, and strengthen mechanisms for mutual recognition of regulatory standards. | The government has started a campaign to reduce regulatory compliance costs by AUD 1 billion every year. Following a repeal, the stock of un-enacted tax legislation was reduced in March 2014. |

### Encourage innovation but also prune business subsidies

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
| --- | --- |
| Aim for greater simplification and flexibility in the menu of programmes encouraging collaboration between universities and businesses.<br>Consider new schemes to encourage collaboration, for instance, a voucher scheme for contracting academic research. | The Science and Industry Endowment Fund is investigating investments in activities that will increase collaboration between industry and researchers.<br>Innovation voucher schemes have been adopted in some states. The South Australia government intends to expand its voucher programme as part of a broader plan to help the economy following the announced closure of car assembly plants. |
| Reduce subsidies to the automotive industry and to the farm sector which are ineffective and encourage poor management practices. | Automotive subsidies are set to decline following announcements of plant closures in early 2014. |

## Improving business conditions: Infrastructure and network services

### Improve infrastructure investment

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
| --- | --- |
| Introduce more systematic publication of cost/benefit analyses and mandatory independent evaluation for large investment projects. Consider creating a new body to assist agencies in economic analysis. | The current government has tasked Infrastructure Australia to develop a 15-year infrastructure plan, undertake an audit of infrastructure and assess the cost effectiveness of all non-defence Commonwealth projects over AUD 100 million. The Productivity Commission has completed a review into public infrastructure project costs and alternative options for funding and the government is considering the response. |
| Simplify infrastructure-investment processes and improve planning. In network industries move towards a national approach to developing and paying for transmission infrastructure. | The 2014-15 budget outlined plans to strengthen independence and transparency of Infrastructure Australia through new governance arrangements that have subsequently been legislated. |
| Remove barriers to private participation in financing investment infrastructure. Further improve public-private partnership processes, including the management and assessment of risk. | The government intends to use alternative financing arrangements for infrastructure (including the provision of loans, guarantees and/or equity) as a complement to grant funding on a case by case basis. The Productivity Commission has completed an inquiry into public infrastructure and the government is considering its response. |
| Improve the regulatory framework for private investment through a detailed assessment of the implementation of the National Access Regime | Most state access regimes have been submitted and certified by the National Competition Council, according to 2013 CRC Report. The Productivity Commission's final report on the effectiveness of the National Access Regime and the potential reform options was released in February 2014. The government announced in February 2014 that it would respond to the Productivity Commission's review, after it receives the final report of the Competition Policy Review due early 2015. |

### Work towards better transport

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Further simplify and harmonise the regulation of nationally significant freight infrastructure. Implement uniform state standards for heavy goods vehicles and regimes for access to railway infrastructure. Extend AusLink Nation Building Program to the port sector. | The National Rail Safety Regulator became operational from January 2013, administering a single national set of rail safety laws for Australia. The national rail safety framework has been adopted by four states and one territory and the National Rail Safety Regulator has started operating. Subject to the passage of legislation at the state level, the other states and territory will also be under the regulator. The national operator for heavy vehicles commenced its operations in February 2014. One heavy vehicle rule book now applies in five states and one territory. |
| Implement a road freight pricing scheme that takes into account the intensity of network use and place of use. | The Infrastructure Growth Package outlined in the 2014-15 budget provides funds for ramping up road building and upgrading existing roads of national importance. The Budget further provides financial incentives for the states to sell assets and reinvest the sale proceeds into additional infrastructure (Asset Recycling Initiative). |
| Consider reforming arrangements for managing and funding road infrastructure. Give more financial responsibility and adequate resources to the local jurisdictions to cover the operating costs and investment needs of their road networks. | The Productivity Commission has completed a review into public infrastructure project costs and alternative options for funding and the Government is considering the response. |

### Harmonise regulation and enhance market mechanisms in the energy sector

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Harmonise safety regulations across states and eliminate legal obstacles to exploration and development of gas deposits. | State-level reforms continue via implementation of the National Energy Customer Framework (setting out protection and obligations for small business and household consumers), according to 2013 CRC Report. The package of measures began in South Australia and New South Wales in 2013. A review of derogations in energy market legislation is intended to be completed in 2014. |
| Pursue the privatisation of companies still under government control. | The proposed Asset Recycling Initiative is expected to encourage privatisations, notably of state-owned energy producers. |
| Remove the ceilings on retail electricity prices rapidly. | Following a review by the Australian Energy Market Commission, the New South Wales government has removed retail price regulation from the electricity market in July 2014. |
| Install advanced metering infrastructure (“smart meters”) for electricity to promote energy-efficient consumption choice. | A national framework of rolls-out of smart meters and other advanced metering has been agreed. The installation process has advanced in Victoria. |

## Jobs and welfare: Encouraging employment

### Adjust tax and benefit settings to encourage employment while ensuring adequate safety nets

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Rationalise the income support system, inter alia, to reduce problems from multiple benefit withdrawal rates and consequent incentive problems from high effective marginal tax rates. | No major reform. |
| Continue to improve job capacity assessment for those receiving the Disability Support Pension (2010 *Survey*). | No major reform, though there are proposals targeting recipients under 35, including review of the eligibility and introduction of “compulsory activities”. |
| Make the child care benefit more conditional on employment or job search of parents, except when children face multiple disadvantages (2010 *Survey*). | No major reform.. However, the productivity Commission is conducting the Inquiry into Child Care and Early Childhood Learning which will, amongst other matters, examine and identify future options for a child care system that supports workforce participation. The final report was due by the end of October 2014. |
| Consider raising the Newstart Allowance for a limited-duration to improve the safety net for the unemployed (2010 *Survey*). | No action, the thrust of current policy is towards less generous pay-outs. |

## Seek further improvement to employment services

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Strengthen the links between the funding and performance of employment-service providers, tie remuneration more tightly to the "Star Rating" performance evaluation system (2012 *Survey*). | No major reform. |
| Consider a greater degree of streaming of claimants into different categories to better target services (2012 Survey). | No major reform. |

## Maintain labour market flexibility and address supply constraints through migration

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Preserve the existing framework of direct and decentralised bargaining but nevertheless, seek avenues for improvement, for instance consider more flexible requirements for negotiation with unions when setting up new business operations (2012 *Survey)*. | No major reform. as yet but initiatives are underway regarding the building sector. Draft legislation proposes removal of the effective union veto power over Greenfields Agreements. The Government has committed to an independent review of the Fair Work laws. |
| Push for reform in sector-specific labour regulations embodied in negotiated agreements (2012 *Survey)*. | The first four-yearly review of Modern Awards (which provides for industry-specific minimum rates of pay and conditions) is currently underway. |
| Aim for a more even balance of litigation costs in unfair dismissal procedures between employees and employers; employees have an overly advantageous position on this front (2012 *Survey*). | The government aims to implement a number of outstanding recommendations of the Fair Work Act Review 2012, which include providing a new mechanism for employers to defend against unfair dismissal claims and providing the Fair Work Commission with clearer powers to dismiss unfair dismissal proceedings. |
| Given the already relatively high minimum wage, future increases should be moderate (2010 *Survey*). | Increases remain reasonably moderate; annual increase in the Federal Minimum Wage (which is set by the Fair Work Commission) was 2.6% in 2013 and 3% in 2014. |
| Continue to fine-tune the skilled-worker immigration system. In particular improve the system for assessing and recognising foreign qualifications develop a national licensing regime and further develop offshore assessment of skilled workers (2010 *Survey*). | No major reform. since the introduction of the New Skilled Worker Programme in 2012. |

## Improve early childhood education and care (ECEC) to help parents combine work and family life

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Improve the efficiency and quality of services, in particular through reforms to the staffing regime that bridge the split for pre-school teachers and staff for child care. Proceed swiftly with the development of a more streamlined staff accreditation system (2008 *Survey*). | No major reform. However, the National Quality Framework is currently under review and the Productivity Commission Inquiry into Childcare and Early Childhood Learning is underway, with a draft report released in July 2014 and the final report due by the end of October 2014. |
| Continue to extend access to care and education services (2008 *Survey*). | The government announced in September 2014 that the National Partnership Agreement on Universal Access to Early Childhood Education will be extended until the end of 2015, and reaffirmed commitment to universal access to early childhood education program in the 12 months before full-time schooling for 15 hours per week, 40 weeks per year, delivered by a 4 year degree qualified early childhood teacher. |

## Jobs and welfare: Health care, disability and disadvantage

### Address challenges in healthcare, disability services and problems of multiple disadvantage and homelessness

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| In health care, increase resources for preventive medicine, improve care services for the elderly and mentally ill and, reduce hospital costs by promoting primary care interventions (2010 *Survey*). | No major reform. |
| Improve disability services, especially for people with mental illness. Reduce the fragmentation and complexity of the system, develop a national system of quality assessment and move swiftly to a person-centred approach to disability services (2010 *Survey*). | The National Disability Insurance Scheme currently being implemented entails major re-organisation of the provision of disability services and a significant increase in resources for services. |
| Improve services for those with multiple disadvantages, by taking a more individualised approach and improve co-ordination among the various providers (2010 *Survey*). | No major reform. |
| Continue efforts to reduce homelessness, consider reforming the approach to public housing and rent assistance (2010 *Survey*). | No major reform. |

## Tackling environmental challenges

### Establish goals and mechanisms for greenhouse gas reduction and tackle traffic congestion

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Clarify the measures to reduce greenhouse gas emissions. | A carbon-credit system was introduced in 2012 but was repealed in 2014 in line with the government's election promise. A suite of new measures, the Direct Action Plan, which centres on the Emissions Reduction Fund has been proposed.<br>Legislation implementing the Emission Reduction Fund passed the Australian House of Representatives in June 2014 and is now before the Senate.<br>The Government is continuing to consult with business on the development of the safeguard mechanism. |
| Broaden the use of road user charges. Introduce location-specific and time-varying congestion charges for road infrastructure in large cities (2012 *Survey*). | No major developments, though there are intentions to ramp up investment in new roads that are likely to involve new toll systems. The Productivity Commission Report on Public Infrastructure recommended greater use of user charging. The Government is currently considering its response. |

## Improve water management

| Recommendations from the 2012 Survey | Actions taken since the 2012 Survey |
|---|---|
| Continue to establish economically efficient and sustainable fresh water use that is uniform across states. Inter alia, correct over-allocation of water entitlements, lift restrictions trading water rights, publish transaction prices and abolish "exit fees" (2008 *Survey*). | Implementation of the Sustainable Rural Water Use and Infrastructure Programme continues. Water management is now undertaken on the basis of water plans that cover over 80% of water resources. Measures supporting the growth of the water markets continue.<br>Major reform of water management in the Murray-Darling Basin continues, including implementation of the 2012 Murray-Darling Basin Plan (the "Basin Plan"). Specific steps include the introduction of basin-wide water trading rules in 2014, further lifting of barriers to trade and improved reporting of market developments. |
| Reform water charging to ensure full cost recovery, including management and planning costs. Abolish subsidies to infrastructure projects (2008 *Survey*). | Processes for setting bulk water charges have been reformed. In particular, State Water Corporation charges in the Murray-Darling Basin have been set by the Australian Competition and Consumer Commission according to user pays and cost recovery principles.<br>The 2010 National Water Initiative pricing principles, which call for full recovery of capital infrastructure and water planning and management activities, are currently being reviewed with a view to improving transparency and implementation.<br>There is generally full cost recovery in urban systems and rural systems are transitioning to lower-bound pricing. |
| Consider putting an end to the public monopolies of urban water management (2008 *Survey*). | Several state governments are considering legislation to improve competition in the supply of urban water services through third party access regimes. There is also increased private sector participation in planning arrangements and investment decisions through public private partnerships.<br>From July 2014, the Northern Territory's Power and Water Corporation was restructured to separate its monopoly and competitive businesses into standalone government-owned corporations with separate boards. |

# Thematic chapters

*Chapter 1*

# Improving taxes and transfers

*Getting tax and transfer systems to efficiently deliver sufficient revenues to achieve macroeconomic targets, address goals in re-distribution and social welfare, encourage employment, accommodate business-competitiveness concerns and incorporate environmental issues is difficult. In Australia, slowing economic growth in the wake of the mining boom has sharpened the trade-offs and brought into focus the importance of encouraging broad-based advances in employment and productive capacity while also dealing with other long-term challenges, in particular population ageing and greenhouse-gas emission reduction. This review particularly recommends shifting away from income taxation to indirect taxation, for instance by raising more revenue from the Goods and Services Tax. The report also advises caution in some recent welfare-reform proposals, and advocates broad support for business rather than targeted subsidies and other forms of corporate welfare. As regards environmental policies, the report comments on the proposed Emission Reduction Fund for reducing greenhouse gases and supports reform to vehicle-related taxation.*

Taxes and transfers are key tools for addressing economic, social and environmental issues, including achieving fiscal targets, creating a competitive business environment, motivating employment, and ensuring adequate levels of welfare. Given the multiple facets of tax and transfer policies, making the most of "win-win" opportunities and having a good gauge of trade-offs where these occur are keys to sound policy. In Australia, the end of the resources-investment boom, population ageing and a need for broad-based productivity growth mean effective tax and transfer systems are all the more important. This chapter evaluates current policies and plans for the future and concludes with a series of recommendations.

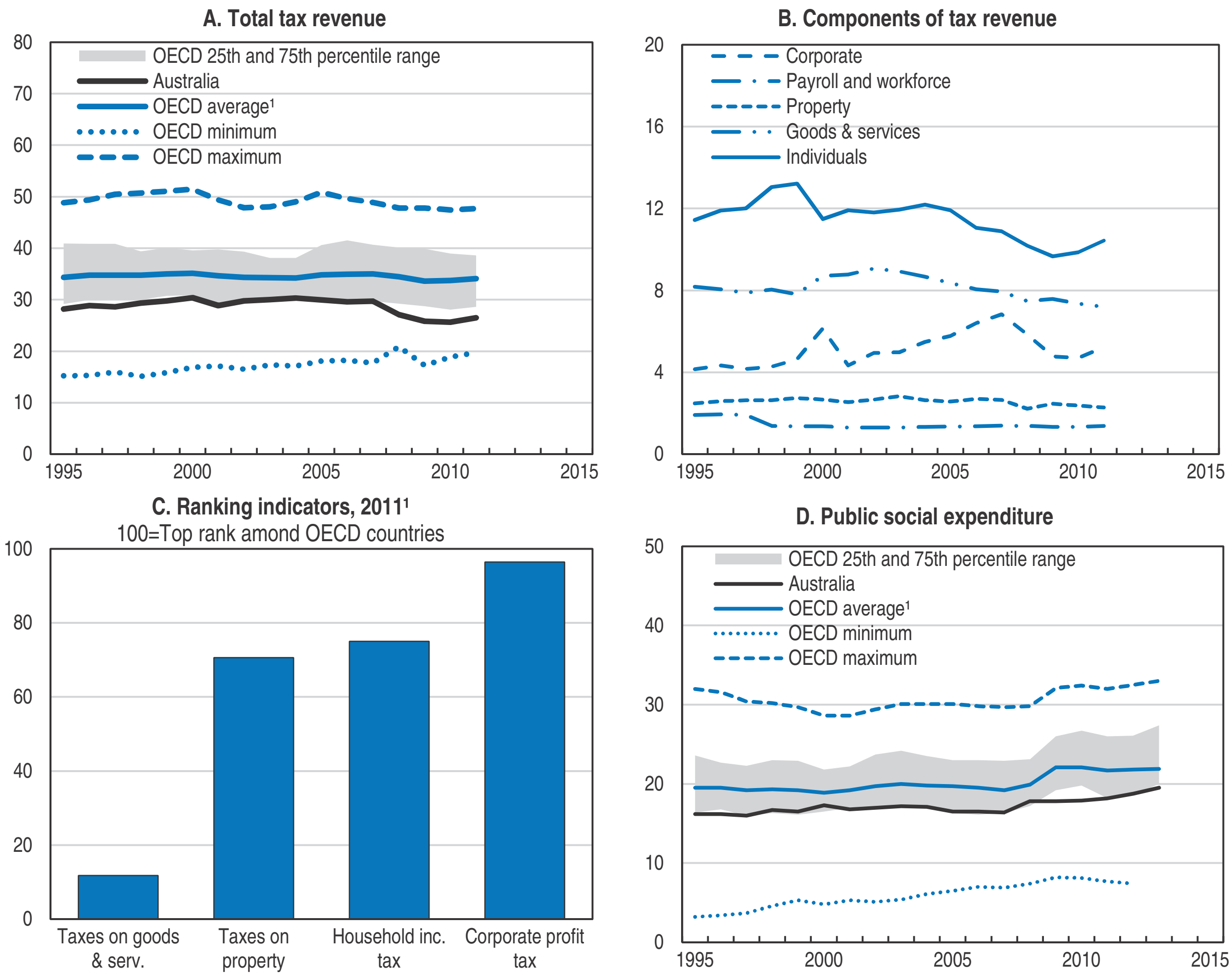
## Notable features of the system

Australia's tax and transfer system has a number of striking characteristics:

- Government spending has long been relatively low compared with many other OECD countries, and this is echoed in the relatively light overall tax burden. Since at least the mid-1990s total government revenues have ranged between 25% and 30% of GDP (Figure 1.1, Panel A); the OECD average is around 35%. As in many other countries, both individual and corporate tax revenues have dipped as a share of GDP following the global financial crisis (Figure 1.1, Panel B).
- Regular income tax on households and businesses features prominently and comparatively little revenue is collected from indirect taxes, which is less employment and growth friendly. Indeed, as a proportion of GDP, indirect-tax revenues rank among the lowest in the OECD area, while revenues from income taxes on both households and corporations are among the highest (Figure 1.1, Panel C).
- Spending on welfare transfers is low in international comparison. Though public social spending has risen somewhat over recent decades (Figure 1.1, Panel D), it nevertheless has remained clearly below the OECD average.
- As regards support for business, in common with many other countries, encouraging R&D activity is a core theme of the various programmes and incentives. However, Australian business policy has concentrated rather less than other countries on cutting the rate of corporate income tax as a means of attracting investment and has a history of subsidising struggling industries (notably automobile plants).
- Taxes and transfers are a key dimension in federal-state relations (see Chapter 2 of this review). Broadly, the Commonwealth (central) government plays a greater role over taxes and transfers than do state governments; the latters' own revenues cover only about half their outgoings with federal-government grants making up the difference. In addition, practically all cash benefits to households are federally run; the states, in contrast, have considerable responsibilities in service provision, in particular much of health and education.

Figure 1.1. **Tax revenue and social spending indicators**

As a percentage of GDP




1. The ranking indicator re-scales rankings so that 0 is the lowest ranked country and 100 is the top ranking country. The rankings are based on the shares of revenue in GDP. 2011 or latest available year, except for corporate tax which is based on the average of the previous seven years to reduce the influence of cyclical variation.

*Source:* OECD (2014), *Tax Revenue Database* and OECD (2014), *Social Expenditure Database*.

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## Key challenges

Australia's challenges for tax and transfer policy comprise several inter-related issues:

- Identifying the economically least damaging measures to raise revenue and restrain public spending to achieve deficit and debt reduction.
- Getting taxes and transfers to help growth potential by encouraging labour supply, and enhancing the climate for business activity in other respects.
- Ensuring the taxation of natural resources brings an appropriate return to the public as ultimate "owners" of Australia's natural resource wealth.
- Using the tax and transfer system to help reduce poverty and inequality.
- Improving the tax system's environmental characteristics.

The following sections first briefly discuss the present government's intended approach to taxes and transfers. Subsequent sections discuss the best way forward for policy under five headings: indirect taxation; household income tax and social benefits; taxes on property and wealth; business taxation; and evasion, avoidance and administration issues.

## Recent policy developments

Under the previous administration, policy on taxes and transfers was guided by the recommendations of a major review (commonly referred to as the "Henry Review") that was commissioned in 2008 and whose final conclusions were published in 2010 (Australian Government, 2010). This Review aimed for a comprehensive assessment of taxes and transfers. However, its terms of reference excluded some important issues. Most notably, reform of the Goods and Services Tax (GST) was not considered, reflecting an electoral promise of the government of the time. Various other government-initiated reviews are underway which have relevance for tax and transfer issues, notably welfare policy is being investigated (by the *Reference Group on Welfare Reform,* Australian Government, 2014a) and so is the financial system (the *Financial System Inquiry,* which will include coverage of second-pillar pensions ("superannuation") (Australian Government, 2014b).

The current government has signalled a significant change in tone on taxes and transfers. This is illustrated by the selected reform proposals listed in Table 1.1. Some of these echo the government's fiscal ambitions alongside political concerns for burden sharing; the temporary top-end tax, for instance, probably falls into this category. There are deeper structural themes too. Proposed welfare measures demonstrate a desire for stronger incentives to join and remain in the workforce (as illustrated in proposals for longer waiting times for benefit for young unemployed) and for greater financial support in the first months of parenting through expansion of paid parental leave – a flagship reform of the administration. The items in Table 1.1 also underscore the current government's pro-business agenda, with reduction in the rate of corporate tax, replacement of a carbon tax with subsidies to firms for reducing greenhouse-gas emissions, and scrapping a tax on supernormal profit for mining companies.

## Taxation and households

### *Indirect tax is underutilised*

Theory and evidence suggests indirect taxes are preferable to direct taxes when considering economic growth (Arnold, 2008; Johansson et al., 2008), as they favour saving and investment and have a smaller impact on business costs and profits as well as work incentives compared with other major tax bases, notably corporate-income tax and personal-income tax. Also, taxation of goods and services where there is inelastic consumer demand (or producer supply), provide opportunities to raise revenues with low deadweight losses in economic welfare. Indirect taxes can also "internalise" externalities, in particular those connected with the environment and public health. Of course there are potential downsides: some forms of indirect tax can be a vehicle for protectionism, distort household consumption and saving behaviour and can be regressive.

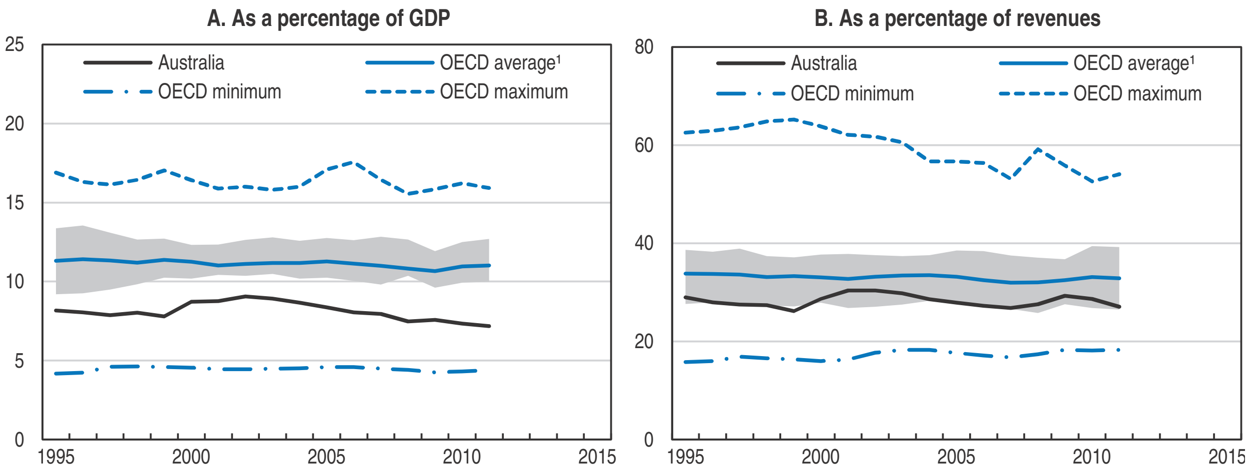
Table 1.1. **Key tax and transfer reforms proposed in the 2014-15 budget**

| Action | Progress in implementation (as of September 2014) |
|---|---|
| Personal income tax | |
| **A temporary top-end tax (the Temporary Budget Repair levy)**, an additional 2% tax on the current top personal-income tax rate of 45% for those earnings above AUD 180 000 (i.e. about twice the average wage). | *Legislation passed (Royal Assent June 2014)* |
| **Reversal of a hike in the universal tax-free threshold**, as part of a partial unwinding of the measures that were introduced to compensate for the impact of the carbon tax on household incomes (the impact is primarily increased energy prices). | *Legislation in parliamentary process* |
| Family benefit | |
| **More generous paid parental leave.**[1] A proposal for pay-out at previous earnings (capped at AUD 50 000) for 26 weeks, plus superannuation contributions. | *Yet to enter parliamentary process* |
| **Reduced scope of Family Tax Benefit B**. From July 2015, the benefit will only apply to families where the youngest child is aged under 6 (implementation will be grandfathered for two years and Family Tax Benefit A will be increased for lone parents on the maximum rate of this benefit). In addition, the maximum family income for receipt of Family Tax Benefit B will be AUD 100 000 instead of AUD 150 000. | *Legislation in parliamentary process* |
| Unemployment benefit and activation measures | |
| **Longer unemployment benefit waiting periods for those aged under 30**; waiting periods of up to 26 weeks are proposed. | *Legislation in parliamentary process* |
| **Subsidies to employers taking on those aged over 50** worth up to AUD 10 000 over a two-year period ("Restart"). | *Program commenced July 2014* |
| **Mandatory work experience for certain jobseekers**, the Work for the Dole programme started in July 2014 across 18 high-unemployment areas. The plan is for nationwide roll-out from July 2015. A six-month wage subsidy will be available to employers for taking on those participating in the programme. | *Implementation underway* |
| **Stronger penalties for jobseekers who refuse or persistently fail to meet requirements.** Specific penalties include loss of payment for eight weeks with no option for the penalty to be waived through participation in additional activities or due to financial hardship. | *Legislation in parliamentary process* |
| Pensions | |
| **Increase in age of access to the Age Pension**, for the first pillar pension this is currently scheduled to reach 67 years by 2023; draft legislation proposes further increases (six months every two years) from 2025 to bring the age to 70 years. | *Legislation in parliamentary process* |
| Welfare payment indexing | |
| **More indexing to CPI.** A number of benefits are currently indexed to wages and some to more elaborate criteria (notably the Age Pension, see Table 1.7). The plan is to shift most indexing to CPI only. | *Legislation in parliamentary process* |
| **Eligibility threshold freeze**, a three-year freeze on the means-testing thresholds that trigger eligibility to benefit. | *Legislation in parliamentary process* |
| Corporate tax and business support | |
| **Reduction in rate of corporate tax** but also an offsetting new levy for large businesses that is nominally hypothecated to funding the expansion of paid-parental leave. | *Yet to enter parliamentary process* |
| **Repeal of the "carbon tax"** and introduction of a new suite of GHG-emission reduction measures (the Direct Action Plan) including subsidies for business to reduce emissions. | *Carbon tax repealed (July 2014); new legislation in parliamentary process* |
| **Repeal of the mineral-resource rent tax (MRRT)** that applies to coal and iron ore extraction. | *Legislation passed (Royal Assent September 2014)* |

1. Spending on this item was not actually included in the 2014-15 budget but was nevertheless discussed in budget documentation and is a flagship reform of the government.

Indirect taxation is relatively light in Australia, with revenues equivalent to about 7% of GDP compared with an OECD average of a little below 12% (Figure 1.2, Panel A). Also, the portion of indirect taxation in total government revenues is low (Panel B). The Goods and Services Tax (GST), which is a value-added type tax, accounts for nearly half of all indirect

Figure 1.2. **Tax on goods and services**




1. The shaded area is the 25th to 75th percentile range of available OECD countries.
*Source:* OECD (2014), *Revenue Statistics Database*.

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tax with the remainder being dominated by items relating to vehicle use (Commonwealth excise on fuels plus various state-level motor vehicle taxes), customs duties and excise taxes on alcohol and tobacco (Table 1.2).

Table 1.2. **Key items of indirect taxation**

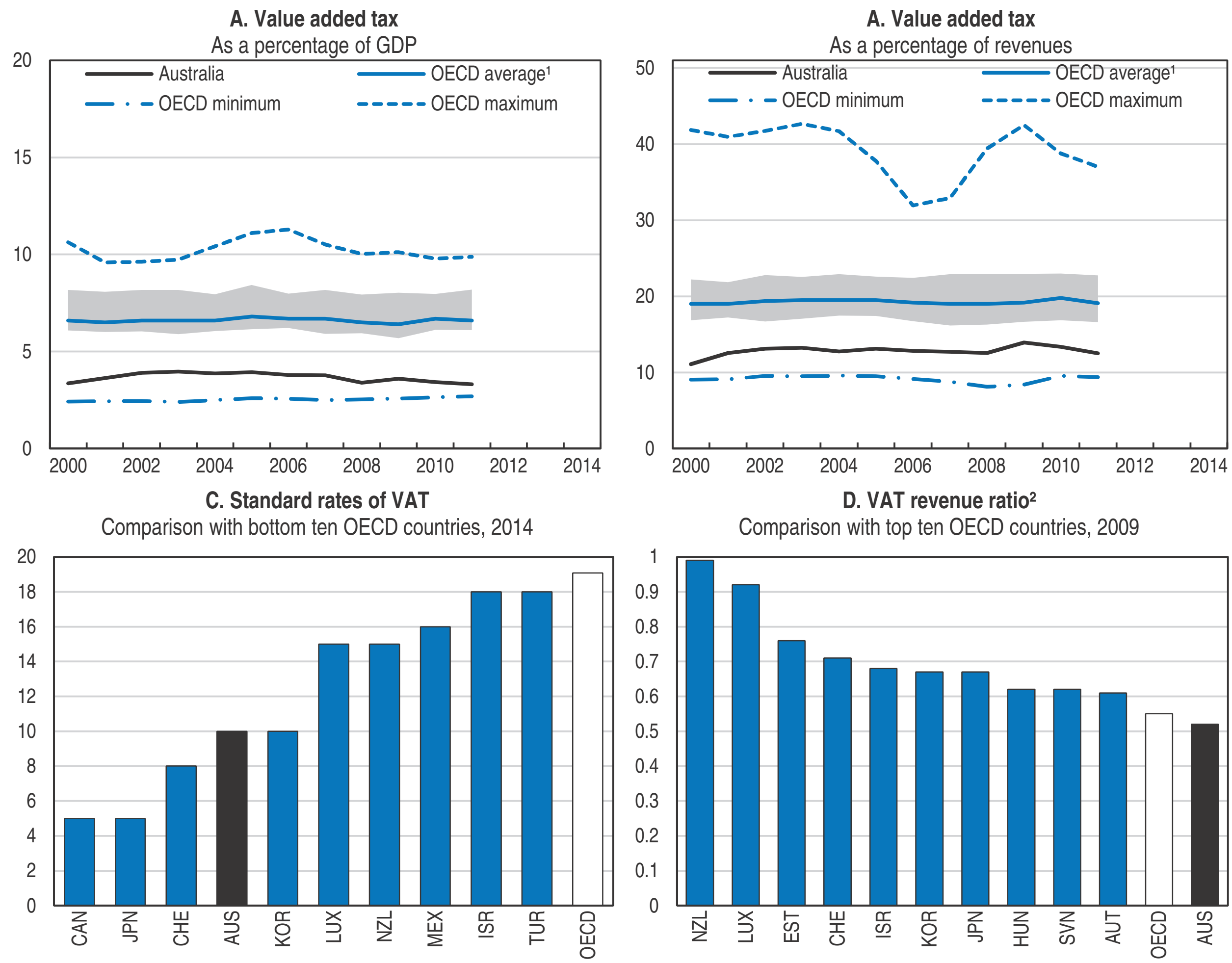
| | Revenue (2012-13), AUD billion | As a percentage of total revenue | As a percentage of GDP |
|---|---|---|---|
| **Commonwealth government** | | | |
| Taxes on the provision of goods and services | 86.0 | 20.7 | 5.6 |
| *Of which:* Goods and services tax | 50.3 | 12.1 | 3.3 |
| Excise on crude oil, petrol and diesel | 17.8 | 4.3 | 1.2 |
| Taxes on international trade (mainly customs duty) | 8.2 | 2.0 | 0.5 |
| Other excises (mainly those on tobacco and alcohol) | 7.9 | 1.9 | 0.5 |
| **State and local government** | | | |
| Taxes on the provision of goods and services | 11.1 | 2.7 | 0.7 |
| *Of which:* Taxes on gambling | 5.5 | 1.3 | 0.4 |
| Taxes on insurance | 5.5 | 1.3 | 0.4 |
| Taxes on the use of goods and performance of activities | 9.7 | 2.3 | 0.6 |
| *Of which:* Motor vehicle taxes | 8.5 | 2.1 | 0.6 |
| **Total** | 106.7 | 25.7 | 7.0 |

*Source:* Australian Bureau of Statistics, *Taxation Revenue*.

### *The case for raising more revenue from GST*

Australia introduced a general tax on goods and services later than many other OECD countries. The Goods and Services Tax (GST) was introduced in 2000 after prolonged political debate. Value added taxes are in principle designed to impose a broad-based tax on final household consumption collected by businesses on the "value added" at each stage of production and distribution. However, Australia's GST base is narrowed considerably due to extensive preferential treatments (i.e. zero rates and exemptions). Furthermore, the GST rate remains comparatively low, having remained unchanged from the "introductory" level of 10%. The share of revenues, with reference to GDP or to government revenues is correspondingly low in international comparison (Figure 1.3). Also, the fairly extensive exemptions are reflected in a middle-ranking VAT Revenue Ratio (this ratio is derived by dividing actual revenues by the revenues implied by applying the standard VAT rate to total household consumption).

Figure 1.3. **Value-added tax (VAT)**




1. The shaded areas are the 25th to 75th percentile range of available OECD countries.
2. This ratio expresses the revenue collected from the actual VAT/GST in a country as a proportion of the revenue that would be raised if the main standard rate were applied to all consumption. Although the VRR has to be interpreted with care and erosion of the tax base may be caused by a variety of factors (incl. non-compliance), it provides an indicator of the amount of revenue foregone due to the application of preferential treatments such as zero rates and exemptions.

*Source:* OECD (2014), *Revenue Statistics Database*; OECD (2012), "Consumption Tax Trends 2012: VAT/GST and Excise Rates", *Trends and Administration Issues*, OECD Publishing.

StatLink http://dx.doi.org/10.1787/888933176601

Broadening the GST base by reducing the number of zero rates and exemptions would make sound economic sense. Most tax expenditures in Australia's GST are accounted for by zero rates on food, healthcare, education and exemption of financial products. The fiscal cost is sizeable; the total effect of GST zero rates and exemptions for 2013-14 in these categories is estimated at around AUD 20 billion (1.3% of GDP) in foregone revenue (Table 1.3). Much of the preferential treatment is aimed at various distributional and social

Table 1.3. **Large tax expenditure items for 2013-14**[1]

| | Estimate AUD billion | As a % of GDP[2] |
|---|---|---|
| **Total of items listed below (this does not include all tax expenditures)** | **108.7** | **6.8** |
| **Household capital gains and savings** | **38.6** | **2.4** |
| Exemption on main residence – discount component | 16.5 | |
| Exemption on main residence | 13.5 | |
| Discount for individuals and trusts | 4.3 | |
| Concessional taxation on non-superannuation benefits | 2.5 | |
| Exemption on interest withholding tax on certain securities | 1.8 | |
| **Superannuation** | **32.1** | **2.0** |
| Concessional taxation of earnings | 16.1 | |
| Concessional taxation of employer contribution | 16.0 | |
| **GST exemptions** | **20.1** | **1.3** |
| Food | 6.2 | |
| Education | 3.7 | |
| Health; medical and health services | 3.4 | |
| Financial services | 4.1 | |
| Child care services | 0.9 | |
| Water, sewerage, drainage | 0.9 | |
| **Other household tax expenditures** | **5.7** | **0.4** |
| Family tax exemptions ("Parts A and B") | 2.1 | |
| Exemption of private health insurance rebates | 1.5 | |
| Exemption from medicare levy for households below a threshold income | 1.3 | |
| Application of statutory formula to value car benefits | 0.8 | |
| **Business-related expenditures** | **8.2** | **0.5** |
| Non-coverage of agriculture in the carbon-pricing mechanism | 2.1 | |
| Caps on the effective life of capital equipment for accounting purposes | 1.7 | |
| Simplified depreciation for small business | 1.3 | |
| Non-coverage of deforestation in the carbon-pricing mechanism | 1.2 | |
| Research and development tax offset | 1.0 | |
| Deduction of capital works expenditure | 0.9 | |
| **"Philanthropic" expenditures** | **4.1** | **0.3** |
| Healthcare providers (notably public and not-for-profit hospitals) | 1.5 | |
| Exemptions for "benevolent" institutions (this can include certain types of private school) | 1.3 | |
| Exemptions relating to certain types of gift | 1.3 | |

1. These estimates are calculations of "revenue forgone", which do not provide the full impact on revenue of removing a tax exemption (as, for example, they do not take into account behavioural responses by taxpayers). In addition, strictly speaking, such tax expenditures estimates should not be aggregated.
2. Assuming GDP of AUD 1 590 billion in 2013-14.

*Source:* Australian Government (2014b), *Tax Expenditure Statement 2013*, Canberra.

concerns, but is ill-suited to this role. A recent OECD study on the distributional effects of consumption taxes (OECD, 2014a) underscores that reduced or zero rates are a very poor tool for targeting support to low-income households. At best, high-income households receive as much benefit from a reduced rate as those on low incomes, and at worst they benefit vastly more than poor households, as their consumption of the tax-favoured goods and services is greater than that of low-income households.

In addition, the "low value threshold exemption" for GST on imported goods requires attention. Such exceptions mean tax is not applied to imported goods below a certain value and are common among OECD countries. They are primarily motivated by the fact that for low-value goods the administrative cost of tax collection can outweigh any tax collected, or if this cost is passed onto consumers then the price would be exorbitant. Australia's low-value threshold is particularly high at AUD 1 000 on any single item and is motivating internet retailers to locate outside the country. The revenue foregone was estimated to be AUD 470 million in 2013-14 (Australian Government, 2014b). Tackling this issue is important, not least because of internet retailing's growth potential. One possibility is to require offshore suppliers of low value parcels to charge, collect and remit the tax, rather than the customs authorities. This could potentially reduce administrative costs and therefore allow for a lower threshold.

In addition to base-widening, international comparison suggests room to raise the rate of GST. In many countries the standard rate of VAT is over 20%; more than twice that of GST. However, this is probably not a good guide for reform as high standard rates often reflect systems riddled with exemptions and concessional rates. Rates in systems with few exemptions (i.e. a high VAT revenue ratio) provide a better model for Australian to adopt. For instance, New Zealand and Israel have wide bases and rates of 15% and 18%, respectively.

Under current arrangements, all GST revenues are passed onto state governments, effectively representing an unconditional grant (see Chapter 2). Given this, any substantial GST reform has ramifications for state financing and, as such, would most likely only make progress as part of a package of reforms to state financing and other aspects of the federation. For instance, increased GST revenues (with corresponding cutbacks in conditional grants) could be one element in a federation reform that aims to give states some more autonomy (but also responsibility) in financing, as is suggested in Chapter 2.

### *There is room for better balance in vehicle taxation*

Australia's vehicle taxation comprises various state-based overhead taxes, excise tax on fuel and tolls (Table 1.4). Retail-fuel taxation in Australia has long been low in international comparison and increasingly so since 2001 when automatic indexing of the excise duty to the consumer price index was stopped. The indexation provided a useful "default" way of ensuring revenue increases for the treasury and preserved the positive influence of the excise environmentally. Therefore, the government's intention to reinstate indexation on the excise represents a sound move. There are also plans to establish a fund that will channel the increased excise revenue towards road infrastructure investment. Such ties between specific revenue and spending areas can compromise efficient resource allocation (as there is no reason why the revenues should match the optimal level of spending). However this is not a risk in this instance as the fund will not be used to fund specific road building projects and will only contribute a small proportion of overall spending on road infrastructure (the fund is expected to raise about AUD 2.2 billion over the four-year "forward estimate" period, while the current road-infrastructure programme over same period will cost over AUD 25 billion).

Even if the government's planned reintroduction of indexing on the excise goes ahead, Australian fuel taxation will likely remain comparatively low (as other countries typically increase excise over time either through indexation or periodic adjustment), see Figure 1.4. *Prima facie* this implies headroom for pushing excise higher. However, as in other countries with low population density, such as Canada and the United States, Australia has many rural communities in which long-distance road travel, either for work, leisure or shopping is practically unavoidable. Thus, raising the fuel excise rate could have distributional consequences. Furthermore, as is generally the case, any environment justification of high fuel excise has to assume that the excise is offsetting additional externalities over and above those relating to greenhouse-gases such as congestion, noise pollution and local-air

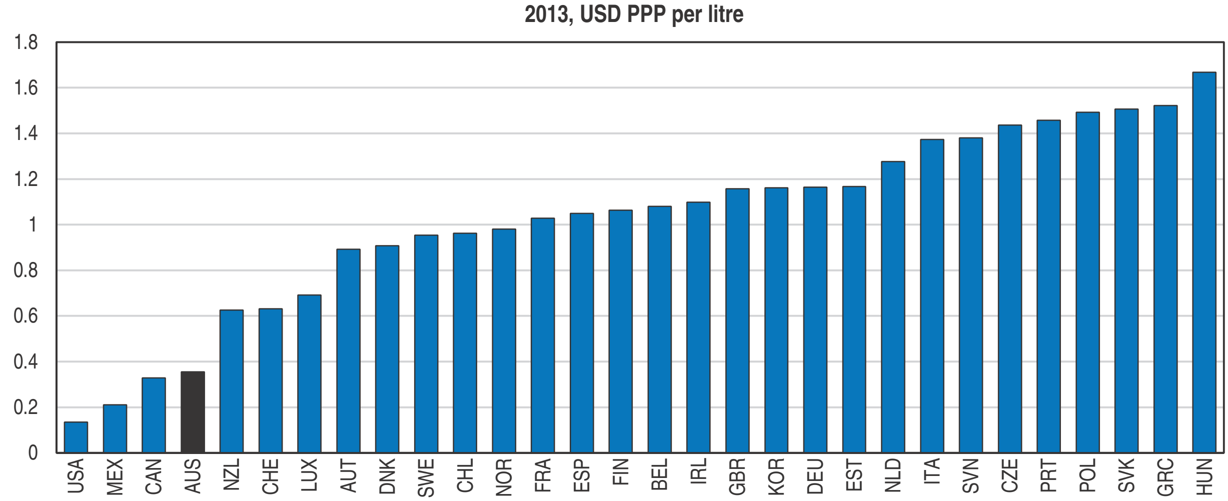
Table 1.4. **Key taxes and charges relating to the ownership and use of vehicles**

| Area of taxation | Detail |
|---|---|
| Purchase of a vehicle | • Goods and services tax (10%).<br>• Stamp duty (5%).<br>• Luxury Vehicle Tax (LVT); 33% of the value of the car above a threshold amount.<br>• Registration fee calculated on the value of the vehicle. |
| Regular overhead charges | Annual state-based fees that vary according to vehicle's value and/or other characteristics ("Motor Vehicle Duty" or colloquially, "Rego"). |
| Vehicle use | • Excise and GST on fuel. Excise has remained unchanged since 2001, and is, for instance, AUD 0.38143 per litre on unleaded fuel, fuel and automotive diesel. Liquid Petroleum Gas (LPG) is much less taxed with a rate of AUD 0.10 per litre, but is undergoing a schedule of increases.<br>• Cashless toll systems on most stretches of motorway but few charges on other sections of road. |

pollution because the price of carbon implied by the excise is typically way above even high-end estimates of its appropriate value. While it can be convenient to give credence to high fuel excise by considering it covers a range of externalities, in fact it may not be the first-best tool to tackle these problems.

Figure 1.4. **Tax on gasoline**[1]

2013, USD PPP per litre




1. Unleaded premium 95 RON. Tax refers to excise tax and general sales tax.
*Source:* OECD (2014), *Energy Database*.

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In sum, the Australian context favours road charging rather than fuel taxation as the most feasible economic instrument for dealing with transport-related externalities. To date most road pricing comprises tolls on sections of motorway that have been built under build-operate-transfer (BOT) contracts with the private sector. Time-varying charges operate in some cases (for instance the Sydney Harbour Bridge and Tunnel), reflecting good practice. Also, parking levies are being used to discouraging car use; for instance Victoria imposes an annual "congestion levy" on parking spaces in certain urban areas. However, comprehensive schemes that directly target car use, for instance along the lines of London's "area charging" model or GPS-based charging have not yet been introduced in any of Australia's states. As stressed in previous *Survey* discussion (OECD, 2012a), getting public acceptance for congestion charging can be a major hurdle.

As in many other countries a substantial share of vehicles are company cars; for instance it is estimated these accounted for one third of new car registrations in Australia between 2001 and 2011 (Harding, 2014). Company-car taxation is inherently tricky because the vehicles are invariably used for both personal and business travel, resulting in complex tax rules. As a result the provision of company cars often features in employee (and employer) tax optimisation strategies, undermining efforts on other fronts to discourage car use. In Australia, company cars are taxed as a fringe benefit. There has been some improvement in the rules recent years. Previously, there was a stepped schedule with four tax rates that declined with distance travelled. This created incentives to purposefully add mileage to enter a lower-rate distance band. Transition to a single-rate began in 2011 and was completed in 2014. Avenues for further improvement should be sought.

Alterations to vehicle taxation and further development of road charging need to be part of a wider transport strategy in the context of a co-ordinated federal and state government policy that strives to make the best allocations of infrastructure development between road infrastructure and options in public transport. Reforms to vehicle taxation should also broadly align with efforts to shift taxation from inefficient tax bases towards those that have favourable characteristics both as in terms of revenue but also economic incentives, as advocated in Chapter 2 in relation to state-level taxation.

### *Carbon taxation has been cancelled under a new approach to greenhouse gas emission reduction*

The present government has dramatically changed the policy approach to mechanisms for reducing emissions. In July 2014, it delivered on its election commitment to repeal a carbon credit and purchasing system (dubbed the "carbon tax", as its initial phase involved companies buying carbon credits from government as a first step towards a cap and trade system). By way of replacement, the government has proposed a suite of new measures called the Direct Action Plan.

The Direct Action Plan centres on the Emissions Reduction Fund which is a mechanism for crediting emissions reductions. Emission-reduction projects will be selected via a sealed bid auction and the government will then enter into contracts with successful bidders which specify that it will purchase a specific quantity of emission reductions on delivery. To sell emissions reductions to the government or into the secondary market, participants must first have the reductions verified and be issued with tradable carbon credits. In principle, such a scheme can have the appropriate incentive effects – indeed, it can have the same effects as a carbon tax at the margin, providing difficulties in establishing baseline emissions and checking the achievement of emissions reductions are overcome. Unlike a carbon tax or cap and trade system, the Direct Action Plan will involve a net fiscal cost to the government.

However, there are avenues for enhancing the Emission Reduction Fund. Encouraging the development of a secondary market for the credits would help deepen efficient allocation through market forces. Also, in a sound move to address the risk of offsetting increases the government intends to implement a safeguard mechanism in which large industrial facilities will be encouraged not to exceed an established historical baseline. As of October 2014, legislation establishing the fund was in the final stages of parliamentary process while the safeguard mechanism was still at the consultation stage.

## Household income tax and benefits

### *Encouraging employment and combating poverty*

Household income taxes and benefits account for a significant portion of fiscal revenues and expenditures, and are an important tool of social policy. Income tax, particularly those aspects applying to people with low earnings capacity, in combination with the generosity, accessibility and qualifying conditions of welfare benefits, govern households' disposable incomes and influence their incentives for engaging in the labour market. Ensuring this aspect of the system of taxes and transfers is well designed is therefore extremely important. As discussed above, the present administration has signalled intention for substantial change in this area.

The architecture of Australia's tax-benefit system shares some characteristics to those of other OECD countries with a progressive personal-income tax (PIT) schedule with various credits incorporating social policy objectives coupled with a range of further support through cash benefits. Welfare is financed largely out of taxes rather than social insurance charges (Table 1.5) and benefits are predominantly means tested (see Table 1.6) rather than universal. There are two core benefits for the unemployed (Newstart, and the Youth Allowance and Parenting Payment), three for families (Family Tax Benefits A and B and the means-tested Parenting Payment) and one main form of cash support for the disabled (the Disability Support Pension) (Table 1.6).

Table 1.5. **Personal income tax and related social security contributions**

| Dimension | Notable features |
|---|---|
| Scope of the tax base | Levied on an individual basis. |
| Rates and thresholds | There are four rates of taxation, the lowest at 19% and the highest at 45%. Thresholds are not automatically indexed. There was a substantial hike in the universal tax free threshold from AUD 6 000 in 2011-12 to AUD 18 200 in 2012-13 (offset by the reduction in the Low Income Tax Offset from AUD 1 500 in 2011-12 to AUD 445 in 2012-13). |
| Tax deductions (i.e. deductions from taxable income) | Individuals pay tax on their total income less the costs to incur this income (allowable expenses).Tax deductions are allowed for certain work related expenses and expenses incurred from earning interest, dividend or other investment income. The latter can result in a "negative geared" asset. |
| Social charges and other mandated payments | Employers are mandated to transfer 9.5% of gross salary to employee's second pillar pension fund (superannuation fund), see Table 1.7. |
| | A standard charge of 2.0% applies to taxable income (the Medicare Levy). This is reduced (or eliminated) for those on low incomes. There is an additional charge (the Medicare Levy Surcharge) of 1-1.5% of income applying to those on high incomes who do not have complying private hospital cover. |
| Fringe benefits tax | Levied on employers for spending on non cash benefits provided to employees. The standard rate is 47%, increasing to 49% for two years from April 2015. Exempt items include, for instance, superannuation and relocation expenses. Special rules apply for motor vehicles. |

Partly thanks to light overall revenue demands, the tax wedge on labour in Australia is comparatively low. This is helpful for employment and competitiveness and particularly important at the low-end of the earnings distribution where workers are most vulnerable to unemployment. As of 2011-12 the compulsory payment wedge for a single person on two-thirds the average wage (including the employers' superannuation payment) was a little under 30% which is well within the bottom half of the OECD distribution (Figure 1.5). Furthermore, following an increase in the tax thresholds in 2012-13, the wedge will now be lower than this. Given benefits from shifting the tax mix away from income tax, cuts in personal-income tax rates and/or increases in the thresholds are certainly desirable in

Table 1.6. **Key features of unemployment, welfare benefits and activation**[1]

| Type of benefit | Details |
|---|---|
| General features | **Means testing** is common and, linked to this; benefits are usually "tapered" to reduce discontinuities in the tax benefit schedule. The rate of benefit withdrawal when income is above means test limits is typically 50%. |
| Unemployment benefit | **Newstart Allowance**: A means and asset tested benefit targeting the unemployed (and low income earners) of unlimited duration with fixed pay outs. Recipients are subject to ongoing activity requirements that are administered by private sector job centres operating under contract with government.<br>**Youth Allowance**: Equivalent scheme for young unemployed. |
| Family benefits: One off and short duration support | **Parental Leave Pay** (introduced in 2011): Means tested payment (individuals with income of AUD 150 000 or more ineligible) to 18 weeks' publically funded benefit set a level equal to the minimum wage.<br>*Note:* In addition, all employees are entitled to 12 months unpaid leave and some wage agreements contain provisions for employer funded paid leave.<br>**Dad and Partner Pay** (introduced 2013): Means tested payment to dads or partners, equivalent to two weeks full time minimum wage.<br>**Newborn Upfront Payment and Newborn Supplement.** One off supplements to the Family Tax Benefit (see below) at the birth of a child (the (eligibility notably excludes those receiving payments under Parental Leave Leave). |
| Family benefits: Long duration support | **Family Tax Benefits Parts A and B.** A two component means tested family tax benefit that is effectively a welfare benefit; "Part A" is paid per child while "Part B" provides additional support for families with one income if earning below AUD 150 000, i.e. is also means tested.<br>**Parenting Payment**: Means tested support for when children are under 6 (for those with partners) and 8 years (for single parents).<br>**Child Care Benefit and Child Care Rebate and the Jobs, Education and Training Child Care Fee Assistance** subsidies paid to parents for expenditure on childcare services (proof of expenditure on care services is generally required). |
| Financial support for the disabled | **Disability Support Pension (DSP)**<br>Recipients automatically also receive the **Pension Supplement** (which is also available to other benefit categories, notable the Age Pension). |
| Other Support | **Rent Deduction Scheme**: Rent subsidies in which the benefit administrator (Centrelink) pays rent on behalf of the beneficiary, benefit pay outs are reduced but by less than the cost of rent.<br>**Pension Supplement**: automatically paid to certain benefit recipients, notably those receiving the Parenting Payment, Disability Support Pension and the Age Pension. Several supplements have been rolled into it (the Pharmaceutical Allowance, GST Supplement, Utilities Allowance and the Telephone Allowance).<br>**Pension Education Supplement**: Fortnightly payments to a range of groups on approved study courses including those on the Newstart Allowance.<br>**Income Support Bonus**: Automatic biannual payment to certain recipients of other benefits (nominally designated as helping prepare for unexpected living costs).<br>**Mobility allowance**: A two level cash benefit designated to help with transport costs.<br>**Energy Supplement**: Cash benefit designated to help eligible households with everyday expenses. There is a fairly wide range of eligible groups (includes those who receive Family Tax benefit).<br>**Education Entry Payment**: Small annual payment for low income groups enrolled in education courses.<br>**Health Care Card and Pensioner Card**: Entitlements include: larger subsidies for prescription medicines, cheaper medical services (at provide discretion) and bigger benefits for medical expenses through safety net arrangements. State and Territory Governments also grant cardholders various concessions on energy costs, public transport and rates. |

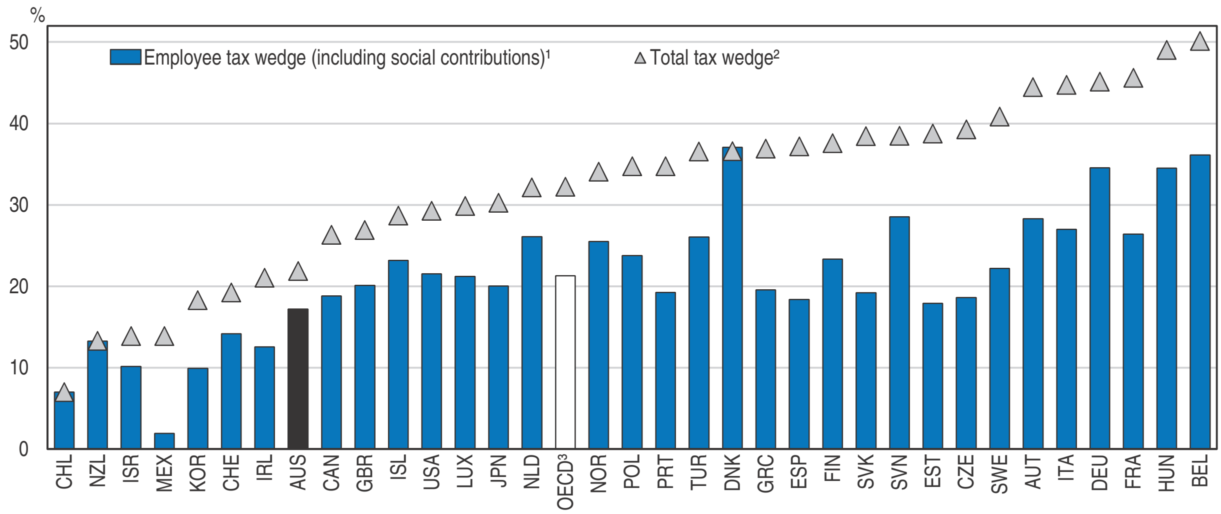
1. Operational details as of September 2014, unless explicitly stated intended reforms, including those in the legislative pipeline are not covered.
2. Typically automatic assessment and provision as part of assessment for the main benefits.

principle. Current fiscal challenges will probably preclude pressing ahead on this front in the near term, but such reforms should nevertheless remain an aspirational goal.

International comparison of pre- and post-tax (and benefit) Gini coefficients and poverty rates (Figures 1.6 and 1.7) indicate that, overall, Australia's tax-benefit system, at least as of 2011, was reducing overall inequality and poverty by rather less than systems elsewhere. For instance, Australia's Gini coefficient was 16th highest in terms of gross incomes but was 8th highest once taxes and benefits are taken into account. These rankings partly reflect the wide differences in the economic positions of OECD countries in recent years. High and persistent unemployment in some countries has pushed up pre-tax

Figure 1.5. **Tax and compulsory payment wedges for a single person at two-thirds average wage, no children**

2013




1. The sum of income tax and employee social contributions as a share of gross earnings.
2. The sum of income tax, employee social contributions, employer social contributions, payroll tax, net of cash transfers as a percentage of gross labour costs.
3. OECD is a simple average of member countries' data.

*Source:* OECD (2014), *Taxing Wages Database*.

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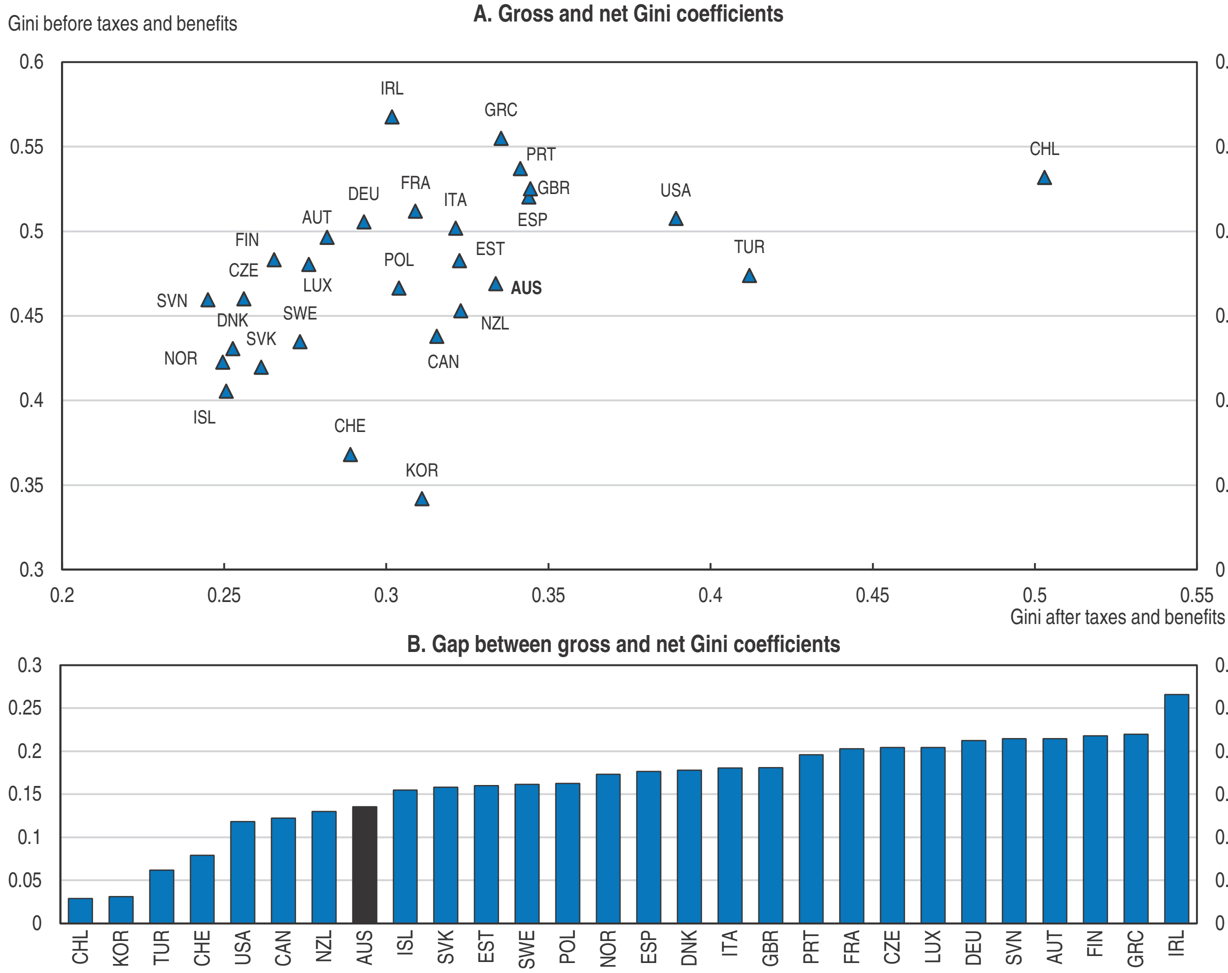
inequality and poverty and their benefit systems are doing a lot of work to ameliorate this. Some of the differences between Australia and other countries in Figures 1.6 and 1.7 may also reflect certain elements of Australia's tax and benefit system. For instance, the income tax schedule loses progressivity fairly early in the income distribution; the top marginal tax rate threshold is reached at only about two and a half times the average wage. Also, as for other countries with flat-rate means-tested unemployment-benefit, replacement rates are low in the initial phase of unemployment. However, these are not the only factors influencing the progressivity and generosity of tax-benefit systems. In particular, the wide use of means tested benefit and the small role played by social-security contributions in Australia implies a more progressive tax-benefit system compared with counties where universal benefits and contributions feature heavily in the system. Overall, evidence suggests that for Australia the factors that increase progressivity tend to be outweighing those that reduce it. Indeed, indicators based upon micro-simulations for various types of household suggest progressivity in the country's tax-wedge is typically among the highest in the OECD (examples of these calculations are shown in Figure 1.8).

### *There is room for further simplification*

If unchecked, tax and benefit systems typically grow in complexity over time. Political "credit" is often greater from bringing in new schemes and mechanisms than it is from identifying and removing obsolescent or ineffective ones. Furthermore, visibility often matters in the politics of making reform happen. For instance, new benefit allowances (with attendant labels) are sometimes added as separate entities even when they effectively represent an increase in an existing payment. In Australia, the core tax and transfer benefits are accompanied by a host of auxiliary benefits; some of which, at least *prima facie*, seems somewhat surplus to requirements.

Figure 1.6. **Gross and net income inequalities**[1]

Total population, 2011 or latest available




1. The Gini coefficient takes values between 0 for maximum equity (all households receive the same income) to 1 for maximum inequality (one household receives all income).

*Source:* OECD (2014), *Income and Poverty Distribution Database.*

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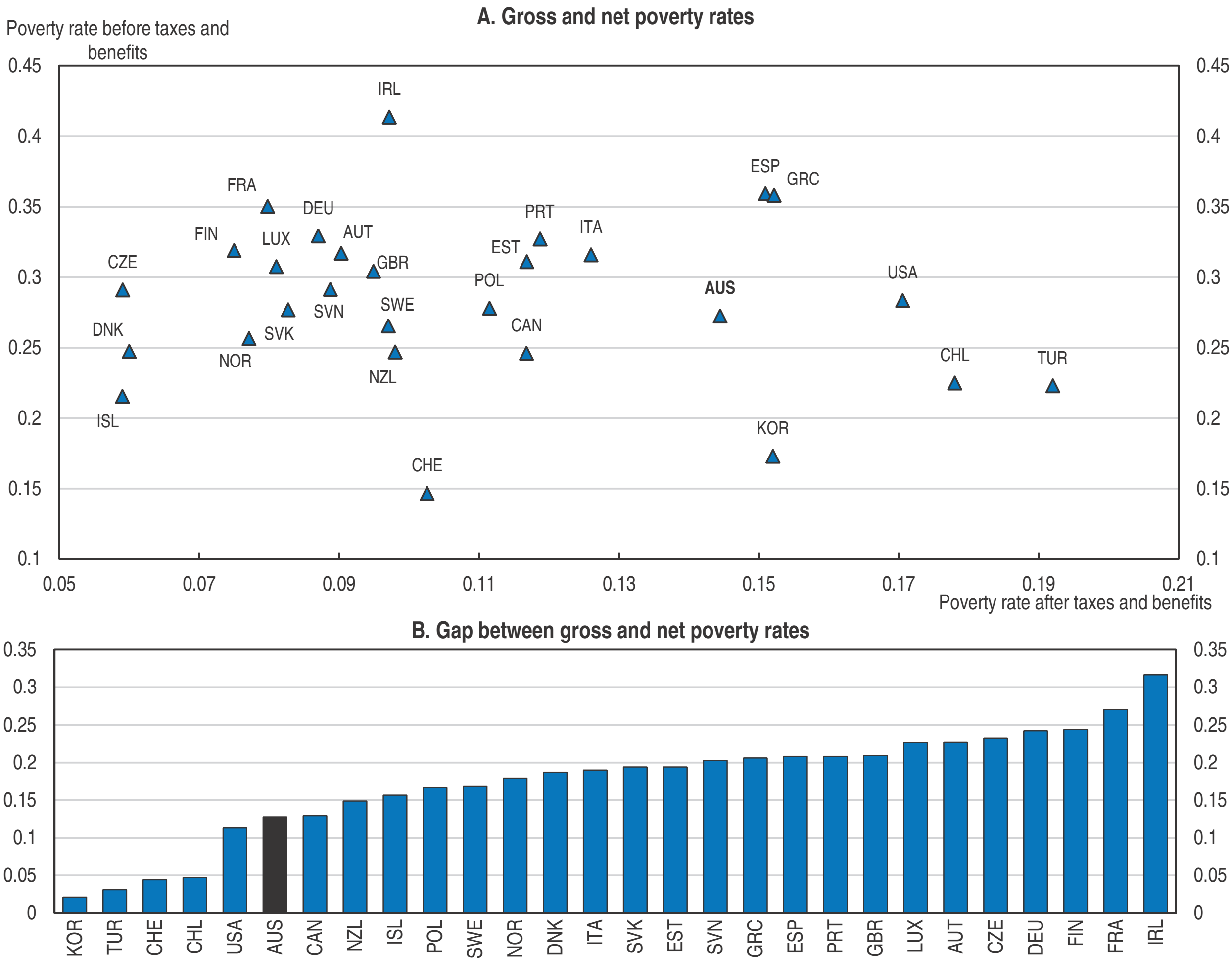
There has been some concrete progress in simplification. For instance a number of designated supplements (including a GST Supplement) are now rolled into a single auxiliary payment, the Pension Supplement (to which beneficiaries from several main benefit schemes are entitled). However, there is room for further reform. For instance, the Henry Review advocated replacing Parts A and B of the Family Tax Benefit with one benefit and suggested combining the Child Care Benefit and the Child Care Rebate. Encouragingly, the present government appears committed to simplification. For instance, there are plans to concentrate support for indigenous Australians. There are currently 150 programmes operating under the Department of Prime Minister and Cabinet; these will be compressed into a new strategy (the Indigenous Advancement Strategy) comprising five core themes. Similarly, programmes operating under the Health portfolio will be rationalised (into the Indigenous Australians' Health programme). The sheer number of programmes currently in operation certainly suggests that consolidation makes sense. However, sorting out

Figure 1.7. **The incidence of relative poverty based on gross and net income**[1]

Total population, 2011 or latest available




1. The incidence of relative poverty measures the share of households whose equivalised income is less than 50% of the median income.

*Source:* OECD (2014), *Income and Poverty Distribution Database*.

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which elements of the system are worth preserving and which should be scrapped in the interests of improving efficiency will be challenging.

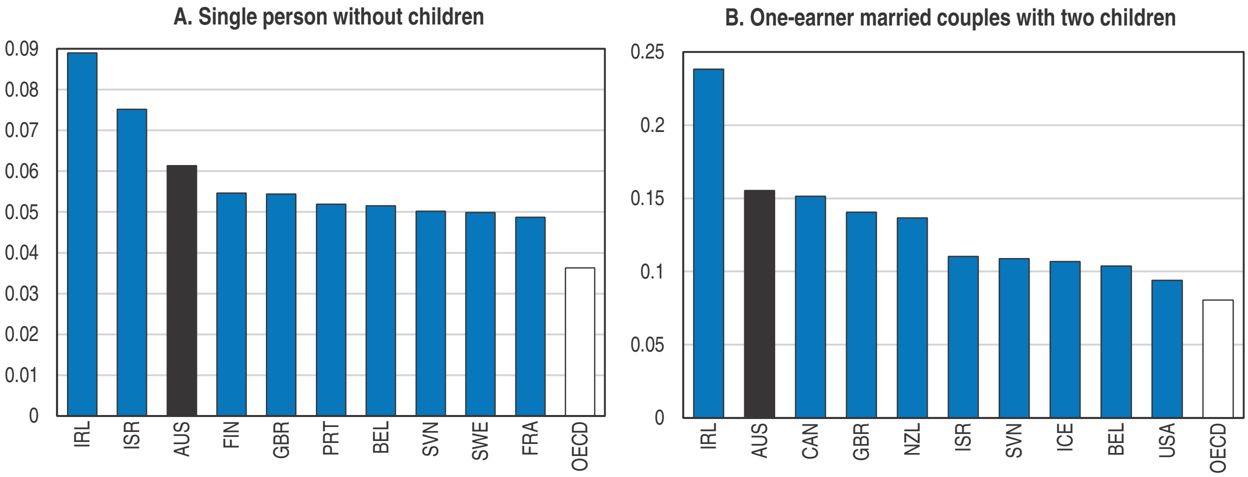
### *Reform proposals targeting youth unemployment will require close surveillance*

Australia's system of unemployment benefit and activation has some admirable qualities. The value of the fixed-rate, means-tested unemployment benefits (Newstart and the Youth Allowance) are modest (Figure 1.9). Indeed, past *Surveys* have proposed more generous benefit in the initial months of unemployment (OECD, 2010). Furthermore, the system of private-sector placement services operating under contracts with government that contain financial incentives for getting the unemployment-benefit claimants into work has attracted much international attention and has been the subject of a comprehensive OECD review (OECD, 2012b).

The present government aims to improve the pathways to education and the labour market, while making unemployment less attractive, especially for young people, by

Figure 1.8. **Average tax wedge progression – Comparison with top ten OECD countries**[1]

Across income intervals ranging from 50% to 500% of AW, in 2012




1. The average tax wedge progression takes into account the effect of employee and employer social security contributions, payroll taxes and cash benefits on progressivity. The indicator measures the percentage point increase of the average tax wedge per percentage point increase of the average wage over the 50%-500% of the average wage income interval.

*Source:* OECD (2014), *Taxing Wages 2012-13*.

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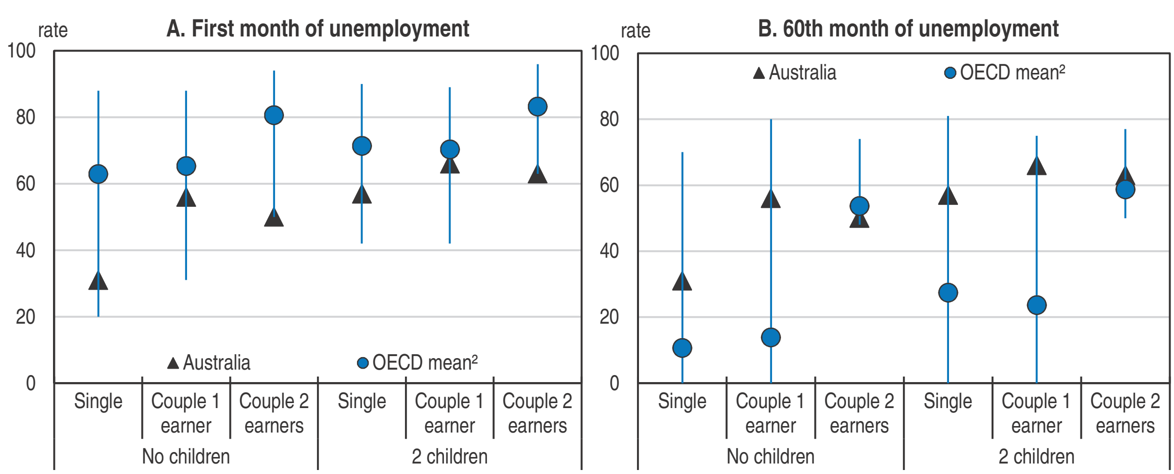
Figure 1.9. **The unemployment benefit replacement rate at two-thirds average wage**[1]

2012




1. The microsimulations normally cover only benefits for which there is a general entitlement. For many OECD countries, where no broad social-assistance programmes exist, the simulations indicate that benefits are zero for some types of household at the 60th month of unemployment. Hence, the minimum OECD replacement rates are zero in some cases. However, in many countries, local authorities or sub-national governments may provide some form of cash support on a case-by-case discretionary basis.
2. OECD mean is depicted on a line connecting the minimum and maximum values within OECD.

*Source:* OECD (2014), *OECD Tax-Benefit Models*; see *www.oecd.org/social/workincentives*.

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reducing financial support. Proposals outlined by the government (Australian Government, 2014b) include:

- Tougher rules for unemployment-benefit claimants aged under 30, including demonstration of up to six months job search before becoming eligible for payment (i.e. longer "waited periods" for benefit).

- Increase in the minimum age of eligibility to the Newstart Allowance (and Sickness Allowance) from 22 to 24 years.
- Extending the range of qualifications covered by government-subsidised student loans available to help students pay their contribution to tuition fees (though proposals also include less favourable conditions in these loans and reduction in the government's direct contribution to tuition fees).
- Provision of employment services for jobseekers during the benefit waiting period. The level of services will depend on individual circumstances. At a minimum the aim is for job centres to assist claimants in preparing a resume, and to offer advice on employment opportunities and information about training.
- Expansion of a pilot programme, Work for the Dole, which provides mandatory work experience for certain jobseekers in selected areas of high unemployment.

Under these reforms, particularly the longer waiting periods for benefit, the system will move into unchartered territory and therefore the overall behavioural response is uncertain. The aim is for many unemployed youth to either return to education and training or to intensify job search and compromise more on what jobs they will take. However, the scale of such responses to this type of reform is uncertain and other, less desirable, reactions might be significant. For instance, the changes may prompt some to "drop out", considering that the effort to apply for Newstart or the Youth Allowance and engage in activation programmes is no longer worthwhile. In addition, the changes may elicit intensified application for other benefits (such as disability benefit). Given these possibilities, the government's proposals require close monitoring.

### *A large increase in public spending on parental leave pay may not be optimal*

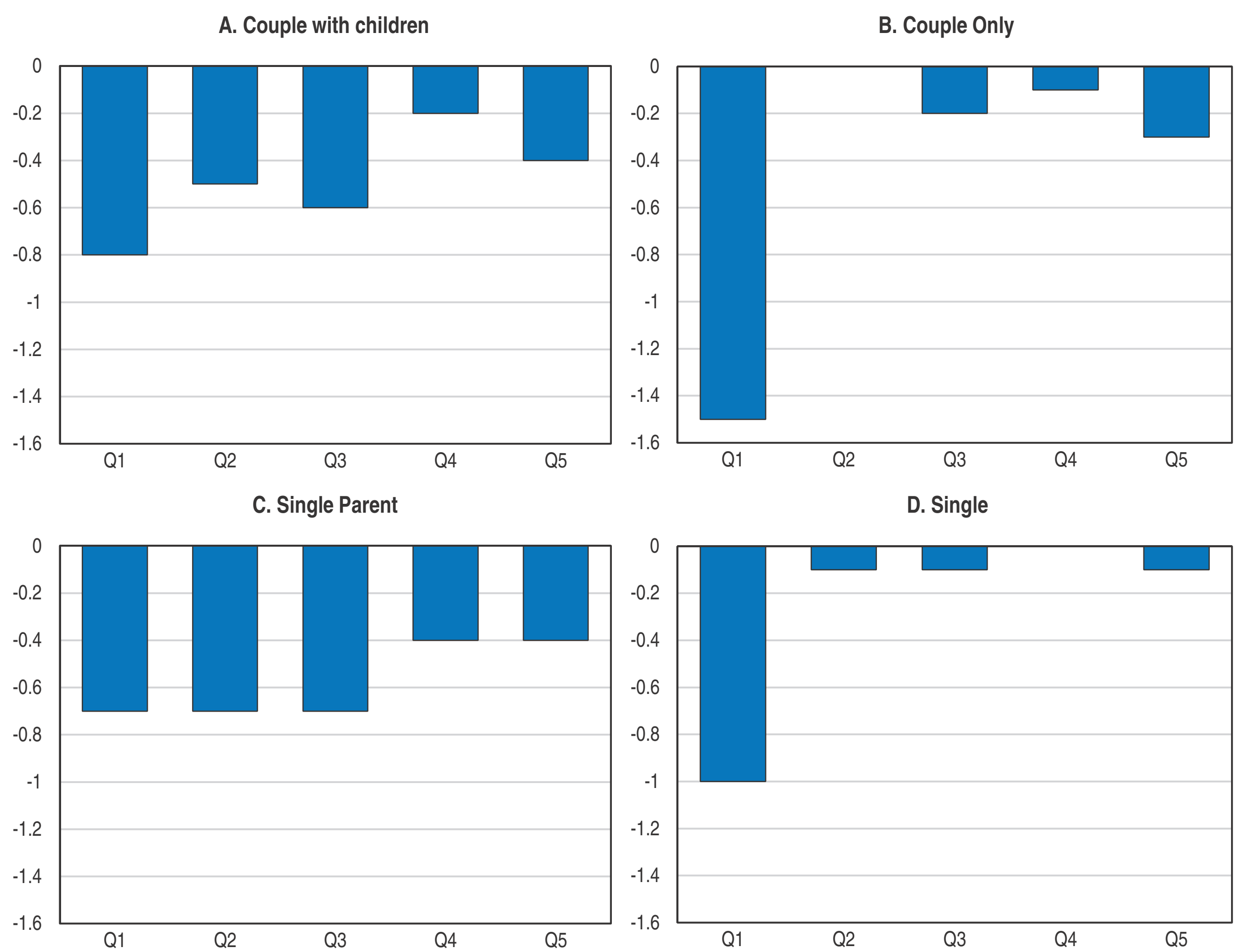
Reforms proposing substantial increase in the generosity of paid parental leave mentioned in earlier sections have been given high priority by the current government. The introduction of publically funded paid parental leave in 2011 established common minimal provision to the various sectoral and employer-specific arrangements for paid parental leave already in place. The scheme provides a flat rate of 18-weeks benefit at the same level as the full-time minimum wage. In many other countries paid parental leave is linked to previous earnings (with caps) and the present government intends to introduce a similar system. The proposal envisages payment over 26 weeks equal to previous earnings or the full-time minimum wage (whichever is the greater) and superannuation contributions will also be paid. Under current proposals the pay-out will be capped at AUD 50 000 in total which is equivalent to a little over six months benefit at the average wage. Such a scheme would broadly encourage labour supply, making the pursuit of careers more attractive (particularly for women), support improved maternal and child wellbeing and increase the retirement savings of women by providing superannuation contributions. However, as for any substantial increase in funding on a specific mechanism, there should be careful cross-checking to ensure that the move stacks up favourably against a more diversified strategy given there may be diminishing marginal returns. Indeed, a recent review of child-care issues (Productivity Commission, 2014) questions whether such substantial additional funding on this form of parental support is the best allocation of resources for boosting female labour supply or for more generally facilitating and encouraging parents to combine work and family life. Indeed, the report suggests diverting some funding for the proposed scheme to other aspects of family policy, for instance to supporting early childhood education and care.

### *Other welfare-reform proposals will reduce payments to families*

In other respects the government's proposals reduce payments to families, for instance with plans narrowing the scope of some family tax benefit, threshold freezes and new indexing restrictions. This is illustrated by simulations of budget-measure impacts using a tax-benefit model based on details from 44 000 families (the "Stinmod" model) by the *National Centre for Social and Economic Modelling*. This modelling suggests that the budget measures will have very little impact in 2014-15 among most of those without children, but may result in a small fall in income, on average, among lower quintiles of those with and without children (Figure 1.10). Low-income families and individuals will continue to receive public assistance, which the government judges to be substantial. Some calculations of the value of assistance following implementation of the proposed welfare reforms are included in the government's budget documents. For instance, it is estimated

Figure 1.10. **Mean impact in 2014-15 on disposable income of households in each quintile from the 2014-15 budget measures**[1]

Percentage impact




1. The analysis is based on the STINMOD14 model of NATSEM (at the University of Canberra), measuring the impact of tax and benefit changes under the Coalition Government. The calculations do not include proposals to expand paid parental leave. Q1 refers to the lowest quintile (i.e. the bottom 20% of households in terms of mean disposable income) and Q5 refers to the top quintile. The impact refers to the difference between a baseline scenario of disposable income and a scenario including budget measures.

*Source:* NATSEM (2014), *National and Regional Analysis of the 2014-15 Federal Budget*, September.

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that as of 2016-17 a lone parent with two children with income of AUD 30 000 will receive AUD 18 454 in government payments (Australian Government, 2014c). In addition, as in the current system, the household and may be eligible for a range of other government benefits and services.

### *High marginal tax rates from benefit tapering remains a challenge*

In Australia, policy challenges arising from benefit tapering (or "benefit withdrawal") are greatest in tax-benefit configurations for families. Means-tested benefits are not entirely cut off if a recipient's income rises above a certain threshold; instead they are typically reduced by a fixed proportion, hiking up the effective marginal rate of tax. The lower the rate of withdrawal, the lower the marginal-tax effect and attendant risk to incentives, but the greater the fiscal cost with respect to pay-outs and the weaker the benefit's targeting. Furthermore, schemes cannot be viewed in isolation, as it is the net effect of all benefits and taxes that matters most for incentives. Therefore, tax-benefit systems with multiple means-tested benefits require careful engineering to avoid large numbers of households facing very high (possibly greater than 100%) effective tax rates on additional income, while also bearing in mind the deadweight loss of handing out benefit to households who are outside the intended target range.

These challenges are illustrated in Figure 1.11 which shows marginal-net-tax-rate calculations (i.e. including income tax and benefits) for earnings in cases of a single-person household with and without children and, similar for a couple with one earner. OECD tax-benefit simulations assume children are quite young, which for Australia means parents are potentially eligible for the Parenting Payment as well as Family Tax Benefit. As shown in Figure 1.11, the family-related benefits are pushing up marginal taxes from additional income for those earning up to the average wage, mainly from Parenting Payment withdrawal (at a rate of 40%). The benefits also create a "bump" in marginal taxes further up the earnings distribution (between about 1.3 and 1.5 times the average wage) due to withdrawal of the Family Tax Benefit.

These tapering issues reinforce the case for further simplification of the tax-benefit system. Reducing instances of overlapping tapering schedules would allow for some smoothing the marginal tax "bumps", thus improving the returns to households from increases in earned income.

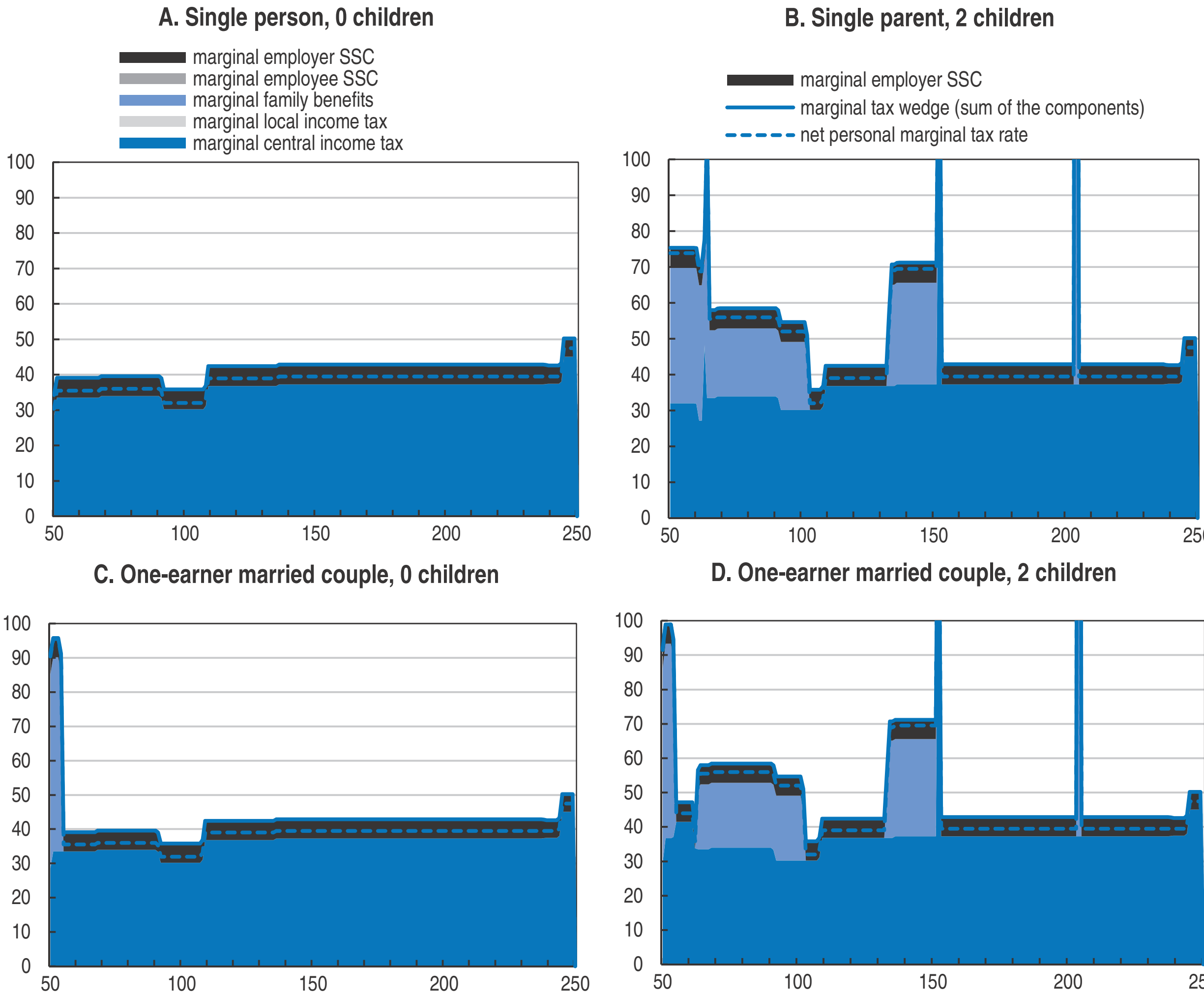
### *Issues for middle and upper-income households*

In Australia, the top marginal rate of tax, at 47% (including the Medicare Levy but excluding the recently introduced Temporary Budget Repair Levy), starts at a relatively low threshold of around 2.5 times the average wage. These settings are not too distant from those in many European countries (Figure 1.12), and broadly are a consequence of heavy reliance on income tax (or, the failure to fully utilise the potential for indirect taxation). This reinforces the case for tax-mix reform that envisages an increase in in PIT thresholds, and possibly rate reductions too.

Much time, effort and money is expended by Australian households on understanding the tax system and filing their tax return. The comparatively low PIT thresholds mean many households have incentives to minimise the taxable component of income. One avenue is through deductible expenses, which are relatively generous compared to other OECD countries. There are also opportunities for employers to provide some remuneration in the form of fringe benefits (such as a car). Employers pay tax on the latter under fringe-

Figure 1.11. **Marginal tax wedge decomposition**

By level of gross earnings expressed as a % of average wage




*Source:* OECD (2013), *Taxing Wages 2011-12*, OECD Publishing.

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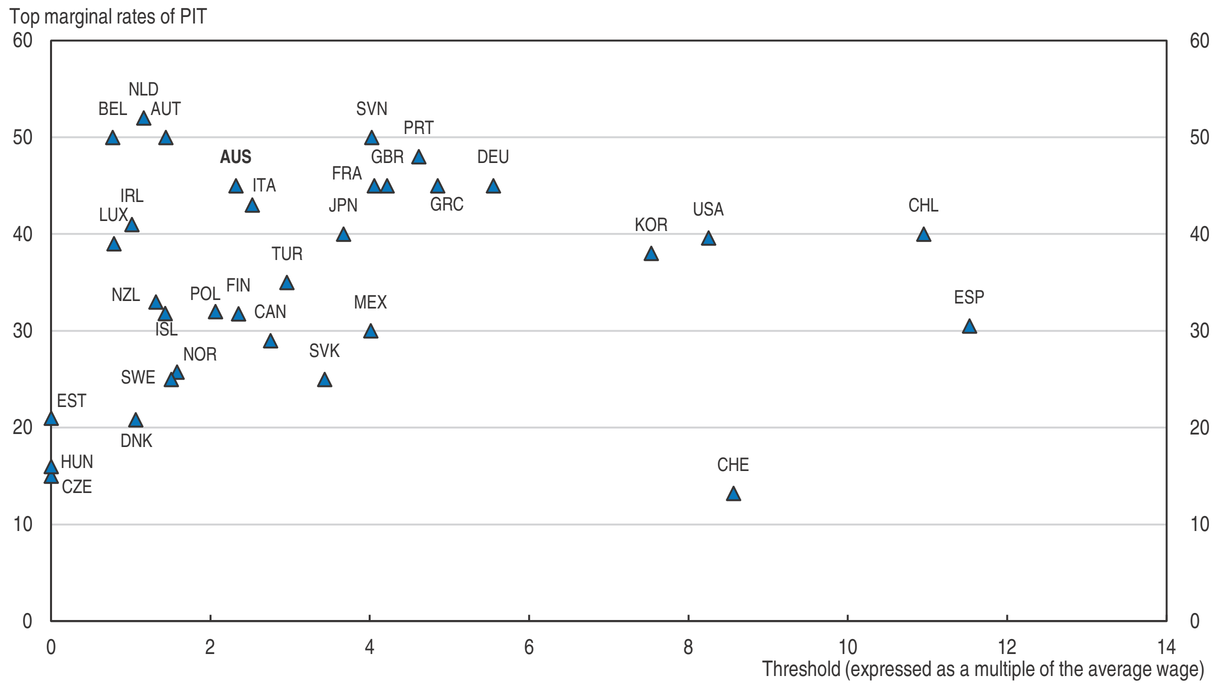
benefits tax, but there are a number of concessions available for certain types of expenses, which can make this an attractive avenue to pursue and further complicates tax planning. Reforms underway by the Australian Taxation Office reducing tax compliance costs will certainly help, such as increased pre-population of tax returns (see below). However, avenues for simplifying PIT deductions and fringe benefit taxation should be sought too. Increasing PIT thresholds and/or reducing the rates would lower incentives for sophisticated avoidance strategies, though this should be regarded as a beneficial side-effect rather than a primary driver of such a move.

The government's Temporary Budget Repair Levy, a 2% extra tax on taxable income above AUD 180 000 (i.e. about twice the average wage) for three years, was legislated in June 2014. According to government calculations (Australian Government, 2014c) about 400 000 taxpayers will pay the levy, raising AUD 3.1 billion in revenues over the three years (i.e. about 0.2% of current annual GDP). While these revenues certainly help, the levy probably also reflects a desire by government to signal "burden sharing", especially as the

Figure 1.12. **Top marginal rates of personal income tax (PIT) and corresponding thresholds**[1]

Per cent, 2013




1. Data comprise the top statutory personal rate plus additional deductions (such as social security contributions) that apply at the threshold where the top statutory PIT rate first applies.

*Source:* OECD (2014), *Tax Database*.

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budget includes economies in welfare spending. Given the levy comprises a small and temporary increase in top-end tax, undesirable behavioural responses by employees and firms (for instance, relocation outside Australia) will probably be negligible. However, the levy has no doubt sparked a search for avoidance strategies. For instance, some speculate that a delay in the increase of fringe benefit tax to match the new effective top rate of personal-income tax of 49% will be exploited. However at this stage, there is no evidence whether this or other avoidance strategies, are being extensively exploited.

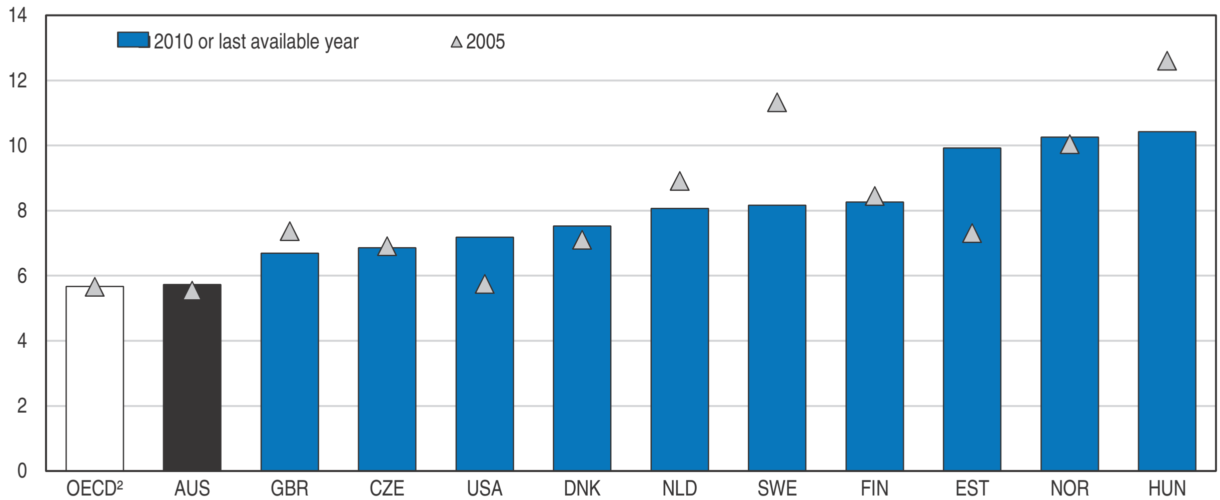
### *Further reform of the disability system remains important*

While the portion of the working-age population receiving disability benefit stopped increasing in the early 2000s, it is nevertheless quite high at a little over 5% (Figure 1.13). Furthermore, as elsewhere, comparatively few exit the system and become re-employed. Preventing "leakage" of claimants into disability benefits arising from the somewhat greater generosity and, in some respects, the lower conditionalities compared with unemployment benefit remains a challenge as does supporting and encouraging rehabilitation and employment among the existing stock of beneficiaries.

Disability pension systems cannot typically be reformed quickly or easily and therefore typically require a continuous campaign of measures. Adjustments to the Disability Support Pension proposed by the present government comprise a five-year plan to increase activation among recipients aged under 35. These proposals include compulsory activities (with sanctions for non-compliance) for those with an assessed work capacity of 8 or more hours and, for the same age group a review of individuals' eligibility

Figure 1.13. **Disability benefit recipients – Comparison with highest 10 OECD countries**[1]

As a percentage of working-age population (15-64)




1. Australia has the 13th highest rank.
2. The OECD average excludes Chile, Iceland and Turkey.

*Source:* OECD (2014), *Economic Policy Reforms 2014: Going for Growth Interim Report.*

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for the Pension. In addition, the authorities plan on imposing tighter rules on overseas travel for disability pension recipients to counter a perceived problem that individuals are embarking on extended holidays while on benefits.

The government is also committed to continuing a major reform of disability support services. The reform, the National Disability Insurance Scheme, endeavours to resolve uneven service quality, underfunding and fragmentation by introducing a more centralised and better-resourced system run by a new body, the National Disability Insurance Agency. The reform essentially aims to provide a much greater range of universally available support services for the disabled. It entails roughly a doubling of expenditure on disability support services to about AUD 14 billion – i.e. an increase in spending from about 0.5% of GDP to 1% of GDP. About one third of those receiving the disability support pension receive some form of disability service, and therefore improving the latter will mark a substantial rise in living conditions for many of those receiving the pension.

### *A broadly sound pension system but requiring some specific fixes*

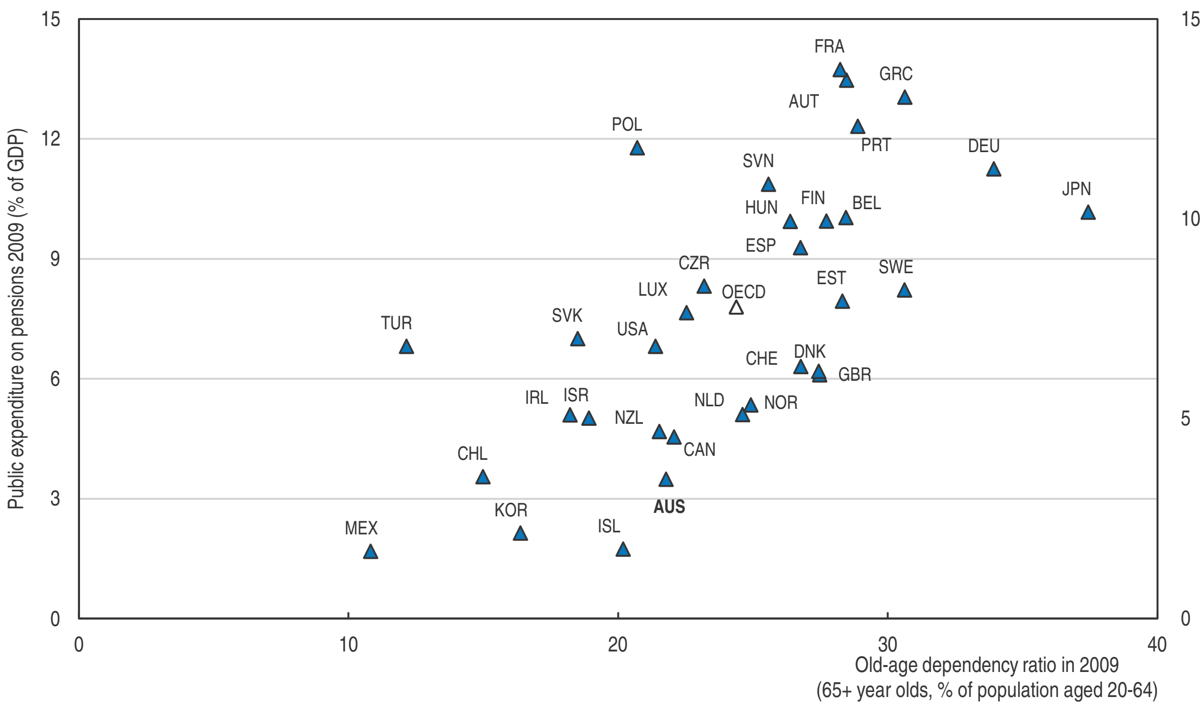
Australia's pension system centres on a means-tested benefit (the Age Pension) in combination with a defined-contribution pension ("superannuation") (Table 1.7). The age of access to the Age Pension is currently 65 but scheduled to increase to 67 by 2023 under reforms of the previous government and the current government intends to programme increases to 70 by 2035. Superannuation comprises a compulsory minimum contribution from the employer (the "superannuation guarantee") to which voluntary contributions can be added. The latter (up to certain limits) can be channelled as an employer contribution (called a "salary sacrifice" as the employee's salary is reduced correspondingly) or otherwise taken out of post-tax income. Under "preservation rules" superannuation can be first accessed at age 55 (due to increase to 60 years). In addition to the Age Pension and superannuation schemes, there are some "sunset" pay-as-you-go pension funds that are closed to new members but which will continue to run for some decades to come.

Table 1.7. **Key features of the pension system (excluding tax treatment and "grandfathered" schemes)**

| | |
|---|---|
| | First pillar (the Age Pension and related benefits) |
| Age of access and coverage | Currently 65 years and scheduled to increase gradually to 67 years by 2023. Legislation is in the pipeline for further increase. Coverage is practically universal. |
| Means tests and tapering rules | Both income and asset tests apply. The taper rate is either 40% or 50% in the case of earned income (depending on circumstance) and a reduction of AUD 1.50 is made for every AUD 1 000 of assets exceeding thresholds. Due to tapering, around 40% of Age-Pension recipients' have income and assets above the means-test thresholds.<br>There is an additional income-test concession (the Work Bonus) in which earnings from work (up to a certain value) are not counted in the income test. |
| Pay-outs | Basic rates vary according to circumstance. For instance, the maximum basic rate for a single person is AUD 751.70 per fortnight and that for a couple is AUD 1 133.20.<br>The effective pay-out exceeds the basic rates because eligibility to the Age Pension automatically means eligibility to some additional benefits: notably the Pension Supplement (a payment that was created to replace a variety of designated payments supposed to cover certain living expenses) and the Clean Energy Supplement. With these two supplements the single-person pay-out is AUD 827.10 and that for couples is AUD 1 246.80 per fortnight. |
| Indexing | There is biannual indexing based on the greater of the CPI or a special index (the Pensioner and Beneficiary Living Cost Index).They are then "benchmarked" against a percentage of Male Total Average Weekly Earnings (MTAWE). The combined couple rate is benchmarked to 41.76 per cent of MTAWE; the single rate of pension is set at 66.3 per cent of the combined couple rate (which is equal to around 27.7 per cent of MTAWE. Benchmarking means that the pension cannot fall below these values. |
| Other aspects | Access to the Age Pension can mean access to a range of other benefits (though, possibly conditional on additional eligibility requirements), such as rent assistance. |
| | Second pillar (compulsory and voluntary contributions to "superannuation" funds or similar) |
| Types of fund | The superannuation funds are run by individual employers, industry associations, financial service companies; these are supervised by the Australian Prudential Regulation Authority. "Self-managed" funds, which have at most four members, are increasingly popular, and are supervised by the Australian Taxation Office. |
| Contributions | There is a mandatory employer contribution (the "superannuation guarantee") that remained at 9% for many years but is now being increased in stages. For 2014-15, the contribution rate is 9.5% and is scheduled to reach 12% by 2019-20. Contributions are not compulsory for employees earning small amounts and there is a contribution cap at roughly 2.5 times the average wage.<br>Employers can make additional contributions on employees' behalf (the "salary sacrifice") up to certain limits, and employees can make additional voluntary contributions out of their post-tax income.<br>There is a co-contribution scheme for those on low earnings in which the government makes an additional pension contribution.<br>There are no special provisions for contributions when unemployed or when caring for children. |
| Rules on investment | Rules on the composition of portfolios are light. |
| Minimum age for access | Superannuation can currently be accessed from age 55 years (the "preservation age"), though as of 2015 increases are scheduled that will see the preservation age reach 60 years by 2025. The tax treatment favours retirement at 60 or above. |
| Pay-out conditions | There are no annuity requirements; the pay-out can be taken out as a lump sum on retirement. |

Pay-out from the Age Pension ranks as one of the most modest first-pillar pensions in the OECD despite an increase in provision as part of reforms in 2009. This, combined with comparatively favourable demographics, contributes to a comparatively low level of government spending on pensions (Figure 1.14) and augers well for future fiscal sustainability. This implies heavy reliance on superannuation in ensuring adequate incomes in retirement. For example, OECD pension simulations show that for an individual with lifetime earnings at half the average wage, the pension system will provide a respectable 91% of previous earnings-well above the OECD average of 70% (Figure 1.15). However, about 40 percentage points of this total comes from superannuation under assumptions that the individual makes an undisrupted stream of contributions throughout their working life. In the real world there may be sizeable numbers of current (and future) pensioners whose superannuation pay-out falls (or will fall) well short of that assumed in such calculation. Compulsory pension saving for employees via the superannuation system has only been in place since the early 1990s, and in any case there will always be some who, for instance due to low earnings capacity and few contributions due to intermittent employment, will only accumulate a modest superannuation pay-out (Box 1.1).

Figure 1.14. **Demographic pressures and public pension expenditure**




*Source:* OECD (2014), *Social Expenditures Database* (SOCX); United Nations, *World Population Prospects – The 2012 Revision*.

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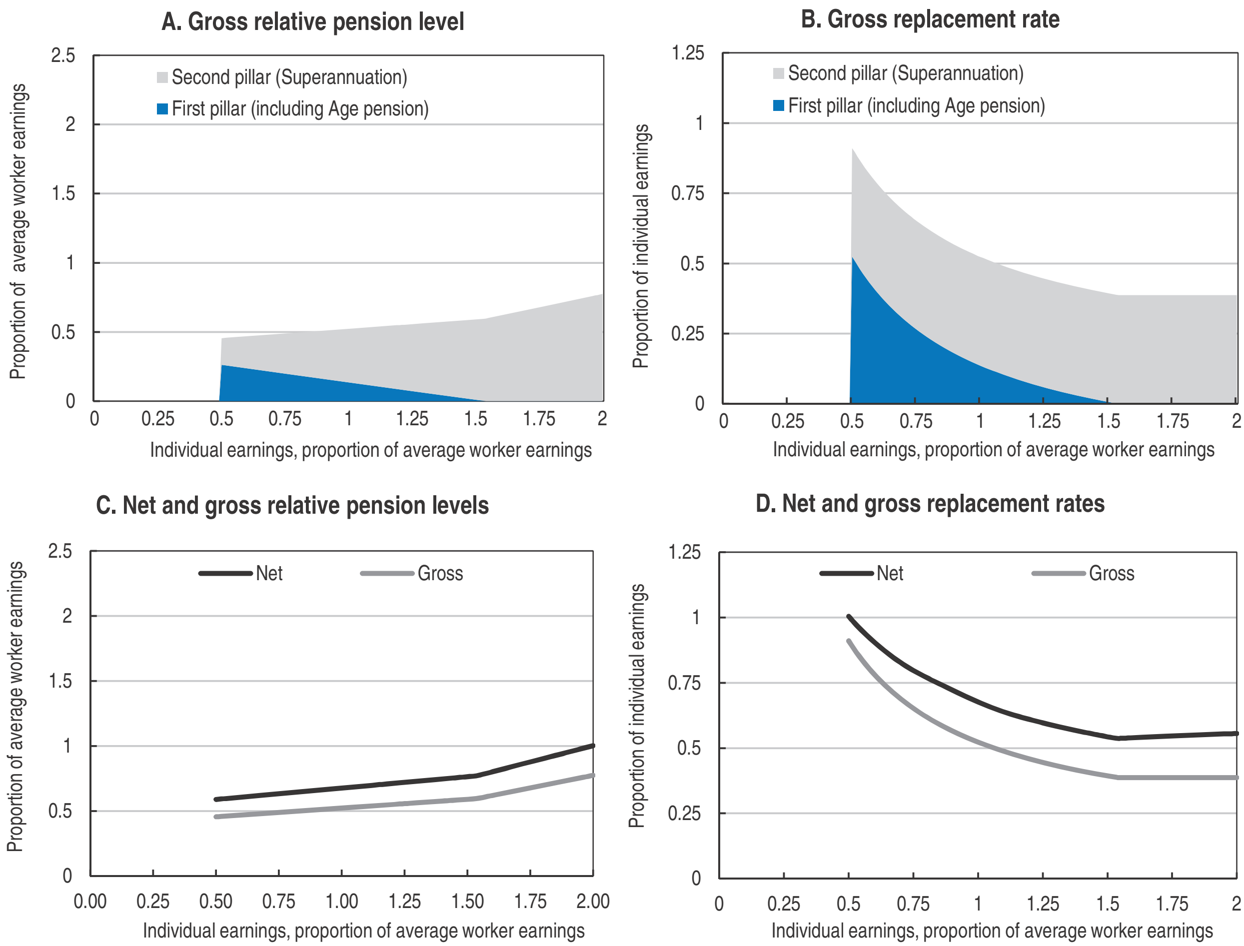
At present, the Age Pension's position relative to incomes in the wider population is protected by a floor condition linked to average wages in addition to a favourable indexing rule based on using whichever increase is greatest between consumer-price index and a cost-of-living index for pensioners (Table 1.7). The present government plans to abolish the floor condition and index the Age Pension only to CPI as part of a general strategy for more homogenous indexing across the welfare system and to help with fiscal savings. However, this reform will mean the pension's value will drift down in relation to average incomes, and at some point may cross socially acceptable limits of adequacy. The government's Intergenerational Reports which are published every five years and examine demographic challenges, provide a mechanism for parametric adjustment of the Age Pension, including indexation. However, constant change to pension indexing is not optimal, given the importance of stability in pension-system parameter settings to help households plan for the future. Narrowing the focus of the Age Pension or increased superannuation contributions (which implies lower pay outs on the Age Pension) may provide alternative avenues for managing the fiscal pressure from the Age Pension.

Figure 1.15. **Pension simulations for Australia**




*Source:* OECD (2013), *Pensions at a Glance 2013: OECD and G20 Indicators.*

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Box 1.1. **An important caveat on measures of pensioner poverty in Australia**

Some statistics on poverty among pensioners in Australia ring loud alarm bells. For instance, based on income distribution databases, *Pensions at a Glance* (OECD, 2013a) shows a relative poverty rate of 40% among Australian pensioners. This contrasts sharply with the OECD average of 15% (this poverty measure is the share of the pensioner population estimated to have incomes less than half of median income for the population as a whole). However, there are a number of reasons why this type of poverty measure is not necessarily a good indicator of the living standards of older people (OECD, 2013a). These include: the non-consideration of non-cash benefits, such as the value of health and other publicly-provided services; the non-consideration of wealth, including lump-sum superannuation payouts and home-ownership (and the costs associated with different housing tenures); and the sensitivity of a "headcount" poverty measure where there is a flat-rate basic pension. In the Australian case, these issues significantly reduce the accuracy of a simple headcount measure of income poverty. For these reasons, pension poverty and adequacy in Australia is better gauged through other approaches, for instance the simulation results shown in Figure 1.14 address some of these issues.

The current tax treatment of pensions is unusual and raises questions of focus and efficiency. As is commonly the case elsewhere, contributions up to certain limits are not taxed (unless voluntary and coming out of post-tax income). But unlike most other systems there is some tax in the accumulation phase, and, most strikingly, following a government decision taken about a decade ago, annuity income is not taxed at all (see Table 1.8). This latter move was primarily motivated by a desire to simplify what had become an overly complex tax treatment of superannuation pay-outs. A number of reforms "grandfathered" existing settings (i.e. reforms only applied to new retirees), generating multiple tax treatments. However making superannuation income tax-free has meant that sizeable sums of public money are implicitly being spent in a way that largely benefits middle and upper income earners; for 2013-14 the spend is estimated at around AUD 32 billion, i.e. equivalent to about 2% of GDP (Table 1.3).

Table 1.8. **Tax treatment of pensions**

| Contribution phase | Accumulation Phase | Pay-out phase |
|---|---|---|
| First pillar (the Age Pension and related benefits) | | |
| Not applicable. | Not applicable. | Included in taxable income (but the effective tax rate is typically very low). |
| "Concessional contributions" (compulsory and "salary sacrifice" contributions) | | |
| Not taxed in that the contributions are made by employers and therefore do not figure in the employees tax returns. | An initial tax of 15% applies to incoming contributions. Subsequent dividends and capital gains are also taxed.<br>For many households the rate is "concessional" in that the tax is lighter than on other forms of saving. | For those aged over 60 pay-outs in the form of annuities are tax-free.<br>Lump-sum pay-outs are tax free up to certain thresholds. |
| "Non-concessional" contributions | | |
| Taxed in that these are contributions made out of post-tax personal income. | No initial tax on contributions, but there is tax on dividends and capital gains. | Neither annuity pay-outs nor lump-sum withdrawals are subject to tax. |

There are a number of other issues regarding the pension system, some of which are being addressed in the Financial System Inquiry, which is scheduled to report to the government in November 2014. One question is whether there should be rules on how individuals access their superannuation. At present there are no restrictions; the pay-out can be taken as a lump sum or as an income stream product (such as an annuity) or as a combination of both. There are tax incentives to take up an income-stream product; in particular investment earnings on assets supporting an income stream are tax free. Nevertheless, the take-up of lifetime annuities in Australia is relatively low. While this accords with the notion of giving retirees complete freedom in how to deploy their superannuation benefits it is somewhat inconsistent with the core motivation for compulsory-contribution pensions; that of combatting myopia in households' financial planning. On this basis one might expect, for instance, rules stipulating that individuals must take out an annuity (even if only for part of their superannuation) to ensure all retirees have a regular cash income stream from superannuation. This said, such rules are only worthwhile if superannuation pay outs are typically of a size that can generate a non-trivial income stream (net of costs). This may be a relevant factor in Australia given that the compulsory superannuation system has only been in place since 1992 and so pay outs for those currently retiring are only based (at most) on 22 years of contribution.

Questions have also been raised about superannuation funds' high equity content and related to this the absence of default-track provisions in which risk is reduced as the individual heads to retirement. Concerns have been raised about superannuation-fund fees too (for instance, Minife, 2014). Partly in reaction to this, provisions allowing self-managed funds have proved very popular. Evaluation of the superannuation system will be a core theme of the *Financial System Inquiry*'s report mentioned previously.

## Property and capital gains taxation

### *Taxation relating to housing takes a fairly standard approach*

Capital gains and income tax treatment of owner-occupied housing is similar to that in many other countries (see Table 1.9). Following a seemingly ubiquitous practice, capital gains from the sale of owner-occupied dwellings are not taxed. Furthermore as in quite a number of OECD countries, owner-occupiers are not taxed on imputed rental income (tax theory suggests otherwise). Equally however, owners are not allowed to deduct mortgage interest payments, which represents a reasonable compromise.

Table 1.9. **Key features of the tax treatment of housing in Australia**

| Tax or charge | Further detail |
|---|---|
| | Taxes and charges relating to property transactions |
| State-based stamp duty | *Example.* New South Wales imposes a progressive seven-rate stamp duty on purchase price of the property with marginal rates ranging from 1.25% to 7%. |
| Capital-gain treatment | Principle residences are exempt and various deductions apply. As for other capital gains, the tax is computed as part of personal-income tax. For individuals and trusts, only 50% of the net capital gain is subject to personal-income tax if the asset is held longer than 12 months. |
| VAT treatment | GST levied on new housing construction and housing improvements. |
| | Taxes and charges during ownership |
| Treatment in personal income tax | • Principle residence: imputed rent not included but also there is no deduction for mortgage interest.<br>• Investment residence: the net balance of rental income against claimable costs (including interest payments) can often be made negative, thus reducing taxable income. |
| State-based Land Tax | *Example.* Victoria imposes a progressive schedule comprising five rates ranging from 0.2% to 2.25% with land values supplied by municipal councils.<br>Principle residences are exempt. |

*Source:* Based on Andrews et al., 2011.

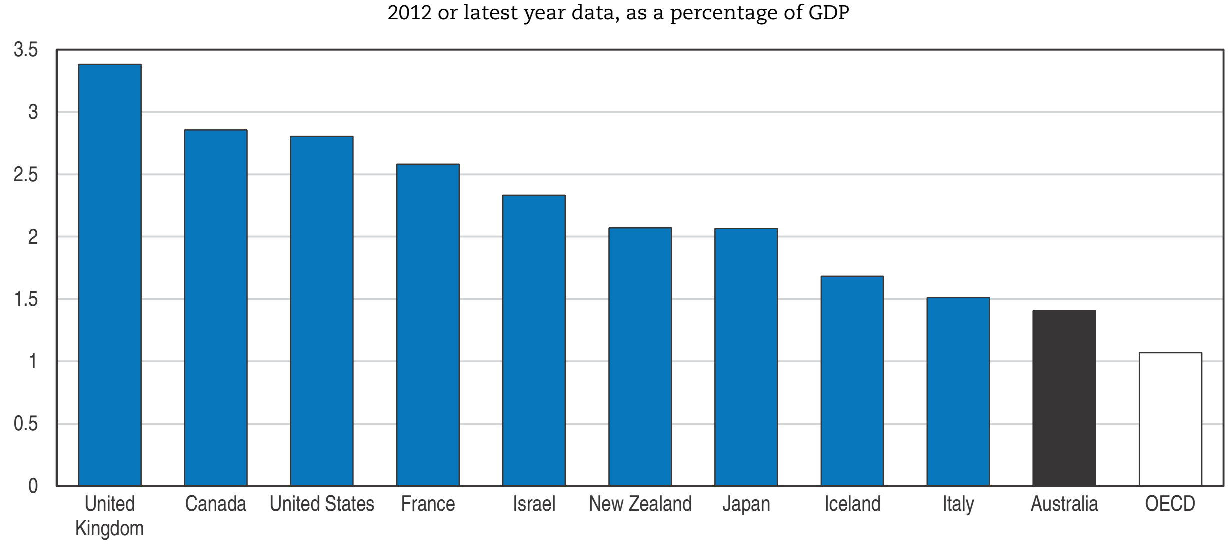
In Australia, income from housing that is purely an investment is subject to personal income tax following the tax-system's principle of inclusiveness; i.e. that of applying PIT to all forms of income (net of costs incurred to derive it). Therefore, taxpayers are allowed to claim deductions for the costs of running such properties (for instance accounting expenses, interest payments, and maintenance and management costs). When these expenses exceed the rental income, the taxpayer is able to deduct this "loss" against their other income, such as salary and wages. This is known as negative gearing, and in principle, the same situation can arise for other forms of investment. Those investing in housing anticipate that the capital gain when they sell the property will more than offset the initial loss of disposable income. This is assisted by only half of the net capital gain being liable to income tax (the same applies for equity investments). While the inclusive approach is theoretically neat, the incentives to negatively gear could be reduced. For instance, the Henry tax review recommended a discounting mechanism that would lower the reduction in taxable income from net investment losses (Australian Government, 2010).

Transactions costs on purchasing residential property and businesses most notably include a state-based "stamp duty" (i.e. a tax levied on documents). The cost can be sizeable; for instance the duty in New South Wales for an AUD 750 000 property is about AUD 29 500, or nearly 4% of property value. These add to already sizeable transactions costs; an OECD study estimates the total housing transactions costs in Australia at close to 14%, which is among the highest in international comparison (Andrews et al., 2011). Given the potential for transactions costs to reduce household mobility (again, see Andrews et al., 2011) the state stamp duties should be pruned or eliminated, and efforts made to reduce the other transactions costs.

Recurrent tax on property (that is, immobile property) comprises state-based land taxes and municipal rates charged by local governments. In international comparison the revenues collected as a portion of GDP are somewhat above the OECD average (Figure 1.16). Broadly speaking this is good, given the attractive economic properties of such a tax (immobile base, little distortion of economic decisions). Indeed, as frequently recommended for other countries, this form of tax should, in principle be exploited more. An exemption of owner-occupiers from land tax could be abolished, and greater use of municipal rates could also be considered, as discussed in Chapter 2.

Figure 1.16. **Recurrent taxes on immovable property**[1]

2012 or latest year data, as a percentage of GDP




1. This sub-heading covers taxes levied regularly in respect of the use of ownership of immovable property. These taxes are levied on land and buildings. OECD refers to the simple average of OECD member countries.

*Source:* OECD (2014), *Revenue Statistics Database*.

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### *Is there a case for more wealth transfer taxation?*

Australia no longer imposes any form of wealth transfer tax, such as estate tax or gift tax. In the past, death duties were imposed at both the state and Commonwealth levels but by the late 1970s all had been abolished.

Despite this, as proposed by the Henry Tax review (Australian Government, 2010), the case for specific tax on bequests warrants further investigation. Evidence that definitively teases out and quantifies the relative importance of the various motivations for bequests is unlikely to emerge. However, it is reasonable to assume that bequests are to some extent "accidental", i.e. a residual from precautionary saving, rather than the result of a plan to leave inheritors a specific sum of money (Cremer et al., 2012). In these circumstances taxes on bequests are non-distorting in that the tax does not affect the amount saved. Furthermore, some argue that the motivational impact of reducing wealth transfers on recipients (or potential recipients) is also a positive. Similarly, some see merit in the implications for equity arising from the reduction in wealth transfer from bequest tax.

However, bequest taxes raise questions and pose practical difficulties. Such taxes are likely to prompt criticism that they represent unfair double taxation, an issue which is not a concern economically (as taxes are anyway imposed at many points in the economic system), but a point which probably needs defending. More problematic economically, bequest taxes require auxiliary provisions to limit losses from avoidance, for instance rules on gifts need attention. Indeed, such complications contributed to the demise of death duties (along with inter-state tax "competition"), and require close evaluation against the potential revenue.

Clearly, any feasibility study of bequest taxation needs to look closely at a wide range of issues. In particular, research on behavioural reactions, compliance and avoidance needs to focus closely on wealthy households. This is where most of the tax base for bequests will lie given that similar to systems elsewhere, any bequest tax proposal for Australia is likely to have a fairly substantial tax-free threshold that implies only large inheritances are subject to tax.

## Company taxes and business subsidies

A number of issues drive policy on corporate tax and business subsidies, including revenue and tax-mix concerns, competitiveness issues, and efforts to encourage high-value-adding activity (such as scientific research and development). In addition, Australia is one of several OECD countries where royalties or special taxes on natural resources are of particular importance.

### *There is a case for lowering the headline rate of corporate taxation*

As in other open economies, exposure to capital mobility means there are tensions between keeping business tax light in the interests of investment while accommodating revenue needs and tax-fairness considerations. Tax expenditures in corporate taxation and business subsidies (Table 1.10) are, in effect, often differentiating between different degrees of mobility, thus helping ease this tension.

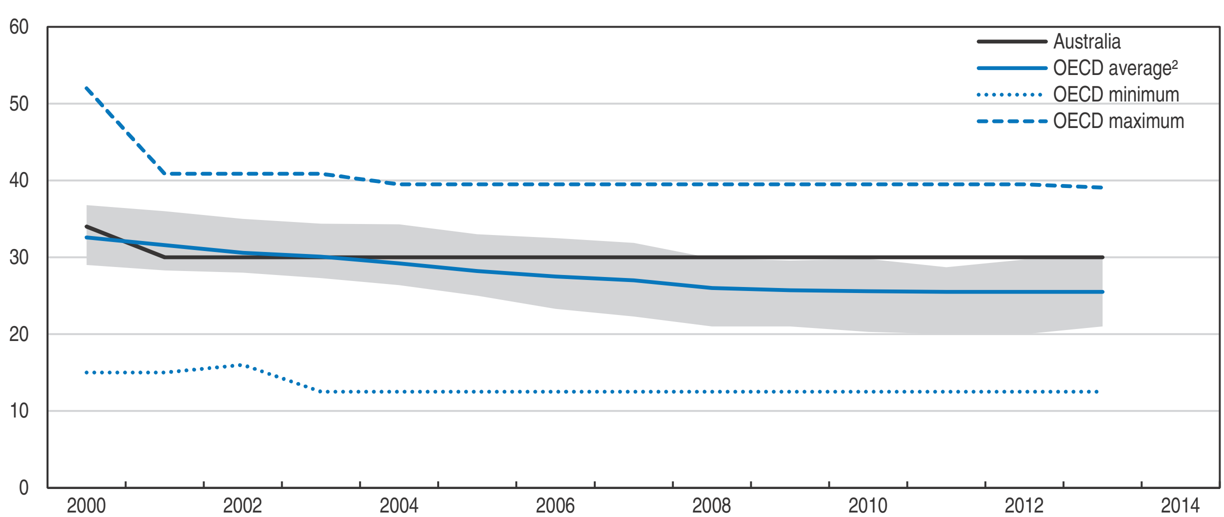
Table 1.10. **Key features of corporate taxation and business support**

| | |
|---|---|
| **Corporate taxation** | |
| Corporate income tax | • 30% rate on taxable income, deductions notably including R&D spending.<br>• Dividend imputation system through "franking credits".<br>• Absence of concessionary rates or similar, for instance to attract large greenfield investors.<br>• Favourable rules for small- and medium-enterprise. |
| Tax/royalty for natural resource exploration and extraction | • Separate state-based royalty systems (technically, the states are the owners of land-based mineral resources).<br>• A Commonwealth super-normal profit tax on offshore petroleum resources has been in place since the mid-1980s (the Petroleum Resource Rent Tax).<br>• Before end of September 2014, a federal-level tax aiming to capture super-normal profits in the iron ore and coal sectors (the Mineral Resource Rent Tax) operated. |
| **Business support** | |
| Federal tariffs on imported goods | • Although less substantial than in the past customs tariffs still apply to many imported goods the rate is typically 5%. |
| Federal direct support | • Sector-specific support offering a mixture of grants and support services, most substantial grants are for available for the automotive industry (but expenditure is due to decline following announced closure of plants). |
| State-level support | • Packages of support to "mobile" capital, such as manufacturing.<br>• Agreements with mining companies on auxiliary building of infrastructure and services. |

Despite headline rates of corporate tax being only one of several influences on the effective rates of business tax, they feature prominently in international comparisons of tax systems. Therefore, Australia's relatively high rate of corporate taxation, at 30%, does not help the country's "profile" in the eyes of investors (Figure 1.17). To its credit, the current government intends to cut the corporate-tax rate by 1.5 percentage points to 28.5% from July 2015. Further reductions should be envisaged, perhaps in the form of commitment to a schedule of cuts over several years, to enhance certainty for businesses and maximise positive near-term expectation effects on business decisions.

Figure 1.17. **Statutory rates of corporate income tax**[1]

Per cent




1. The proposed rate for Australia of 28.5% from July 2015 is not shown.
2. The shaded area is the 25th to 75th percentile range of available OECD countries.
*Source:* OECD (2014), *Tax Database*.

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However, the government's 1.5 percentage point cut in the corporate tax rate is to be offset by a levy of 1.5% on taxable corporate income above a threshold of AUD 5 million. The revenues have been nominally linked to funding the expansion of paid parental leave (see above). One side-effect of the levy is that broadly speaking the effective rate of corporate tax will be lower for small and medium sized enterprises; thus representing an implicit form of support for that sector. However, it is moot whether there is an economic case for support of this nature. Assistance for small-and-medium enterprise is perhaps better delivered through existing programs that address shortfalls in expertise and specialisation for handling regulation and administrative processes and in conducting marketing campaigns for exports.

Australia commendably avoids double taxation of dividends by accompanying pay outs with a "franking credit", a tax credit equal to the value of corporate tax paid on the dividend. However, the approach amplifies home-country bias in investment for (as yet) there are no mutual tax agreements with other countries on this issue. For instance, one paper estimates that the franking-credit effect accounts for between 20 and 30 percentage points of domestic content of Australian portfolios out of a total domestic content averaging about 75% (Klement et al., 2013).

#### *Ensuring the fruits of natural resource wealth are appropriately distributed*

In principle, resource taxation should ensure that the public (as owners of the resources) receive the value of the resource itself (the resource rent), which implies that companies extracting the resources should not make supernormal profits. In practice, optimising royalty/tax regimes to this end is complicated by variations in extraction costs; connection between mining-company return, exploration effort and (therefore) known reserves; uncertainties and risks, especially in exploration; and, information asymmetries between resource companies and revenue authorities. Furthermore, the nature of revenue streams differ, some regimes deliver regular and reasonably certain income stream (such as fixed volume-based royalties for which demand and production are reasonably predictable), while in other regimes revenues can be lumpy and unpredictable.

Taxation of Australia's land-based mineral resources has traditionally relied on state-based royalties (the states, not the Commonwealth, own land-based resources). These royalty regimes have complex structures. For example in Western Australia there are fairly straightforward royalty "ground rules" but for many resources (including important ones) these are over-ridden by product-specific royalties (Table 1.11). Furthermore, royalties for economically important specific mineral deposits are typically negotiated alongside a range of other issues in deals between the Western Australian government and the relevant mining companies ("State Agreements").

A country-wide tax on supernormal profit, the Mineral Resource Rent Tax (MRRT) was introduced in 2012 for the key mineral resources of coal and iron ore, operating in tandem with state royalties (OECD, 2012a). Ideally it was meant to tax only the supernormal rent from natural resources, allowing "normal" profits and not distorting investment and extraction decisions. A broadly similar tax treatment on offshore petroleum resources (the Petroleum Resource Rent Tax, PRRT) has been running since the mid-1980s.

However, the Mineral Resource Rent Tax's legislation had a bumpy ride to the statute books. Like the "Carbon Tax", the Tax has been a leading issue in political debate. For instance, opponents promoted the notion (through extensive ad campaigns) that the tax

Table 1.11. **Key features of Western Australia's royalty regime**

| Dimension of regime | Detail |
|---|---|
| Legislative framework | Mining Act (1978), Mining Regulations (1981). |
| "Baseline" royalty regime | 1. Specific royalty applied to low-value non-metallic products.<br>1. *Ad valorem* royalty with three (decreasing) rates applied at different points in the production process (designed to encourage investment in downstream processing). |
| Product-specific royalties | *Examples:* Iron ore "fines" 7.5% of *ad valorem* base (as of 2013); Gold, 2.5% spot market price at time of sale. |
| Royalties specified in State Agreements | *Example.* Royalties on iron ore operations run by the two main players, BHP Billion Iron Ore and Rio Tinto Iron Ore, are incorporated in State Agreements. In 2010, new agreements were signed that inter alia ended long-standing preferential royalty rates. |

*Source:* Western Australia Government website.

was very damaging for competitiveness, household incomes and jobs. The views of more impartial experts indicate that the final version of the legislation was less than ideal (though with perhaps different criticisms to those of the business community). Dilution and compromise in the legislation's passage through parliament seems partly to blame and some argue the design was overly complicated. Very little revenue has been raised by the MRRT so far, in part due to many deductions and exemptions. The present government has followed through on an election promise abolish the tax; legislation repealing the tax was passed in September 2014.

A tax on supernormal profit (as previously recommended) would be less dissuasive to investment and exploration compared with royalties as it is only imposed if profits surpass a level compatible with that of a competitive market. However, royalties can fulfil a useful role as they deliver a more regular and predictable revenue stream, as mentioned above.

### *Encouraging innovation includes plans for a medical research fund*

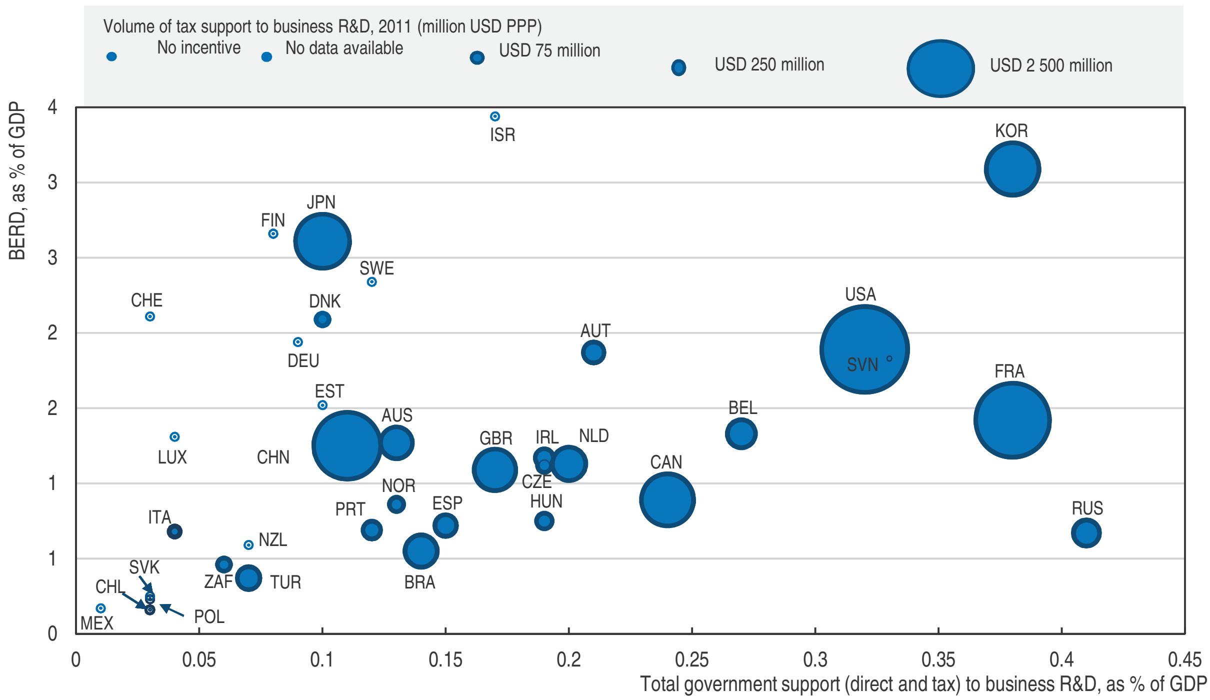
As elsewhere, R&D activity and innovation in general are encouraged through favourable tax treatment and a range of targeted programmes providing grants and other forms of support. Economic justification for favouring innovative activity lies in externalities arising from gaps between public and private returns to innovation and knowledge spillovers. However, while there is little doubt as to the existence of such phenomena, their scale is uncertain, and the processes generating them are complex. Therefore, developing sound support programmes (either in the form of tax exemptions or grants) requires good systems for monitoring and assessing programme impact and low policymaking inertia when it comes to dropping poorly performing schemes or ramping up those that prove successful.

Australian business spends comparatively little on scientific research and development on a per capita basis (Figure 1.18). Distance from major consumer markets and global centres of research act as key constraints and therefore trying to match the R&D spending levels of top-ranking countries is therefore probably not an appropriate goal. However, policy nevertheless needs to give appropriate weight to the potential economic and social gains from pure research, facilitate interaction between public and private research and ensure taxes and business subsidies reflect the beneficial externalities of scientific innovation.

In accommodating these issues, Australian policy relies on instruments that are widely used in other countries, notably favourable treatment of R&D expenditures in corporate income tax and direct public support to research. A review of policy settings in

Figure 1.18. **Business R&D intensity and government support to business R&D, 2011**

As a percentage of GDP




*Source:* OECD, based on OECD R&D tax incentives questionnaire, publicly available sources; and OECD, *Main Science and Technology Indicators Database*, *www.oecd.org/sti/msti.htm*, June 2013.

StatLink http://dx.doi.org/10.1787/888933176759

the 2012 *Survey* (OECD, 2012a) for instance underscored a need for more simple and flexible schemes encouraging collaboration between university and business research.

To raise broad-based productivity, innovation policy ought to take a wide perspective, recognising the important role that non-scientific innovation can play in improving productive capacity, such as improvements in supply-chain management and service-sector innovations. Helping business innovate in this broad sense requires ensuring sound general conditions for business; stable macroeconomic conditions, flexible labour markets, exposure to competition and minimal red tape. Broadly speaking, the Australian authorities appear to recognise the importance such non-discriminatory framework conditions in encouraging broad-based innovation. However, somewhat in contrast to this principle, the current government plans a highly targeted scheme to accumulate a medical research fund worth AUD 20 billion (about 1.3% of GDP) by utilising the savings from various health related measures in the 2014-15 budget.

Similar to other countries, Australia offers wide ranging support to SMEs. As regards financing, the current government is re-examining tax rules on employee share schemes following complaints from businesses that stricter conditions introduced in the 2009-10 budget have considerably reduced the attractiveness of share schemes for employees, thereby closing off this form of financing to SMEs. On other fronts the government plans on discontinuing co-financing the Innovation Investment Fund, which is a form of venture-capital fund. However, it aims to continue with concessional tax treatment of such funds via the Venture Capital Limited Partnerships scheme. A number of countries, for instance Canada, have established secondary trading platforms for high-risk investment (these for instance typically entail lighter reporting requirements than those in the primary stock exchange) and such a platform may be worth considering for Australia.

### *Admirable resistance to additional industry subsidy but new drought support for farmers*

The closure of Australia's three remaining automobile assembly plants has been announced by the relevant companies, marking the end of an era and reflecting healthy resistance to appeals for additional support. Australia's generally high cost and small volume operations (Productivity Commission, 2013) have long struggled to find a viable place in increasingly globalised vehicle supply chains, despite government support via direct financial assistance and tariffs on imported vehicles. It is estimated that closure of the plants will result in savings of around AUD 620 million over the coming years, which is equivalent to little a under 0.5% of current annual GDP (Australian Government, 2014c).

In agriculture, standard measures of producer support continue to confirm that, broadly, Australian subsidy is among the lowest in the OECD area. For instance, the latest OECD calculations indicate producer support is now equivalent to only 2% of farm receipts (OECD, 2014b). In 2013, a new intergovernmental agreement heralded the end of drought-focused programmes (so-called Exceptional Circumstances programmes) and the establishment of more general support for hardship. This has been a good move in that some drought support, such as the Exceptional Circumstances Interest Subsidy, created undesirable incentives, making farmers less inclined to plan and invest appropriately for drought risk. Somewhat counter to the 2013 agreement, in February 2014 the government announced new drought assistance programme worth AUD 320 million, the lions share (AUD 270 million) as concessional loans. There is a risk that similar incentive problems will emerge and the authorities should closely monitor the impact and act decisively if difficulties emerge.

## Evasion, avoidance and administration issues

Enhanced tax compliance, for instance through reduced red-tape for filing tax returns, ramping up campaigns against tax evasion and aggressive avoidance, can raise additional revenues, creating room for manœuvre in tax strategy and helping fiscal balances in general. The increased attention, both domestically and world-wide, to tax evasion and avoidance is providing a political opportunity for renewed policy vigour on this front.

### *A campaign to cut red tape is underway*

As part of the present government's drive to cut red tape, the Australian Tax Office aims to bring savings for government, business and households worth AUD 250 million each year through changes in regulation and processing. As of mid-2014, a scheme offering a streamlined tax return to businesses with relatively straightforward accounts (*MyTax*) was underway and regulations had been changed allowing many small businesses to make pay-as-you-go instalments less frequently. Many other measures are planned, for instance, more "pre-population" of tax returns, further development of the government's internet portal, *MyGov,* reduced transfer-pricing documentation, greater use of digital correspondence and implementation of OECD's standard for the exchange of information on foreign residents. These further efforts will likely enhance the Tax Office's already good reputation.

### *The authorities are actively campaigning against base-erosion and profit shifting*

As in other countries the attention of policymakers, the press and the public has focussed on the seemingly low levels of tax paid by some well-known business operations. Indeed, strategies that erode the corporate tax base by shifting profits between tax jurisdictions (base erosion and profit shifting, or BEPS) has become a focus of OECD analysis (for instance, OECD, 2013b). BEPS not only implies revenue losses but also put multinational enterprises in an advantageous position over domestic firms and distort investment. In addition, the perceived unfairness of BEPS risks damaging trust and compliance elsewhere in the tax system. However, making progress in addressing these issues is tough; proposed measures invariably run counter multinational companies' vested interests and some tax jurisdictions benefit from tax-avoidance strategies. As G20 President, Australia has been actively assisting the international campaign to tackle BEPS through representation by Treasury and the Australian Taxation Office officials at working-level meetings, participation in fora to help developing countries address BEPS and co-hosting a G20 tax meeting in Japan in May 2014.

Several alterations to Australian tax law that aim to reduce BEPS have already been made and more are underway:

- Tighter "thin capitalisation" rules have been introduced to further dissuade multinational enterprises from claiming debt-interest deductions in Australia (thin capitalisation means an entity operating with comparatively little equity capital in relation to debt, the presence of which may reflect efforts to exploit differences in the tax treatment of debt-interest deductions across tax jurisdictions).
- A loophole has been closed that permitted multinational taxpayers to claim a tax exemption for interest income from loans to offshore subsidiaries and ramp up the debt allocated to Australia.
- The Australian Tax Office has stepped up scrutiny of international businesses. For instance, under the four-year International Structuring and Profit Shifting initiative, the Office is reviewing companies that have undertaken an international business restructure or have significant related-party cross-border arrangements. An initial 86 cases have been identified and are currently under review. Furthermore, the Office is also collaborating with tax authorities elsewhere to develop a better understanding of multinationals' activities and their compliance with tax laws.

## Recommendations on taxes and transfers

### Key recommendations

- **Rebalance the tax mix**; shift away from income and transaction taxes and make greater use of efficient tax bases. Reform could, for instance: *i*) make greater use of ***GST*** by reducing preferential treatment and by raising the rate; ii) look toward increasing ***personal-income tax*** thresholds and reducing rates in the medium term; *iii*) in ***taxation relating to housing***, reduce transactions taxes and consider greater use of recurrent tax on property; *iv*) lower the ***rate of corporate tax***, perhaps via a series of rate cuts over several years as a means of signalling a firm commitment to a sustained rate reduction; and, *v*) as regards ***taxation of natural resources sectors***, envisage taxation of supernormal profit for mineral-resource sectors, starting with considering the design of State royalties.
- **Concentrate on broad support for business**; prioritise corporate-tax rate cuts and reduce regulatory burdens but meanwhile be tough on corporate welfare and tax avoidance. In ***support for specific sectors*** maintain a stiff resistance to prolonged subsidies for specific industries and plants; beware of undesirable incentives in the new drought support for farmers. Ensure a co-ordinated and common front in negotiation with resource companies. Campaigning against unwarranted ***base erosion and profit shifting (BEPS)*** strategies should continue through further international co-operation and the closure of loopholes domestic corporate tax settings.
- **Monitor the proposed welfare reforms** to ensure they raise work-force participation cost effectively without adverse social outcomes. In particular monitor the tougher ***benefit-eligibility rules for unemployed persons*** aged under 30 to ensure they meet their objectives Consider on the long-term implications of the change to ***Age-Pension indexing*** through the forthcoming Inter-Generational Report. Better target ***superannuation*** (pension) tax concessions.
- **Achieve greenhouse-gas emission targets.** Ensure the proposed Emission Reduction Fund is efficient through: i) robust measurement and verification methods; and ii) implementation of a safeguard mechanism that prevents offsetting emissions elsewhere in the economy.
- **Make transport policy greener**; enact the proposal to index ***excise duty on retail fuel***, expand other use-based vehicle charges and extend public transport.

### Other recommendations

- Simplify ***household taxes and benefits*** aim, inter alia, to reduce recourse to professional accounting services by households and aim to reduce "bumps" in the marginal tax schedule arising from benefit tapering.
- Re-examine the balance between ***paid parental leave*** and other aspects of family policy following the release of the Productivity Commission's review of child care.
- Continue to reform the ***disability pension system***; by improving assessment processes for new claimants, and re-evaluating the stock of existing claimants; this is a "long game" requiring ongoing policy attention.
- As regards ***old-age pensions***, pursue proposals to gradually increase the age at which first and second pillar pensions can be accessed.
- Re-examine the case for bringing back ***bequest tax***; given past experience only a tax the federal level should be considered.
- Pursue vigorously the Australian Tax Authority's campaign to cut ***red tape and compliance costs*** for taxpayers.

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*Chapter 2*

# Federal-state relations

*Australia's inter-governmental fiscal relations have gradually moved towards greater centralisation. State governments receive sizeable transfers from the federal government and own revenues only partially cover their expenses. Finding the right balance between federal control and state autonomy in public service provision and its financing has not been easy. Over time various compromises have somewhat blurred responsibilities in various functional areas or reduced incentives to raise sub-national revenues potentially affecting public sector efficiency and service quality. A better balance, one in which central government has less steerage over state activities and states have more financing autonomy but also bear increased responsibility is likely to improve outcomes. Federal-state shared responsibilities continue to affect the efficiency of healthcare service delivery in particular. A clearer delineation of roles in shared functions and possibly a reallocation of responsibilities in some cases, are important. There is also scope to reduce federal grant conditionality further to contain red tape and enhance transparency and give the states a more flexible allocation of funds. Strengthening states' revenue-raising by broadening existing tax bases would promote efficiency. Consideration could be given to the introduction of a state-level income tax. The government's current review of the federal system, focusing on both spending and tax responsibilities, is welcome, as is the "whole-of-government" approach to the process.*

Australia's inter-governmental fiscal relations have gradually moved towards greater centralisation. The division of responsibilities between central and state-level, and the attendant system for financing state governments through own revenues and transfers are important challenges in this regard. The chapter discusses current issues in federal-state relations and lays out policy options for improvement.

## Australian inter-governmental fiscal relations: Main features and trends

### *The structure of government and constitutional division of powers*

Australia's federation comprises three levels of government: central (the Australian or "Commonwealth" government); state (six states and two territories with state-type powers); and local (562 local government authorities), which are established through state legislation. Local governments play a minor role by international standards, with their responsibilities mainly confined to local public works, waste disposal, town planning and welfare services (PC, 2005; Brown, 2012a).

Australia is a decentralised federation by Constitution (Box 2.1), with intention that federal and state levels independently exercise powers within their own areas of policy,

Box 2.1. **The constitutional division of powers**

The Australian federation was established in 1901. Only the two higher tiers of the government – the Commonwealth (Australian Government) and the states – are established by the Constitution (the *Commonwealth of Australia Constitutional Act 1900*).

The Constitution assigns the Australian Government a specific set of powers (Fenna, 2012a). A small number of these are *exclusive,* such as: the power of determining rates of customs and excise duties, coinage, national defence. Other Australian-Government powers are to be exercised *concurrently* with the state governments, for example: taxation, apart from customs and excise duties; post and communication; trade; banking and insurance; and industrial disputes that extend across states. In case of inconsistency, the central government has legislative supremacy (OECD, 2006).

The fairly narrow set of Australian-Government constitutional powers means that state governments have considerable responsibilities including: health, education, housing and urban development, police and justice system, energy, agriculture, transport and public services. However, the Commonwealth government can have influence by drawing on its general powers, such as that of "corporation" (the right to legislate with respect to foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth) and "external affairs" powers (Banks et al., 2012). Regarding the latter, the Australian Government can still legislate, for example, in the area of environment for which it does not have constitutional responsibility, in support of any international environmental agreement (PC, 2005). Moreover, the constitution contains a clause allowing the Australian Government to grant financial assistance to states on terms and conditions it deems appropriate, which provides another mechanism for influence.

thereby requiring little co-ordination (Fenna, 2007; Banks et al., 2012). The Commonwealth was assigned a "limited" and "limiting" list of responsibilities, including currency, customs and excise, and defence (Fenna, 2012a). States were to retain most domestic responsibilities, such as education, health and infrastructure. The two levels had concurrent jurisdiction in some areas, including most areas of taxation.

### *Centralisation and extensive joint government responsibilities*

The balance of power has shifted towards central government over time, although the Constitution remains largely unaltered (Banks et al., 2012, Murray, 2012). This diverges from trends seen in comparable federations which have devolved responsibilities (Warren, 2006). To a large extent, centralisation in Australia has arisen from broad interpretation of the Commonwealth's enumerated powers by the High Court. For example, the Court's interpretation of "excise duties" to incorporate all taxes on manufacture, distribution, and sale of goods, barred states from levying sales taxes; and its decision in the second *Uniform Income Case* (1957), effectively confirmed the 1942 judgment that the Commonwealth's exclusive power over the income tax base (constitutionally a shared base) could continue after the war (Fenna, 2012b). The practical operation of the Australian federation has been further influenced by referenda (as on indigenous population affairs) and referral of state powers to the Commonwealth (as, for example, with industrial relations powers), as well as certain constitutional features, and in particular, the Commonwealth's right to grant financial assistance to the states on terms and conditions that it specifies (Box 2.1). Other reasons explaining the shift of power over time include the need for centralised policies in certain areas to meet socio-economic realities and challenges, the increasing complexity in the federal system, and, possibly, an inclination of voters to look at the central government to overcome perceived weaknesses in state/local service delivery (BCA, 2006; Fenna, 2012a).

The growth of "tied" grants from the Commonwealth to the states increased federal control and led to a relatively high degree of shared functions between state and federal governments and a complex pattern of expenditure. Over time, the Commonwealth government became more active in areas that were once the domain of the states – sometimes called "co-operative" federalism (Banks et al., 2012). At present, the two government levels are involved in most areas of public services (Figure 2.1).

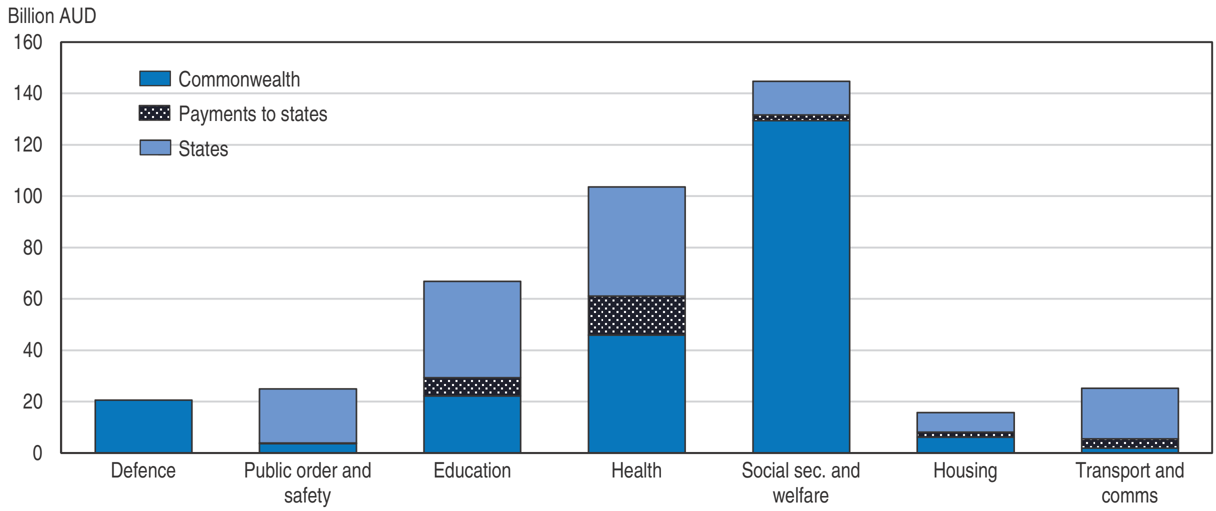
Shared government functions are not an uncommon feature in federations. Australia stands out, however, with respect to the mix of responsibilities in the areas of health and education (Warren, 2006; Twomey and Withers, 2007). A study covering a number of federations (including Canada, Germany and Switzerland) concluded that responsibility for these two areas tends to be allocated almost exclusively to one level of government (Warren, 2006). By contrast, in Australia (and to a lesser extent Austria) both central and state governments have major responsibilities (discussed below in detail) and roughly equal levels of spending (Figure 2.2).

### *A relatively high vertical fiscal imbalance*

Australia's federation has long been characterised by a large vertical fiscal imbalance (VFI): state's own revenues are not sufficient to fund their spending responsibilities, while the revenue sources of the Australian Government are greater than its spending needs (Figure 2.3). In the federation's early days the imbalance was high because revenues from customs tariffs, an important revenue source at the time, was assigned exclusively to Commonwealth (Figure 2.3; Banks et al., 2012). Currently, sub-national spending (as a share

Figure 2.1. **Decomposition of government expenditure by function**

2012-13




*Source:* Australian Bureau of Statistics (2014), *Government Finance Statistics* 5512.0; Commonwealth Final Budget Outcome 2012-13; Australian National Authorities.

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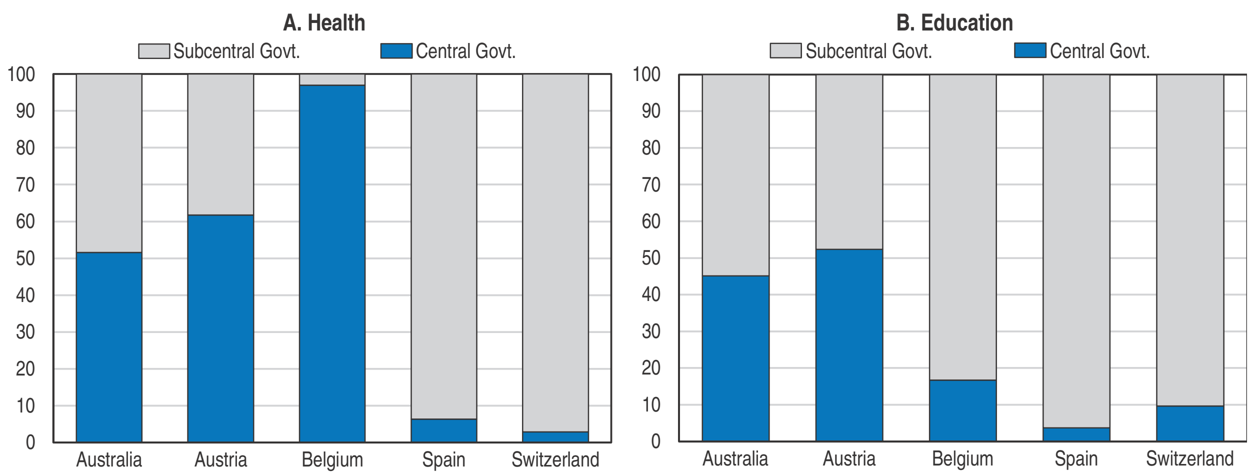
Figure 2.2. **Expenses by government level in health and education in selected federations**

2012 or latest,[1] in %




1. 2011 for Switzerland.

*Source:* IMF(2014), *Government Finance Statistics (GFS) Database*.

StatLink http://dx.doi.org/10.1787/888933176763

of total government spending) is similar to that in the United States and Spain, but less than in Switzerland or Canada (Figure 2.4). Australia's states finance only around half of their spending responsibilities from "own revenues", with the remainder being covered by federal grants. However, an important reservation is the status of the Goods and Services Tax (GST) which is governed by national legislation and administered centrally but all revenues are passed onto the states.

The central government raises around 80% of total tax revenue, when the GST is taken into account, and has control over some broad based taxes including, personal and corporate income, in addition to customs and excises (Figure 2.5). In contrast, state taxes

Figure 2.3. **Vertical fiscal imbalance over time and across countries**[1]

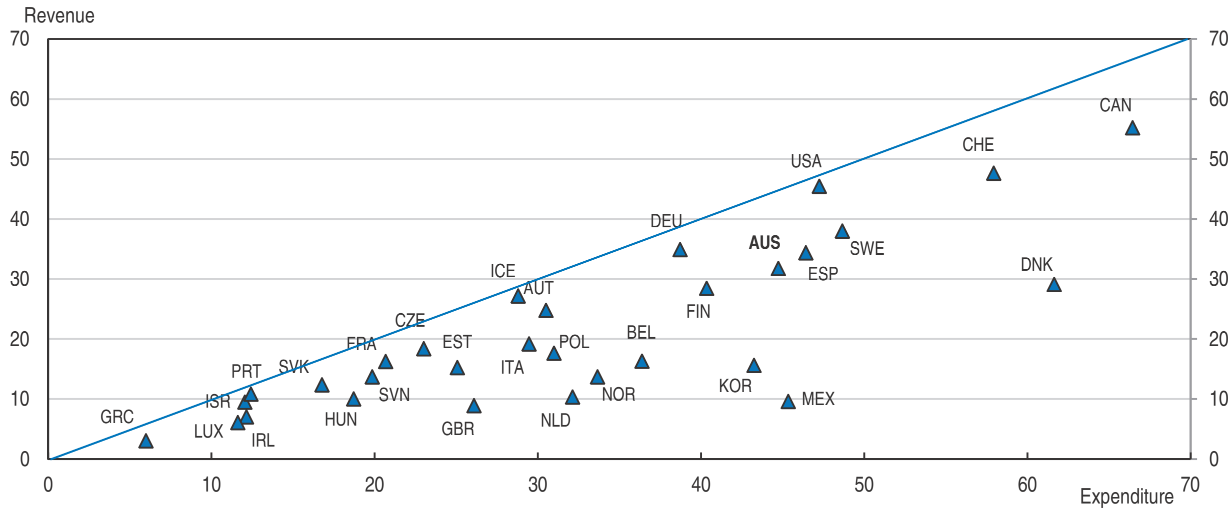

1. The vertical fiscal imbalance (VFI) is defined as the total of federal payments to total sub-national revenue. Data starting from 2013-14 refer to estimates.
2. Own-source revenue is defined as total revenue minus grant revenue; own-purpose expenses are defined as total expenses minus grants to other levels of government. Data refer to the financial year 2012-13.
3. For Australia, VFI is the share of Commonwealth payments in total state revenue. Data refer to 2011 and, in the case of Canada, to 2010.

*Source:* Australian National Authorities; ABS, *Government Finance Statistics 2011-12* (Cat. No. 5512.0); Australian Government (2010), *Budget Paper No. 3: Federal Financial Relations 2010-11* and *Final Budget Outcome Papers 2009-10 to 2011-12*; International Monetary Fund (2013), *Government Finance Statistics Yearbook*; OECD, *Fiscal Decentralisation Database*.

StatLink http://dx.doi.org/10.1787/888933176770

Figure 2.4. **Fiscal decentralisation**

Sub-national shares of revenue and expenditure in per cent of total general government, 2012 or latest year[1]




1. Data refer to 2011 for Korea and Mexico and to 2010 for Canada. Revenue does not include intergovernmental transfers. For Australia, data refer to the financial year 2011-12.

*Source:* OECD (2014), *Fiscal Decentralisation Database*; ABS, *Government Finance Statistics 2011-12* (Cat. No. 5512.0).

StatLink http://dx.doi.org/10.1787/888933176526

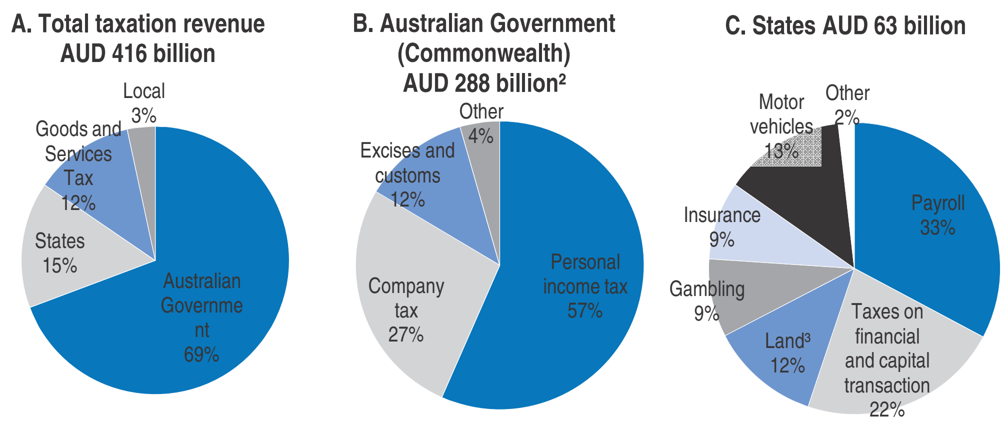
account for around 15% of the national tax revenue, a comparatively small share in international comparison (Figure 2.6); local governments (property tax) collect the rest. State revenues are mostly taxes on property (including immovable property and financial and capital transactions) and payroll taxes. These are also potentially broad tax bases. Australia is among the few OECD countries levying payroll taxes (Figure 2.7). In addition, there is no co-occupancy of tax bases by the Commonwealth and the state governments, unlike in other more decentralised federations, such as Canada and Switzerland (for example, income tax in Canada) (OECD, 2006; Bird and Smart, 2010). Nevertheless, Australian states have the right to set their own tax rates and bases for taxes they control, so at least in principle, sub-national government revenues could play a bigger role.

Large vertical imbalances necessarily imply sizeable transfers from central to sub-central government. In Australia, there is an extensive system of inter-governmental grants comprising general purpose (non-earmarked) assistance (mainly from GST revenues) and specific purpose payments (SPPs). Under the current intergovernmental agreement (discussed below), the Commonwealth provides to the states specific payments with a varying degree of conditionality. The National Specific Purpose Payments (NSPPs), for example, are only conditional on spending in the relevant service sector, while the National Partnership Payments (NPPs) are more narrowly focused and carry more conditionality (Figure 2.8). Specific purpose payments are most widely used in health and education, and in 2013-14, they accounted for around half of the total Commonwealth payments to states (equivalent to approximately around 3% of GDP), partnership payments comprising around a third of all specific payments (Figure 2.8).

The large vertical imbalance is central to the political economy of Australian federalism. It provides the Commonwealth government with considerable de facto power over states because of their reliance on transfers to balance their books. For the states this reliance means reduced autonomy, but it does have advantages. The transfers are, in effect,

Figure 2.5. **Sources of tax revenue in Australian federation**

Per cent of total,[1] 2012-13



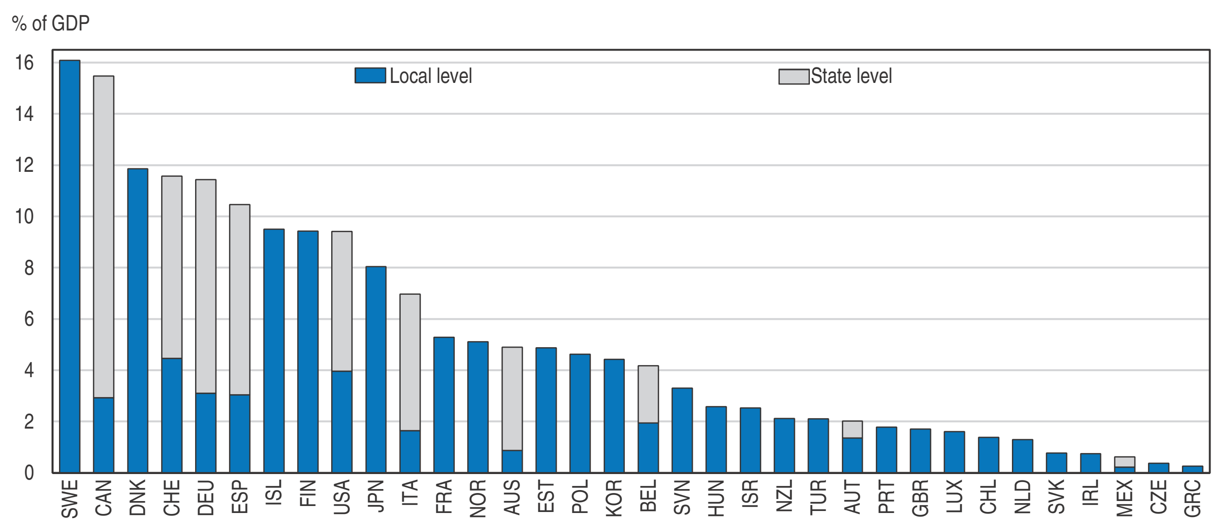

1. Figures are rounded.
2. Goods and Services taxes are excluded.
3. Land taxes comprise all taxes on immovable property.

*Source:* ABS (2014), *Taxation Revenue Australia 2012-13* (Cat. No. 5506.0).

StatLink http://dx.doi.org/10.1787/888933176783

Figure 2.6. **Sub-national tax revenue**[1]

2008




1. Taxes where sub-central governments have power to set the tax base and/or the tax rates, as a percentage of GDP. Local governments in the United States have a wide variety of taxing powers but it is not possible to identify the share of each.

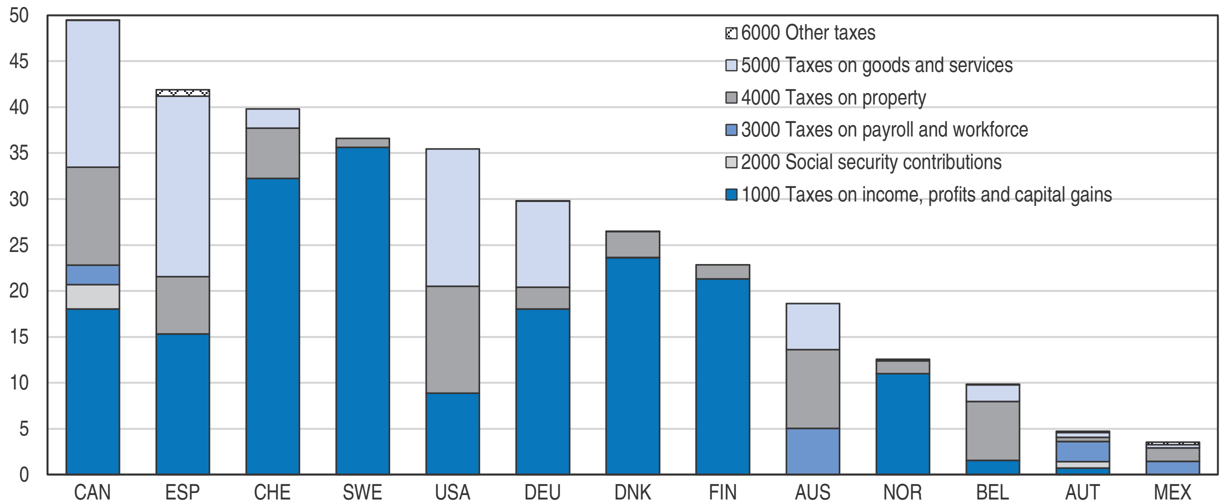
*Source:* OECD (2014), *Fiscal Decentralisation Database*.

StatLink http://dx.doi.org/10.1787/888933176544

a statement of implicit guarantee by the federal government for states' finances. This means that pressuring the federal government for funds can be a more feasible and attractive option than local taxation, which may partly explain why state governments have narrowed their tax bases through exemptions (see below). Thus, the vertical fiscal imbalance effectively reflects a particular "equilibrium" of current de facto powers and responsibilities between federal and state governments.

Figure 2.7. **Composition of state and local tax revenue in selected federations**

As per cent of total tax revenue, 2012 or latest[1]




1. 2011 for Australia.

*Source:* OECD (2014), *Revenue Statistics Database*.

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### *Horizontal fiscal imbalances and the equalisation process*

GST revenue is distributed across the states on the basis of the principle of horizontal fiscal equalisation (HFE) (Box 2.2). This aims to ensure that states have the same *capacities* to deliver services (Banks et al., 2012). Horizontal imbalances are common in a federation, reflecting differences in the revenue raising capacity and/or delivery costs among the states (Australian Government, 2013). Recent estimates by the Commonwealth Grants Commission (CGC) suggest, for instance, that, in 2011-12, the revenue-raising capacity of the Australian states ranged between 79% (Tasmania) and 146% (Western Australia) of the national average, while cost differences across states were within 10% of the national average (excluding the Northern Territory) (CGC, 2013). Western Australia has the greatest revenue capacity, predominately, but not exclusively, due to its vast mining revenue. Indigeneity is an important cost factor for Northern Territory.

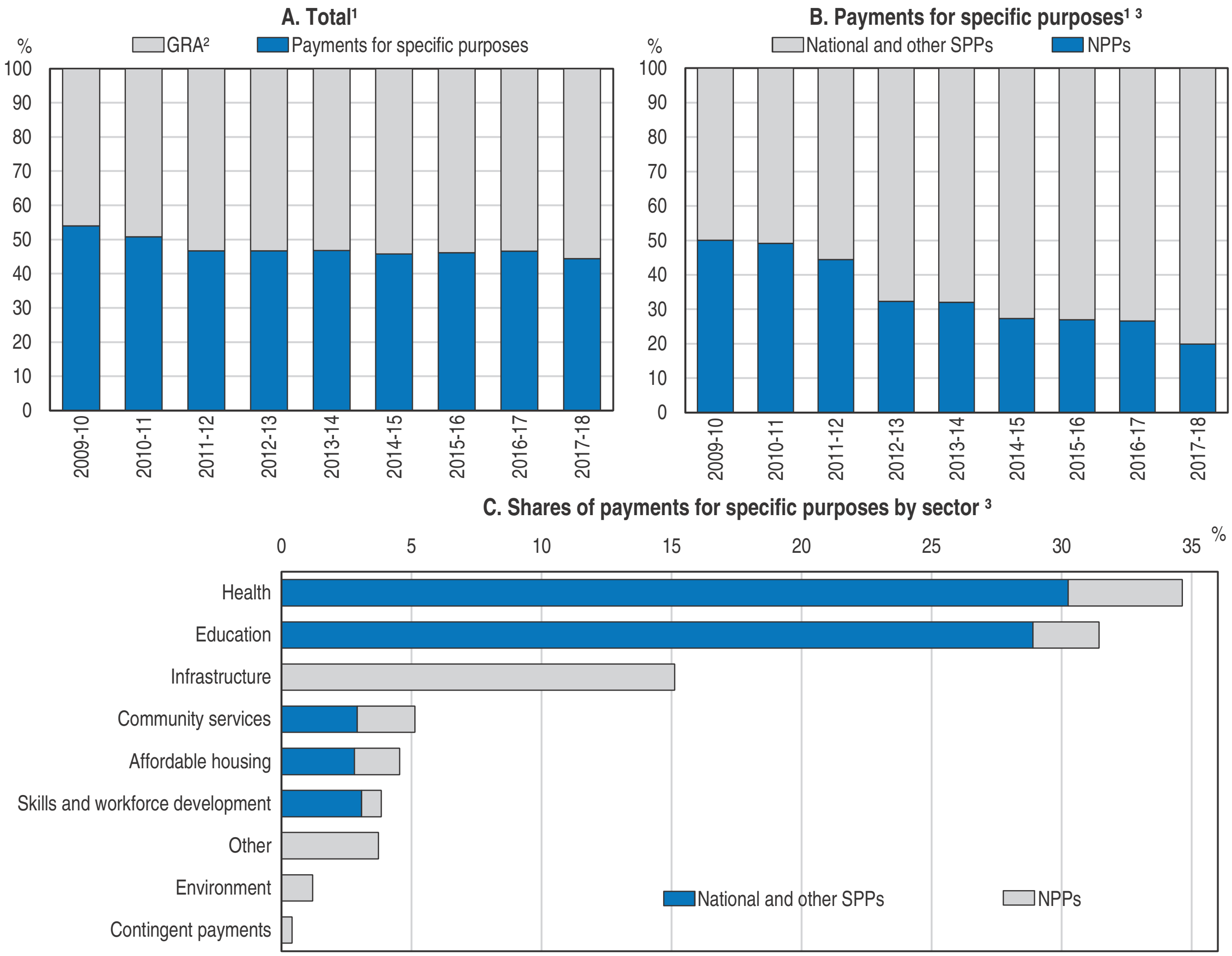
The equalisation process redistributes funds among states (Figure 2.9). Overall, according to the budget estimates, in 2014-15 around 10% (or AUD 5.6 billion) of the GST payments are expected to be redistributed among the states as compared to a notional distribution on an equal per capita basis (Australian Government, 2014a).

## Division of responsibilities in the provision of public services

The relatively high degree of shared functions between government levels in Australia raises challenges. Some overlap may be beneficial if it provides greater choice or better services by addressing perceived gaps, or broadens access to services. Some states, for example, provide services to assist older people's transition from hospital to home, notwithstanding Commonwealth action in this domain (PC, 2005). However, extensive joint government involvement, can blur the lines of responsibility, increasing the risk of administrative duplication, waste and cost, and blame-shifting among government levels (OECD, 2006; BCA, 2006; NCA, 2014). Potentially, this results in reduced cost-efficiency and quality of public services, and there certainly appear to be important instances of this

Figure 2.8. **Commonwealth payments to the states**




1. Starting from 2014-15, values refer to estimates.
2. General revenue assistance (GRA) includes GST payments.
3. National and other SPPs refer to National Specific Purpose Payments (NSPPs), as well as to the current arrangements (National Health Reform and Students First funding) for healthcare and schools which replaced the former National SPPs for these sectors in 2012 and 2014, respectively. NPPs refer to National partnership payments.

*Source:* FBO for financial years 2009-10 to 2012-13; and *Budget Paper*, No. 3 for 2014-15.

StatLink http://dx.doi.org/10.1787/888933176804

(discussed below). The COAG Reform Council (the Council) recently highlighted the increasing pressures on Australia's intergovernmental relations from widespread shared responsibilities (CRC, 2013a).

A 2008 Intergovernmental Agreement on Federal Financial Relations (IGA) attempted to better specify government roles and responsibilities in each National Agreement (Box 2.3). This was the first time that the Commonwealth and states had documented (with a varying degree of descriptions across and within agreements) their individual and joint responsibilities for specific sectors (CRC, 2013a). The overarching aim of the agreement was to improve the quality, efficiency and effectiveness of government services, among other things, through a more co-operative policy development and enhanced accountability to the public.

The 2008 IGA led to some clarification of roles and responsibilities, e.g. in the area of business regulation (O'Meara and Faithfull, 2012). However, a recent monitoring report by COAG Reform Council (the Council) highlighted, for instance, that, in general, the delineation

### Box 2.2. **Horizontal fiscal equalisation: Main features**

The Commonwealth Grants Commission (CGC) – an independent advisory body established in 1933 – recommends how revenues from GST should be distributed among the states to achieve horizontal fiscal equalisation (HFE). The Commission's definition of equalisation is to provide each state with funding such that: "each would have the capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency" (CGC, 2013; p. 30).

The equalisation rests broadly on three principles: i) the process opts to equalise the fiscal capacity of the states, rather than the performance or outcomes they achieve, with states being free to choose how to spend their GST revenue; ii) states are equalised to average standard – no judgment is made by the Commonwealth Grants Commission about the level of service that might be appropriate or appropriate benchmarks; and iii) equalisation is "policy neutral" – own policies or choices should not directly influence a state's share of GST revenue (OECD, 2006).

Under the current equalisation system, the distribution of GST revenue is based on the per capita relativities, recommended by the Commonwealth Grants Commission. The relativities determine how much revenue of the GST pool each state receives compared to an equal per capita (EPC) share (Australian Government, 2011). If the states had the same capacities to raise revenue and deliver services, GST would be distributed on the basis of a state's population. Because there are different revenue and cost drivers in each state, however, that are beyond their control, then under the equalisation system some states receive more than their EPC share (the relativity is greater than one) and others less (the relativity is less than one) (Australian Government, 2011).

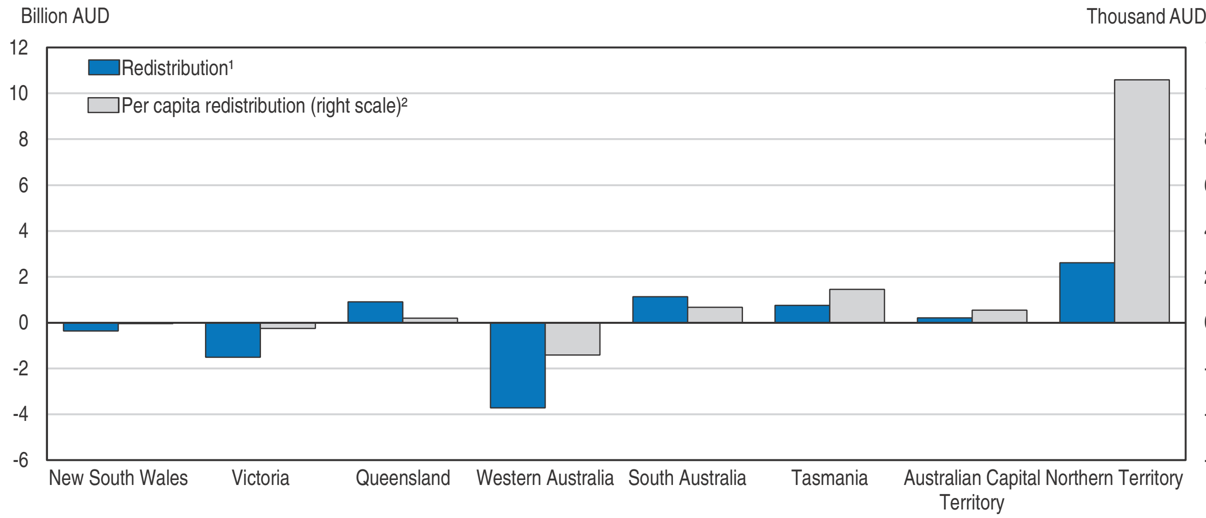
The Commonwealth Grants Commission uses a complex methodology to calculate the per capita relativities (as discussed below). The approach takes account of differences in per capita revenue-raising capacity and differences in spending "needs" (i.e. the per capita amounts required to be spent by the states in providing an average standard of government services). Various control variables are used in the calculation, including population structure and wages. The most important factors driving differences in the relativities are differences in fiscal revenues from mining and differences in the size of indigenous populations across the states (Clemens and Velhuis, 2013; Kirchner, 2013). The latter is influential in the calculation because of high unemployment and low earnings in these communities and the additional public spending in regular and targeted programmes endeavouring to resolve these issues and other socio-economic problems.

Calculation of the relativities incorporates the majority of specific purpose payments to the states, treating them as revenue and adjusting the GST shares accordingly (Australian Government, 2011). The equalisation process, thereby, effectively "overrides" the distribution of payments for specific purposes by the federal government (Clemens and Velhuis, 2013). Some specific purpose payments, however, do not impact GST sharing relativities, either because they are "excluded" by the Commonwealth in its terms of reference given to the Commission, or, effectively excluded due to decisions of the Commission (Australian Government, 2011). Treasury estimates suggest, for example, that around 17% of federal payments to the states had no impact on the calculations of relativities in 2009-10 (Australian Government, 2011). Some imbalances in GST allocation, therefore, may be partially offset by other transfers to the states that are not factored into the equalisation system.

The CGC updates the relativities each financial year, and undertakes broader reviews of its methodology every five years. The next review is currently underway, and is due to be released in early 2015.

of roles between federal and state government in the National Agreements had not been implemented, calling for further efforts to reach consensus on the issue (CRC, 2013a). The recent National Commission of Audit (NCA) has also indicated continuing difficulties (NCA,

Figure 2.9. **Horizontal fiscal equalisation**




1. Redistribution refers to the difference between a state's distribution of the Goods and Services Tax (GST) revenue using the Commonwealth Grants Commission's relativities (see Box 2.2) and a notional distribution of GST on a per capita basis.
2. Per capita redistribution refers to redistribution divided by population.

*Source:* Australian Budget 2014-15, *Budget Paper*, No. 3.

StatLink http://dx.doi.org/10.1787/888933176815

2014). For example, health care faces some of the greatest challenges of co-ordination, and many areas of education also suffer from lack of clarity and overlap of government roles. Public spending on these two sectors accounted for more than 13% of GDP in 2012-13. Dysfunctional federal-state shared responsibilities were also identified by the Commission in other areas, notably housing and infrastructure.

### *Health care*

The fragmentation and complexity of the health system has long been a source of tension and inefficiency in Australia (Fenna and Anderson, 2012). The configuration of federal and state responsibilities is at the heart of the problem. Most notably, the Commonwealth funds general-practitioner services while the states are responsible for segments of primary service plus public hospitals – managing, running and part-funding them (Table 2.1).This structure results in co-ordination and cost- and blame-shifting problems (Australian Government, 2010a; Fenna and Anderson, 2012). There may be an incentive, for example, for public hospitals to refer discharged patients to their general practitioner, rather than providing post-hospital services directly, thereby shifting the cost from the states to the Commonwealth (OECD, 2006; Anderson, 2012). On the other hand, difficulties in accessing general practitioners may cause patients to resort to public-hospital emergency wards for primary care services, thereby shifting the cost from the Commonwealth to the states. A government report in 2010 concluded that the cost and blame shifting means that a large number of patients fall through service gaps, or receive poorly co-ordinated services, particularly in remote or highly disadvantaged areas (Australian Government, 2010a). The complexity of the health system also makes it difficult for patients to work out which level of government is accountable for their care.

Clarifying responsibilities has been a key objective of healthcare reform in recent years (Fenna and Anderson, 2012). Building on previous initiatives, an agreement in 2010 (Health and Hospitals Network Agreement), endorsed by all states apart from Western Australia,

### Box 2.3. **Intergovernmental Agreement on Federal Financial Relations: Key provisions**

The Intergovernmental Agreement on Federal Financial Relations (IGA) was endorsed by the Council of Australian Governments (COAG) in November 2008 and became effective in January 2009. It provided increased federal funding to states and initiated several reforms, notably:

- *A new federal-state financial framework* to rationalise the number of tied grants and increase state funding flexibility. The framework provides financial support for the states through: i) untied general revenue assistance (mainly GST); ii) National Specific Purpose Payments (NSPPs) to be spent in key service delivery sectors, with each payment being associated with a National Agreement;* and iii) a new form of payment – National Partnerships Payments (NPPs) – to fund specific projects and reward states that deliver on nationally significant reforms or service improvements. These payments are granted to the states only upon the achievement of milestones or performance benchmarks. Their terms and conditions are specified by the National Partnership Agreements (NPs). This new framework represents a significant rationalisation of the tied grants, replacing the former numerous specific purpose payments with a small number of much less prescriptive grants (Banks et al., 2012; Blöchliger and Vammalle, 2012).
- *Greater clarity in roles and responsibilities*. The National Agreements reached by the Commonwealth and states under the new framework specify the roles and responsibilities of levels of government, along with objectives, outputs, outcomes and performance indicators for each sector.
- *More transparent public performance reporting* through enhanced outcome and performance, based on monitoring and assessment via the COAG Reform Council (the Council), which ceased to operate in June 2014.
- *Centralised funding arrangements*. Under the IGA framework, payments are processed by the Commonwealth Treasury and paid directly to state treasuries, which have the responsibility for their distribution (Australian Government, 2009a). Previously, funding was provided, instead, to relevant state agencies by the Commonwealth portfolio departments, and each payment had each own administrative arrangement.

* Two former NSPPs have been suspended. Healthcare and schools funding, in particular, are currently under different arrangements – National Health Reform and Students First funding – in effect since 2012 and 2014, respectively (Australian Government, 2014a).

attempted to remap the sector, with the federal government taking full funding responsibility for primary health and aged care, and becoming the majority funder of public hospitals (while holding back a proportion of the GST revenue to the states) (Australian Government, 2010b; Anderson, 2012). In addition, under the 2010 Agreement the operational management of public hospital and accountability for local delivery was devolved to Local Hospital Networks (LHNs), established by the states (COAG, 2010). The states remained the managers for public hospitals (Fenna and Anderson, 2012). Not all of the changes entailed in the 2010 agreement were implemented, however.

Table 2.1. **Commonwealth-state responsibilities for healthcare and education and training**

| Functional area | Commonwealth | States |
|---|---|---|
| | Health[1] | |
| Health care | Funding and administrating Medicare (Australia's national public health insurance scheme) which covers: medical services (including visits to GPs), prescription pharmaceuticals and public hospital treatment (co-funded with the states).<br>Regulation of health services, products and health workforce.<br>National health policy leadership.<br>Rebates to private insurance holders.<br>Funding for improved access to primary care, including indigenous-specific primary health. | Delivering and managing of a range of public health services, including public hospitals, community health and public dental care.<br>Contributing to funding of the above services.<br>Primarily responsibility for the regulation of health care providers and private health facilities. |
| Aged care services | Funding and regulating aged care services, including packaged community care, residential aged care and basic community care services for people 65 years and over (or 50 years and over for Indigenous Australians).<br>Funding specialist disability services (delivered by the states) for the specific age groups above. | Funding and regulating basic community care services for people under 65 years and over (50 years and over for Indigenous Australians).<br>Funding packaged community and residential care for the specific age groups above.<br>Regulating specialist disability services. |
| | Education and training | |
| School education | Majority government funder for non-government schools and provision of supplementary funding to government schools. | Providing schooling (and pre-schooling) to all children at the eligible age.<br>Majority funder of government schools and provision of supplementary funding to non-government schools.<br>Regulation of non-government schools.<br>Responsibility for school policies, including control of teacher wages, hiring and firing decisions, and curriculum design (with a degree of Commonwealth co-ordination). |
| Tertiary education | Provides the majority of public funding for higher education.<br>Responsibility for policy and regulation of higher education institutions and accreditation of some higher education courses.<br>Provision of supplementary funding for vocational education and training (VET). Funding support for apprenticeships (along with the states).<br>Provision of financial assistance for specific educational programmes and categories of students. | Primary responsibility for the delivery of VET (with most states adhering to agreed principles for the development of a national training market).<br>Majority funder for VET. Co-funds for apprenticeships.<br>Provision of only a small amount of funding to some universities. |

1. All three levels of Australia, along the private sectors, are involved in the health sectors but most activity performed by the Commonwealth and state government.

*Source:* National Authorities; OECD (2006); ABS (2012); NCA (2014).

The subsequent National Health Reform Agreement (NHRA) of 2011, currently in force, is implementing reforms in aged care (Table 2.1) and the devolution to Local Hospital Networks. However, the changes giving the federal government greater funding responsibilities in primary and hospital care did not happen (the latter reflecting the fact that the 2010 provision for a reduction in GST payments to states, in exchange for an increased federal funding for public hospital services, was removed) (Anderson, 2012). Nevertheless, the federal funding contribution to hospitals increased in the 2011 NHRA, which will be based largely on actual activity levels, rather than on a block grant basis as in the past (Rimmer, 2012). Hospital funding to the states, therefore, is currently linked directly to the number and type of patients treated (though, on the basis of the May 2014 budget, an indexation rather than an activity-based funding arrangement will apply from 2017). In addition, current arrangements require funding for hospitals to be channelled to a single national pool to be managed by independent bodies that have to report regularly on the performance of hospitals and health services (Australian Government, 2012a; Rimmer, 2012).

The 2011 National Health Reform Agreement increases the transparency and efficiency of hospital funding and services. The introduction of the Local Hospitals Networks, for instance, is expected to reduce some overlaps and duplication of services that would come from individual hospitals operating independently from each other. However, there are concerns that the increased focus on hospitals will adversely affect primary and preventive care, in addition to reducing the flexibility of federal funding (CRC, 2013a). Importantly, complexity and unclear roles and responsibilities in the healthcare sector remain, creating scope for inefficiencies to occur. Recent industry analysis has indicated that, even after several years of reforms in healthcare, a "dysfunctional fragmentation" between the Commonwealth and state governments (and private insurers) persist, as is the "blame game" (CEDA, 2013).

### *Education*

In the school sector, joint federal-state responsibilities and parallel state systems have resulted in a complex setup. Constitutionally, schools are a state responsibility but the Commonwealth has taken an increasing role via school funding, providing today around a quarter of public funding to schools. The central government provides funds to non-government (private) schools, while the states largely fund government (public) schools (Table 2.1). There is also a significant overlap in regulation, with the national agreements on schooling generating administrative red tape and compliance costs for the states, according to the National Commission of Audit (NCA, 2014).

Recent reforms that introduced a needs-based school funding model have not fully solved complexity and inconsistency. Instead of a national funding model, the government and non-government school sectors have their own approaches to allocating funding to schools. To illustrate the complexity: there are currently a Commonwealth model, 8 different state models, and a number of different models for schools in the private sector (NCA, 2014). Incoherent and opaque funding arrangements make it difficult to determine how individual schools are funded, with potential adverse effects on efficiency (OECD, 2013a).

At the tertiary level, there is a considerable state-Commonwealth overlap in the vocational education and training sector (VET) including in the areas of regulation (where some states use the national regulator, while others maintain a state regulator); provision of incentive payments to employers; and student loans and subsidies. Also, multiple and fragmented funding arrangements, along with the multiplicity of state and national programmes, compromise funding accountability and increase administrative costs, with implications for efficiency and responsiveness, according to recent reports (Skills Australia, 2011; NCA, 2014).

The National Commission of Audit assesses that the VET outcomes are weak relative to the public money spent (approximately 0.6% of GDP) on the sector, and the completion rates for trade apprentices, for example, was less than 60% in 2012 (NCA, 2014). Overlaps between the Commonwealth and states in terms of VET funding and programmes may also undermine a fast move towards demand-driven, entitlement-based vocational system, discussed in the previous *Survey* (OECD, 2012a). Cross-state differences with regard to skills recognition also reduce the responsiveness of VET to changing needs by impeding labour mobility. For many occupations, a license acquired in one state does not entitle an individual to work in another (NCA, 2014). There is further a lack of streamlined regulatory and governance frameworks between tertiary education institutions (including both VET and higher education), which also creates duplication and inconsistency, according to a recent report (ACPET, 2013).

#### *Other sectors*

Overlapping and duplicative responsibilities are also evident in other sectors, according to the recent report of the National Commission of Audit (NCA, 2014). The duplication of the Commonwealth and state programmes for Australia's indigenous population (funded almost equally by the Commonwealth and states), for instance, is an area of concern, especially as socio-economic gaps between indigenous peoples and the rest of the population remain, despite several decades of policy attention.

Joint government involvement also raises issues in the housing area. The states, with a constitutional power in housing, provide public housing and address homelessness, in co-operation with community-based organisations (NCA, 2014). However, Commonwealth plays a significant role, providing payments to the states for affordable housing and homelessness and direct rent assistance to households (excluding public tenants). This complex pattern of shared functions creates duplication of effort and administrative burden via the reporting requirements attached to Commonwealth-state agreements for affordable housing and homelessness. According to existing reports, success has been limited so far in these two areas, and especially, in improving housing affordability outcomes at the national level (CRC, 2012, 2013b; NCA, 2014).

Federal-state arrangements in infrastructure are also problematic according to NCA (2014), leading to an extensive institutional and regulatory duplication. Ownership and maintenance responsibilities generally reside with the states but the Commonwealth contributes significantly to funding of major projects. Recent reforms, including an improvement in economic planning, through reforms to Infrastructure Australia, an oversight body established in 2008 (OECD, 2012a; Australian Government, 2014b), should help overcome some of the difficulties by enhancing clarity of responsibilities. In the energy sector, under the Australian Energy Market Agreement the Commonwealth and states have joint policy responsibilities and national regulatory arrangements and institutions for the national energy market have been established. A White Paper on the energy sector (due at end 2014) is, amongst other things, assessing the appropriate role for government.

There are also instances of good inter-governmental co-operation, however. The current level of co-operation on innovation policy, for example, is effective, according to the authorities. The federal and state governments also work collaboratively to pursue water reform. For example, between November 2009 and January 2010, a set of Water Management Partnership Agreements were completed between the Commonwealth and the Murray-Darling Basin States, while in early-2014, the two parties signed the Intergovernmental Agreement on Implementing Water Reform in the Murray-Darling Basin.

### *Potential reform options for better allocation of roles and responsibilities*

Being clear about which government level has responsibility for what is essential for effective action and public service efficiency, as well as enhanced accountability to the public. While the challenges cannot be underestimated, ongoing efforts to identify and resolve problems are required not only in health care and education but in other sectors such as housing and infrastructure.

The new government has committed to produce with the states, a *White Paper on Reform of the Federation*, to be completed by end-2015. The review will attempt to clarify roles and responsibilities, and would appear to lean towards decentralisation. According to government material (Abbott, 2014; Commonwealth Government, 2014), the review will focus on making states, as far as possible, "sovereign in their own sphere", with Commonwealth continuing to play the leading role on issues of genuine national interest, but a small role in areas of primary state responsibility including health, education, housing and homelessness.

In tandem with an overhaul in responsibilities, the review will examine, amongst other things, the ways to address the large imbalance between states' own revenue and their spending responsibilities. Increased fiscal autonomy should be combined with increased responsibility. In this context, the intention of the government to consider both the spending, and taxation, roles and responsibilities of the different levels of government (as part of the forthcoming Reform of the Federation White Paper, in conjunction with the related Taxation White Paper) is welcome. The white paper background material also emphasises the need to reduce, and, as far as possible, eliminate, waste and duplication and simplify the interaction between government and citizens (Abbott, 2014; Commonwealth of Australia, 2014).

The comprehensive review of the federal system, along with the "whole-of-government" approach to the process through the involvement of the states, are welcome. International experience points to benefits from clearly defining the roles and responsibilities of the central and sub-central governments. This is the case, for example, in Switzerland where the separation of the majority of federal and cantonal tasks (not yet fully completed) under a recent reform has yielded positive results, such as important savings for the construction of national roads (Bessard, 2013; Clemens and Veldhuis, 2013).

Reforming Australia's federal system appears also to have public support. A recent survey on constitutional values by the Griffith University shows that two-thirds of the respondents see scope for improving the functioning of the federal system, yet with no clear preference as to whether decision-making should be at the Commonwealth or state/local level (Brown, 2012b).

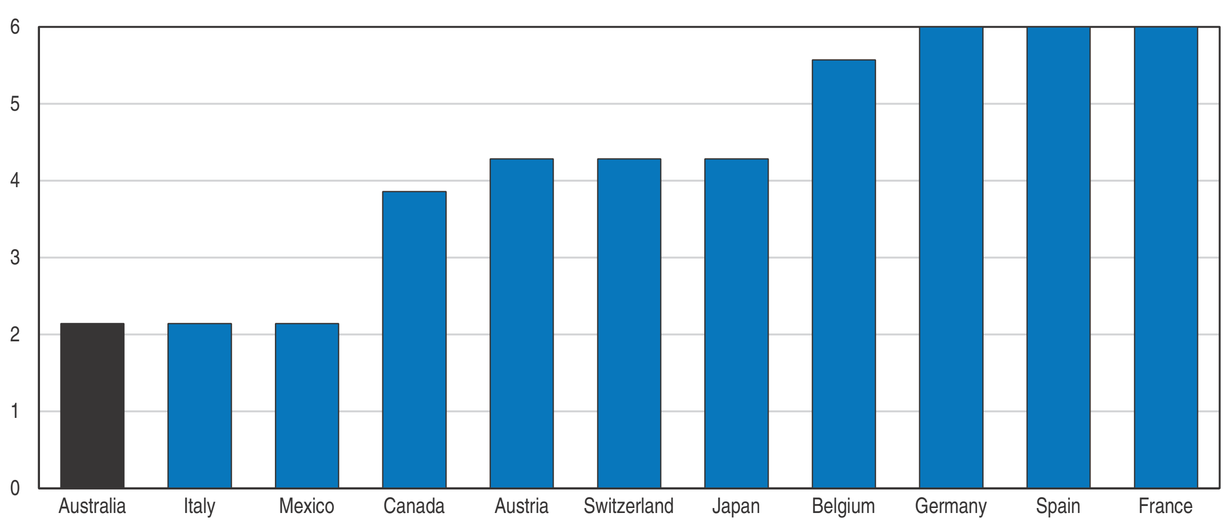
Efforts to clarify the roles and responsibilities within shared functions, and to encourage co-ordination, should continue. For some sectors, however, deeper reform may be required; in particular by re-allocating responsibilities between the federal and state governments. Responsibilities should be allocated on the basis of the "subsidiarity" principle (i.e., responsibility should rest, as far as practical, with the level of government closest to the people receiving those services), while ensuring consistency between national and sub-national policies.

In education, for example, the National Commission of Audit recommends transferring more policy and funding responsibilities for schools and VET to the states, while retaining national mechanisms for ensuring consistency and quality (NCA, 2014). For instance, for the shorter run, the report makes a case for states managing the funding for both public and private schools, rather than as currently that each school sector has its own approach to allocating funding, as discussed above. Over the longer term, the states could undertake more funding responsibilities for schools, if VFI were reduced, with the Commonwealth retaining a co-ordinating role in areas such as national curriculum (NCA, 2014). The new funding arrangements for schools announced in the May 2014 budget, to commence from 2017-18, appear to go in this direction and are in line with reforms in some federal countries, for example, Switzerland (Bessard, 2013). OECD analysis generally suggests that appropriate decentralisation in school education (encompassing school autonomy and other aspects of education regulation and management, rather than simply sub-central shares of spending) can help to increase education performance (OECD, 2013b).

In healthcare, international comparisons show that many countries have scope for enhancing consistency in the assignment of responsibility between federal and state governments (Figure 2.10). Australia's relatively low score reflects the overlapping responsibilities in the sector. Countries have moved in different directions on this front. Some (such as Italy and Spain) have in recent years transferred some health care responsibilities to sub-national levels. Others (including Denmark, Norway, and Poland) re-centralised responsibilities, citing concerns about heightened equity problems, potentially insufficient local funding to finance future heath care needs, duplication and inefficiency and other reasons (Saltman, 2008). Decentralisation could make the health care system more responsive to local needs and promote innovation, but it may also result in institutional complexity, weakening control over spending and insufficient exploitation of economies of scale (Joumard et al., 2010). A careful assessment is required.

Figure 2.10. **Consistency in health-care responsibility assignment across levels of government**[1]

Scores




1. The indicator is based on measures of overlapping as well as irrelevance in the decision-making across levels of government. The lower the score, the lower the consistency in responsibility assignment across levels of government.

*Source: OECD Survey on Health Systems Characteristics 2008-09.*

StatLink http://dx.doi.org/10.1787/888933176823

## Issues in state-level financing

### *Addressing vertical fiscal imbalance*

Vertical fiscal imbalance (VFI) has become an issue in Australia, with concerns that the large fiscal gap potentially reduces accountability and provides opportunities for "blame-shifting" between government levels, reducing the efficiency of public service delivery (Box 2.4). Much focus has been placed, in this context, on the underlying system of transfers to address the fiscal gap, and whether it gives rise to inefficiencies, with the design of "tied" grants (at least, until the recent reforms discussed below) at the centre of the debate. Growing attention has also been given to horizontal fiscal equalisation mechanisms for allocating unconditional federal transfers (GST) among the states (described in Box 2.2 and discussed further below).

#### Box 2.4. **Vertical fiscal imbalance: Potential consequences for the efficient delivery of services**

A large vertical fiscal imbalance (VFI) is often argued to weaken the link between government taxation and expenditure, reducing the efficiency in the delivery of services. Moreover, as both governments fund public services, a large imbalance reduces accountability to the public and provides incentives for blame-shifting between different government levels (BCA, 2013; NCA, 2014). Critics also claim that the vertical fiscal imbalance increases duplication and overlap in service delivery and the administration burden, through a blurring of roles and responsibilities (Australian Government, 2008; CAF, 2009). The increased scope the imbalance provides for central government in areas of sub-national responsibility, through the conditionality of federal transfers, raises additional concern (Banks et al., 2012).

Large vertical fiscal gaps may also reduce incentives for fiscal discipline, according to recent cross-country analyses (Eyraud and Lusinyan, 2011, 2013). Some also argue that, a significant imbalance leads to misallocation of resources (including inadequate or inappropriate funding) and slows governments' responsiveness to their communities' needs (CAF, 2009).

However, a large vertical imbalance has some potential benefits. These include, for example, the economies of scale that can be exploited in centralising tax collection; more uniform standards of sub-national government services; increased scope for reforms of national interest; and smoother economic cycles by enabling the central government to influence the allocation of resources in the economy (for further discussion, see OECD, 2006; Australian Government, 2008).

An effective system of inter-governmental transfers that ensures flexibility and accountability is important in dealing with the challenges posed by the vertical fiscal imbalance. But increasing efficiency further, would also require enhancing states' revenue-raising through tax reforms. Recent OECD work concludes, for instance, that tax decentralisation (using Canada as a benchmark) could have a positive impact on Australian growth (OECD, 2013b). While there is no consensus on the ideal degree of decentralisation, sub-central governments should be given sufficient revenue-raising capacity to make them accountable to local citizens (OECD, 2006, 2013c). These issues are discussed below, and become particularly relevant in the context of the current review of the federation and the present government's intention to hand greater responsibilities to the states, making them, as far as practical, "sovereign in their own sphere" (Abbott, 2014; Commonwealth Government, 2014).

### *There is scope to reduce further the strings attached to federal grants*

Grant conditionality may be justified on the grounds of ensuring minimum national standards for the provision of public service but there are also counter arguments (Ter-Minassian, 1997). Australia's tied grants have long been criticised for their complexity, administrative costs, and the inflexibility and conditions attached to them (Warren, 2006; Ward, 2009; Ramamurty, 2012). In a welcome move, the 2008 Intergovernmental Agreement on Federal Financial Relations (IGA) (Box 2.3) consolidated over 90 Specific Purpose Payments into five, largely untied, broad payments (each associated with a National Agreement) covering health, schools, skills and workforce development, disability services and affordable housing (Australian Government, 2009a; Banks et al., 2012). The 2008 reform also enhanced service-performance requirements (largely regarding measurement and accountability) as part of an effort towards outcome-based policy; however the reform did not make the provision of funding contingent on such achievements (Australian Government, 2009a; CRC, 2013a).

The intentions of the 2008 Intergovernmental Agreement on Financial Relations (IGA) were commendable. More flexible and transparent state funding arrangements are in line with the general principles of best-practice inter-governmental fiscal arrangements; enhancing states' incentives for innovative policy solutions and efficient service delivery (OECD, 2008, 2013c). Less complexity and conditionality also brings Australia closer to the practice of other federations. Transfer payments in Canada, for example, entail three broad programmes: the Canada Health Transfer, with specified use for health care; Canada Social Transfer, which allows provinces considerable leeway in social programmes; and unconditional equalisation payments (Clemens and Veldhuis, 2013).

The recent reforms did not deliver, however, the expected outcomes (CRC, 2013a; NCA, 2014). There has been excessive resort to National Partnership Payments – a new form of grant under the IGA which are designed to help deliver national reforms and contain conditionality clauses (Box 2.3). Increased use of such payments partly arose from stimulus measures to counter the consequences of the global financial and economic crisis of 2008 (Fenna and Anderson, 2012; OECD, 2012b). In other countries too, earmarked and matching constituted a significant share of the national "stimulus" packages to cope with the economic downturn (Smart and Bird, 2009). Even though stimulus-related measures have largely been phased down, these National Partnership Agreements remain numerous. As of mid-2013, there were over 140 of such agreements, with the corresponding payments accounting for about a third of all tied grants. This marks a re-assertion of Commonwealth direction over funding. Moreover, the proliferation of these partnerships has reportedly increased the monitoring, administrative and reporting costs for the Commonwealth and states (CRC, 2013a; OECD, 2012b), contrasting IGA's key objective for reduced red tape.

Welcome efforts have been made to lighten and rationalise the National Partnership Agreements. A streamlined version ("project agreements") has been operating since early 2011 for lower risk/lower value agreements. Project agreements typically include less detail and reporting requirements than National Partnerships and focus on straightforward service delivery or project outputs (than outcomes). And, the Council of Australian Governments (COAG) agreed at end-2013 to consolidate 31 of the Partnerships into four, with the new arrangements to take effect in 2014.

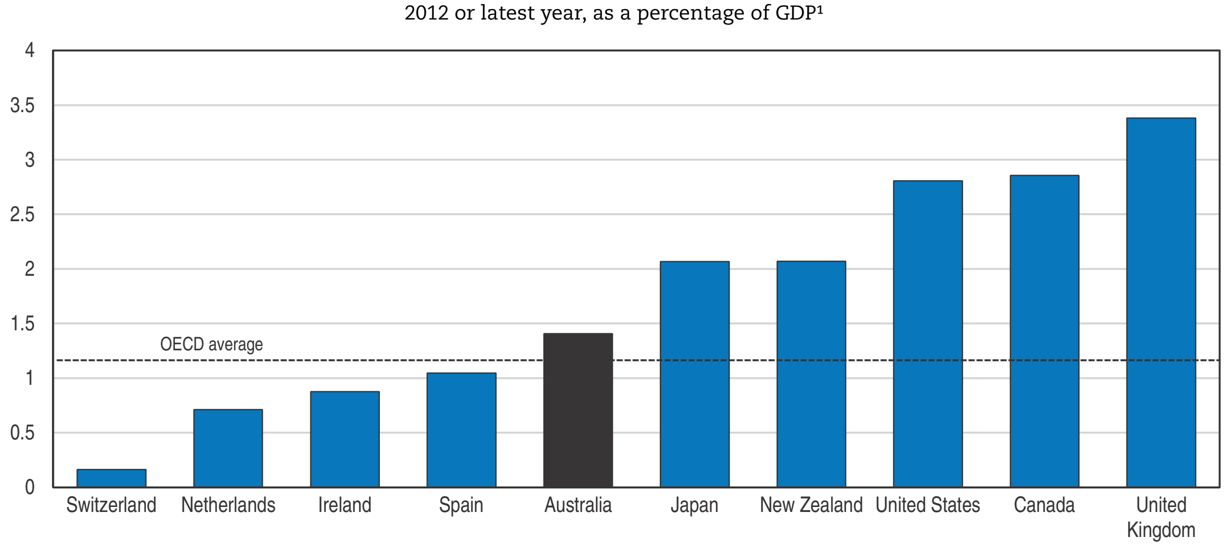
However, reform could go further by converting some types of National Partnership Payments into less conditional National Specific Purpose Payments. The OECD report *Value for Money for Australia* (OECD, 2012b) has recommended, in particular, such conversion for Partnerships that are not time limited. This could be the case, for example, with agreements on early education and care, aiming to improve the quality of services and outcomes for all children, especially those from disadvantaged backgrounds. As regards time-limited agreements, the 2008 framework contains a mechanism for these transformations (or general revenue assistance), but this has not yet been used. Reduction in grant conditionality through such mechanisms would enhance further the flexibility and transparency of the transfer system, while making state funding more predictable, which could facilitate and encourage efficient service delivery.

### *Increasing the efficiency of the state tax base*

Some economically more efficient tax bases, notably land tax, are not fully utilised by sub-national governments. The ratio of property tax revenue to GDP is above the OECD average but lower than in several countries (Figure 2.11). Exemptions for owner-occupied housing alone are estimated to diminish the state land tax base by around 60% (Australian Government, 2009b). Several other land uses are exempt from state-based land tax, including primary production land and land owned and used by non-profit organisations and charities. Moreover, tax free thresholds effectively exempt many small scale investors (OECD, 2006). Aside from foregone revenue, the exemptions distort land-use. The current system, for example, places a particular burden on large property developers that may explain, to an extent, the relative low rental of apartment buildings in Australia (OECD, 2010, 2012a). The exemptions also ramp up compliance and administration costs. The state land-tax base should be broadened to include owner-occupied housing and other exempted assets. There is also scope to increase the utilisation of the rates base by sub-national governments (Figure 2.6). Municipal rates are applied broadly across all residential land, with few exemptions, and are based usually on the unimproved capital value of land.

Figure 2.11. **Taxes on immovable property**

2012 or latest year, as a percentage of GDP[1]




1. 2011 for Australia, Netherlands and OECD. The OECD aggregate is an unweighted average.
*Source:* OECD (2014), *Revenue Statistics*.

StatLink http://dx.doi.org/10.1787/888933176837

They are considered to be an efficient tax base (see, for example, Australian Government, 2009b; and Lambert, 2011).

States impose stamp duties on conveyances of real property (the transfer of property), which can dissuade household mobility and diminish the efficiency of the housing market (Warren, 2006; OECD, 2010). Around a fourth of the tax revenue in 2012-13 came from stamp duties (and particularly, on real-estate transfers) (ABS, 2014), which is a largely inefficient and volatile tax base (Australian Government, 2009b).These should be removed as recommended by previous *Surveys* (OECD, 2006, 2010, 2012a). The Australian Capital Territory is demonstrating that reform is possible, with reforms underway entailing a 20 year transition from transaction taxes (stamp duty on residential conveyance) to general municipal rates (McLaren, 2012). Insurance levies (comprising around 9% of states' total tax revenue; Figure 2.5), are also highly distortionary, as pointed out in a previous *Survey* (OECD, 2010). Such taxes raise the cost of protection against risk, possibly causing low-income households to under-insure.

Large exemptions are also found in payroll taxes. Although they can increase the cost of labour, payroll taxes have advantages in providing a relatively broad and stable base and low administrative costs (OECD, 2006, 2013c; Warren, 2006). However, only 5% of businesses are liable (Australian Government, 2009b) due to the wide-ranging exemptions, which include small firms and firms in particular activities (such as charitable and other non-profit organisations). In addition, there are payment exemptions, for instance on payments for maternity leave. Again, the exemptions represent foregone revenue but also economic distortions, in this case on the allocation of labour. Australia's Future Tax Review (AFTR) concluded that threshold exemptions explain most of the difference between the actual and "theoretical" payroll tax collections (the latter being the amount that would be collected at current rates from its theoretical base, represented by the national account measure of compensation of employees) (Australian Government, 2009b). Therefore, the narrowly-based payroll tax should be broadened mainly by extending it to smaller firms (OECD, 2006). Existing exemptions also increase the complexity and compliance costs for employers, especially those operating in more than one state, as treatment differs, despite steps towards harmonising payroll tax provisions in recent years.

Overall, as previous *Surveys* have also suggested (OECD, 2010, 2012a), there is room to enhance the efficiency of the existing state tax systems. This could be facilitated by a "deal" between state and federal governments on state taxation. For instance, states might sign up to getting rid of distortionary taxes if more GST revenues can be offered (following an adjustment in its base and/or rates, see Chapter 1). Broadening the states' land and payroll tax bases could also contribute to a shift towards lower vertical imbalance, in addition to increasing efficiency.

### *Consider introduction of a state-level income tax*

Better utilisation of relatively efficient existing sub-national tax bases should be a priority, but if additional "own-revenue" is warranted to reduce vertical fiscal imbalance as part of a broad reform of the federation, a state-level personal income tax (PIT) could be considered. The reform should also dovetail with the recommendations made elsewhere in this *Survey* for a shift towards less reliance on direct taxation at the national level. This could imply that the federal government "makes room" by lowering its personal income tax to accommodate both state-level PIT and national tax reform (OECD, 2006; Australian Government, 2009b; NCA, 2014). Various approaches to state-level PIT can be taken, such as a system where states are allowed to set their rate while keeping a unified base throughout the country (a so-called "piggyback" system). This is likely to involve some economic costs, such as the erosion of the base assigned to states due to horizontal competition and efficiency loss, particularly if multiple rates are applied across jurisdictions. Moreover state-level PIT might make future reform of the income tax base more difficult, given the involvement of more government levels in its determination. However, vertical tax competition (i.e. competition of different levels of government for the same tax base) could partly offset the impact of horizontal competition, according to recent OECD analysis (OECD, 2013a). To reduce complexity and potential inefficiencies from different PIT tax rates across states, individual rates could be set within a nationally agreed band. Moreover, piggybacking state-level PIT on national taxation would limit significantly administration costs, since such tax would be centrally administrated and collected (Fedelino and Ter-Minassian, 2010), although there could be increased red-tape and compliance costs around determining the state in which income is earned. Sub-central income taxes features in many advanced economies, but international experience varies. In Canada, for example, most provinces impose their tax rates on the federal income tax base (modified slightly by provincial and credits rebates), which is collected and administrated centrally (except for Québec). Meanwhile, the Nordic countries apply flat, locally set tax rates, imposed on a common tax base and collected centrally (Bird and Smart, 2010). Furthermore, in the United States and Switzerland the federal and state levels set PIT rates and bases separately. Any increased revenue powers must go hand in hand with increased responsibility and accountability such that states have strong incentives for maintaining wide tax bases.

### *The equalisation scheme*

No other country has a system of "full" equalisation akin to that in Australia (Box 2.2), where both revenue and expenditure *capacity* are equalised (Australian Government, 2011; OECD, 2013b) (Table 2.2). The process in many countries aims to ensure a minimum standard of services, rather than full equalisation (Table 2.3). The Australian system does not equalise actual levels of service; the goal is to equalise state fiscal *capacities* to do so, but the actual standard delivered is a matter of policy for each state (Australian Government, 2011).

Table 2.2. **Fiscal disparities before and after equalisation**

Gini coefficients and ratio of the wealthiest to the poorest jurisdiction

| | Gini coefficient | | | | Ratio of highest to lowest tax raising capacity | | | |
|---|---|---|---|---|---|---|---|---|
| | Before equalisation | | After equalisation | | Before equalisation | | After equalisation | |
| | 2005 | 2012 | 2005 | 2012 | 2005 | 2012 | 2005 | 2012 |
| Australia | 0.05 | 0.07 | 0.00 | 0.00 | 4.8 | 7.5 | 1.0 | 1.0 |
| Austria | | | 0.02 | 0.05 | | | 1.1 | 1.5 |
| Canada | 0.10 | 0.11 | 0.07 | 0.08 | 2.4 | 2.4 | 1.7 | 1.8 |
| Germany (2005) | 0.06 | 0.06 | 0.02 | 0.02 | 1.7 | 1.7 | 1.2 | 1.1 |
| Italy | 0.21 | 0.19 | 0.10 | 0.04 | 6.1 | 4.5 | 1.3 | 1.3 |
| Spain | 0.15 | 0.13 | 0.04 | 0.05 | 2.1 | 3.0 | 1.4 | 1.4 |
| Switzerland | 0.15 | 0.17 | 0.11 | 0.11 | 3.8 | 4.3 | 2.5 | 2.6 |

*Source:* OECD (2014), *Fiscal Federalism 2014: Making Decentralisation Work*, Table 5.1.

The equalisation process, and its outcomes have come under criticism in Australia at various times, as discussed in a previous *Survey* (OECD, 2006), and most recently with the

## Table 2.3. **Fiscal equalisation systems in selected federations**

| | Overall objective | Form of equalisation |
|---|---|---|
| **Australia** | For all states to have the same capacity to deliver services to their population, i.e. equalisation in the hypothetical situation that each state makes the same effort to exploit its revenue bases and operates at the same level of efficiency. | Full equalisation. All state revenues (including federal payments for specific purpose) and expenditure (including infrastructure investment) capacities, along with differing state circumstances largely beyond state governments' control are included in the calculation. |
| **Canada** | To ensure provincial and territorial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. | Partial equalisation. The programme equalises the revenue raising capacity of provinces. Equalisation payments are only distributed to provinces with below average capacity, so that they are equalised "up" to the average.<br>Provinces with a capacity above average neither receive equalisation payments nor are obliged to contribute.<br>The territories have a separate programme, where both revenue raising capacities and expenditure needs are equalised. The aim is to enable Territorial governments to provide their residents comparable public services to those provided by provinces at comparable levels of taxation. |
| **Germany** | Ensure uniform living standards throughout the federation. | Partial equalisation. The programme aims mainly at revenue equalisation, with only some small adjustments for expenditure needs (in particular, population dispersion and cross-border issues) The process includes several steps and involves multiple sources of funds:<br>• The share of value added tax revenue allocated by the central government to the states is divided into two parts: Three quarters of this is distributed to the states on a per capita basis, and the remaining is paid to the financially weak states on the basis of the difference between a state's raised tax revenue per capita and the national average.<br>• Less well off states receive adjustment payments funded by the well off states.<br>• States with a financial capacity below the average, after the above described equalisation steps, receive a supplementary equalisation payment from the federal government.<br>• States with particular burdens are eligible for a "special" supplementary federal equalisation transfer, granted to the states whose economies are too small and poor to reach parity in the previous steps of equalisation process. The special supplementary equalisation transfers were introduced in 1995 and will be phased out until 2019. |
| **Switzerland** | Bring financially weak cantons to 85% of the national average. | Both the revenue and spending needs are taken into account when calculating/setting equalisation payments (reflecting to some extent the Australian approach).<br>Resources equalisation (fiscal capacity equalisation), the main redistributive mechanism, is currently based on the cantonal tax potential.<br>The equalisation of financial needs includes compensation for geographic, as well as socio demographic costs, including for urbanisation. The assessment of these specific factors and costs is the outcome of political bargaining, rather than formal evaluation. |
| **United States** | No formal system of fiscal equalisation. | While there is no mechanism for formula based equalisation, specific federal state transfers, do entail equalising elements. Grants based on formulas, in particular, take into account factors, such as demographic and income land poverty levels in determining the amount of support to the state and local governments. Medicaid funding, for example, considers each state's average personal income compared to the country average. The formula determining the Federal Medical Assistance Percentage (FMAP – the federal share of state spending on Medicaid) raises the federal share of spending in states with lower per capita income relative to the national average. |

*Sources:* Warner and Shah (2005); Frey and Wettstein (2008); Australian Government (2012b); Bessard (2013); CBO (2013); Clemens and Veldhuis (2013).

substantial changes in the distribution of GST revenue resulted from mining boom (Australian Government, 2011; Banks et al., 2012). Before the boom, the GST redistribution coefficient for the two main "mining states", Western Australia and Queensland was about 1 (which means they received close to 100% of their respective per-capita weighted shares of GST). During the boom this coefficient fell, especially in Western Australia, where it was about 0.7 in 2011-12. In contrast, the Northern Territory's coefficient, for example, was in 2011-12 over 5 times its equal per capita share (CGC, 2013).

This larger redistribution prompted the four largest states (Victoria, New South Wales, Western Australia and Queensland), which lost out, or remained broadly neutral, to advocate for a more partial equalisation (Australian Government, 2012b; NCA, 2014). In response, the previous federal government launched the *GST Distribution Review* (the Review) in 2011, examining possible reform options. Issues of complexity, efficiency, and predictability and stability of equalisation outcomes (GST shares) received particular attention.

Submissions to the Review confirmed concerns about complexity and data adequacy and quality, despite previous simplification of equalisation methodology. Complexity was generally believed to inhibit understanding of the equalisation process, and ultimately its acceptance (Australian Government, 2012b). The Review also flagged instability and unpredictability of GST payouts. Detailed concerns included the disruptive effect from the "upfront" treatment of Commonwealth infrastructure payments to states, which have a large impact on the annual relativities (determining how much revenue of the GST pool each state receives compared to an equal per capita share, see Box 2.2) of the years when payment are made. However, the Review found little supporting evidence for concerns about efficiency losses due to equalisation arrangements, although Clements and Veldhuis (2013) argue that this conclusion might have been different if the review's terms of reference had not specified that desirability of fiscal equalisation is to be taken as given.

In its final report (October 2012), the Review did not recommend an overhaul of the equalisation system, arguing that replicating the outcomes of the existing system in a radically simpler way was not feasible (Australian Government, 2012c). However, a range of improvements to enhance governance and stability, and reduce complexity, were suggested. For instance, an increase in "materiality thresholds" (the thresholds set the minimum effect on GST distribution required for a factor to be taken into account in the equalisation process) was proposed to remove the insurance tax and six "cost disabilities" (e.g. first home owners scheme expenses and water subsidies) from the calculations of GST relativities (Box 2.2). As regards governance, the final report suggested, amongst other things, subjecting equalisation outcomes to regular independent reviews. These proposals go in the right direction.

There may be scope to further simplify the current equalisation system. A wide range of factors are still taken into consideration in the equalisation process, which makes identification and quantification very complex (Clemens and Veldhuis, 2013). Some equalisation factors, for instance, may become redundant. The methodological reviews of the equalisation process conducted by the Commonwealth Grants Commission every 5 years (Box 2.2) are welcome to this end, with the 2015 review currently under way. Such exercises could be carried out at a higher frequency. Greater methodological simplicity would not increase only the transparency of the equalisation process, but also its relevance and responsiveness as well as the reliability of its outcomes by reducing the amount of required information. However, this should not come at increased uncertainty of the rules underlying the distribution of GST revenue. Setting priorities for equalisation categories to be re-examined in future methodological reviews, as proposed by the final report, makes sense (Australian Government, 2012c).

Broader reforms to the federation, for instance towards lower vertical imbalances, may allow for more radical changes in the equalisation system. An option suggested by the final report of the Review and other studies (for example, Garnaut and FitzGerland, 2002; NCA, 2014) would be to move towards allocating the GST revenue on an equal-per capita basis, with fiscally weaker states being accommodated through other mechanisms. The present government's views on the equalisation reform are due to be elaborated in the upcoming White Paper on Reforming Federation.

### *States can borrow freely but there are disciplining mechanisms*

The Australian states can borrow on their own account with no limits imposed by the central government. Financial markets and rating agencies act in this case as important discipline mechanisms. In addition, the Australian Loan Council monitors borrowing by all levels of government (Craig, 1997). The Council seeks to foster transparency and accountability of public sector finances (including through comprehensive data reporting requirements), rather than securing adherence to strict borrowing limits (OECD, 2006; Australian Government, 2014a). The federal and each state government are required to submit, in this context, their net financing requirements (so called, Loan Council Allocations) for the coming year. Jurisdictions may be requested to provide an explanation to the Council if the agreed financing requirement exceeds the tolerance limit. While the Loan Council cannot provide direct sanctions on jurisdictions' borrowing behaviour it can facilitate scrutiny over borrowing, strengthening potentially fiscal discipline (OECD, 2006).

## There is scope to further improve performance reporting

Effective reporting on policy approaches and outcomes is important for detecting inefficiency and poor service quality, helping states learn from each other, and increasing accountability. Since 1993, an annual Report on Government Services has monitored the effectiveness and efficiency in public service provision, publishing performance information on 16 broad service areas across education, health justice and community services (SCRGSP, 2014). The 2008 Intergovernmental Agreement on Federal Financial Relations (IGA) sought to make additional progress through its focus on "outcomes and outputs" monitoring and improved public reporting by the COAG Reform Council (the Council (Box 2.3). The Council was tasked to appraise achievement against benchmarks, reporting publicly the results on an annual basis, but ceased operating in June 2014, as part of the government's policy to reduce regulation and red tape.

Despite progress made in some domains, for instance regarding the data for indigenous population and homelessness, performance indicators are of varying quality, and are based on inadequate or outdated data in a number of areas (CRC, 2013a). Moreover, well-developed "outcome" indicators are still absent. Data challenges are partly to blame but some also claim that the proliferation of the prescriptive National Partnership Agreements dissuades indicator development (DAE, 2013). Overall, in its assessment for the period 2008-12, the Council concluded an "inadequate attention" on the continuous improvement of the performance framework (CRC, 2013a).

Simple and easy-to-quantify audit targets are essential if operational efficiency is to be enhanced (OECD, 2006), but are not easily formulated. The long timeframes usually required for the achievement of outcomes add to challenges of measuring them properly, as it makes it difficult to track progress in practice. Following systematically the effectiveness of reforms in different areas, through the creation of an "evidence base", as recommended by the Council, would be important in this regard, as it would allow monitoring and assessing progress along the way (CRC, 2013a).

In some policy areas, reporting requirements are overly burdensome. The National Health Reform Agreement, for instance, includes 22 outcomes, 26 measures, 15 outputs, 70 indicators, and 7 performance benchmarks, generating an unnecessarily heavy reporting and compliance burden (NCA, 2014). A more streamlined performance reporting framework, while ensuring the necessary accountabilities, would bring a welcome reduction in administrative burdens, as highlighted by the National Commission of Audit (NCA, 2014). A review of existing reporting arrangements would be helpful in this regard.

The gap left in performance monitoring and reporting, following the abolition of the COAG Reform Council, needs to be filled through a new or existing entity. The May 2014 budget included some provisions in this regard (giving the Department of the Prime Minister and Cabinet a role to monitor state performance on an ongoing basis). Regarding further options, the NCA's recommendation for the Productivity Commission to perform this role is sensible, in light of the Commission's considerable experience in assessing public services (NCA, 2014). Performance reporting arrangements will be covered in the government's White Paper on Reform of the Federation, with transitional arrangements currently being developed.

As a final note, for performance reporting to be worthwhile it has to have impact. Mechanisms helping service providers learn and adjust in light of performance outcomes are therefore important (Thomas, 2006; CRC, 2013a). A systematic monitoring of the policy impacts of the performance reports is important to this end. Moving in the right direction, the White Paper on federation reform will consider transparency in performance reporting and data arrangements, as well as avenues for making better use of the data to improve outcomes (Commonwealth of Australia, 2014).

## Recommendations for improving federal-state relations

**Address federal-state shared responsibilities to improve efficiency**

- Improve co-ordination and co-operation and, in some cases, health care in particular, consider a reallocation of responsibilities.
- In the school sector, consider giving states the management of funding for all schools. Over the longer term, states could be given greater funding responsibilities combined with increased fiscal powers.
- Clarify the roles and responsibilities of the Commonwealth and the states in the vocational education and training sector (VET), and consider shifting more policy and funding responsibilities to states, while ensuring national consistency and quality.

**Reform federal-state financial relations**

- Reduce grant conditionality further, instigate state-level tax reforms to enhance funding autonomy, and increase state-level responsibilities and accountabilities.

**Recommendations for improving federal-state relations** *(cont.)*

- Convert some types of National Partnership Payments into less conditional National Specific Purpose Payments. In particular, roll partnerships with no-time limits, and selected successful time-limited ones, into specific purpose payments.
- Increase the efficiency of existing state-tax mix by abolishing distortionary stamp duties, especially on conveyance of real property, and by increasing the reliance on efficient taxes. The forgone revenue could be met by broadening land-tax base and an increase in revenues from the Goods and Services Tax (GST) transferred to the states.
- Broaden the land-tax base to include owner-occupied housing and other exempted assets.
- Broaden the payroll tax mainly by extending it to smaller firms; further harmonise payroll tax provisions across states.
- Consider a state-level personal income tax as part of a broad reform of the federation, while dovetailing with the recommendations made elsewhere in this *Survey* for a shift towards less reliance on direct taxation at the national level.
- Consider simplifying further horizontal fiscal equalisation. Increase the frequency of methodological reviews, but monitor closely for unintended effects on uncertainty regarding the rules underlying the distribution of GST revenue. In future methodological reviews, prioritise which equalisation categories will be re-examined.

**Strengthen capacity for assessing and comparing state-level public services**

- Further develop performance indicators; and continue enhancing the availability and quality of data. Prioritise demands on data improvements in view of the high costs involved in the process.
- Expedite the development of outcome-based indicators. Simple and easy-to-quantify audit targets are essential to enhance operational efficiency. Create an "evidence base" for the effectiveness of reforms in different areas to allow to monitor and assess progress along the way.
- Prune reporting requirements that are superfluous to acquiring the necessary data for performance evaluation and accountability. Proceed with a review of existing reporting arrangements.
- Fill the gap in performance monitoring and reporting following the abolition of the COAG Reform Council, through a new or existing entity (such as the Productivity Commission). Monitor the policy impacts of the performance reports.

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## Acronyms and abbreviations used in this survey

| | |
|---|---|
| **AFTR** | Australia's Future Tax Review |
| **APRA** | Australian Prudential Regulation Authority |
| **AUD** | Australian dollars |
| **BEPS** | Base erosion and profit shifting |
| **BOT** | Build-operate-transfer |
| **CGC** | Commonwealth Grants Commission |
| **COAG** | Council of Australian Governments |
| **EPC** | Equal per capita |
| **GDP** | Gross domestic product |
| **GHG** | Greenhouse gas |
| **GP** | General practitioner |
| **GST** | Goods and Services Tax |
| **HFE** | Horizontal fiscal equalisation |
| **IGA** | Intergovernmental Agreement on Federal Financial Relations |
| **IMF** | International Monetary Fund |
| **LHN** | Local Hospital Network |
| **LPG** | Liquid Petroleum Gas |
| **LVT** | Luxury Vehicle Tax |
| **MRRT** | Mineral-resource rent tax |
| **MSTI** | Main Science and Technology Indicators |
| **NCA** | National Commission of Audit |
| **NPP** | National Partnership Payments |
| **NSPP** | National Specific Purpose Payments |
| **PIT** | Personal-income tax |
| **PRRT** | Petroleum Resource Rent Tax |
| **R&D** | Research and development |
| **RBA** | Reserve Bank of Australia |
| **SME** | Small and medium enterprise |
| **SPP** | Specific purpose payments |
| **VAT** | Value-added tax |
| **VET** | Vocational education and training |
| **VFI** | Vertical fiscal imbalance |

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