Policy Brief

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Economic Survey of Australia, 1999

Summary

Australia has continued to grow above its trend rate over the past two years with the economy proving to be remarkably resilient in the face of significant weakness in many of its trading partners, especially in Asia. At the same time, inflation remained low and the rate of unemployment was reduced further. This performance was helped by dynamic growth of domestic demand at the time when the crisis broke out, and a credible mix of macro-policies which allowed the exchange rate to move freely, kept monetary conditions expansionary and maintained fiscal retrenchment. Although the current account deficit rose to somewhat above 6 per cent of GDP by mid-1999, the cyclical nature of the increase was well understood by financial markets. Economic growth is now projected to slow and export growth to rise, which may cut the current external deficit to around 4¼ per cent in 2001. The authorities will need to remain vigilant to inflationary risks including the risk of one-off price effects associated with the new goods and services tax being incorporated into ongoing inflation. Fiscal policy should remain geared to preserving the budget consolidation achieved in recent years. It is important that fiscal slippage does not occur if Australia is to maintain its present sound fiscal position. Earlier structural reforms, reflected in an acceleration in trend total factor productivity in the 1990s, also helped cushion the impact of the global slowdown. Economic efficiency should be strengthened further and the rate of structural unemployment reduced through the ongoing move to a flexible industrial relations system, the operation of a competitive market for employment assistance and stronger efforts to integrate the young into the labour market. The broad-based implementation of the National Competition Policy and the introduction of a more efficient tax system in July 2000 should help to consolidate the productivity gains that are now being seen. These gains represent the fruits of a consistent and comprehensive set of interacting macroeconomic and structural policies which need to continue to be pursued with rigour through the coming years if this better performance is to be maintained. ■

This Policy Brief presents the assessment and recommendations of the 1999 OECD Economic Survey of Australia. The Economic and Development Review Committee, which is made up of the 29 Member countries and the European Commission, is responsible for these Surveys. The starting point for the Survey is a draft prepared by the Economics Department, which is then modified following the Committee's discussions and issued under the responsibility of the Committee.

OECD Observer

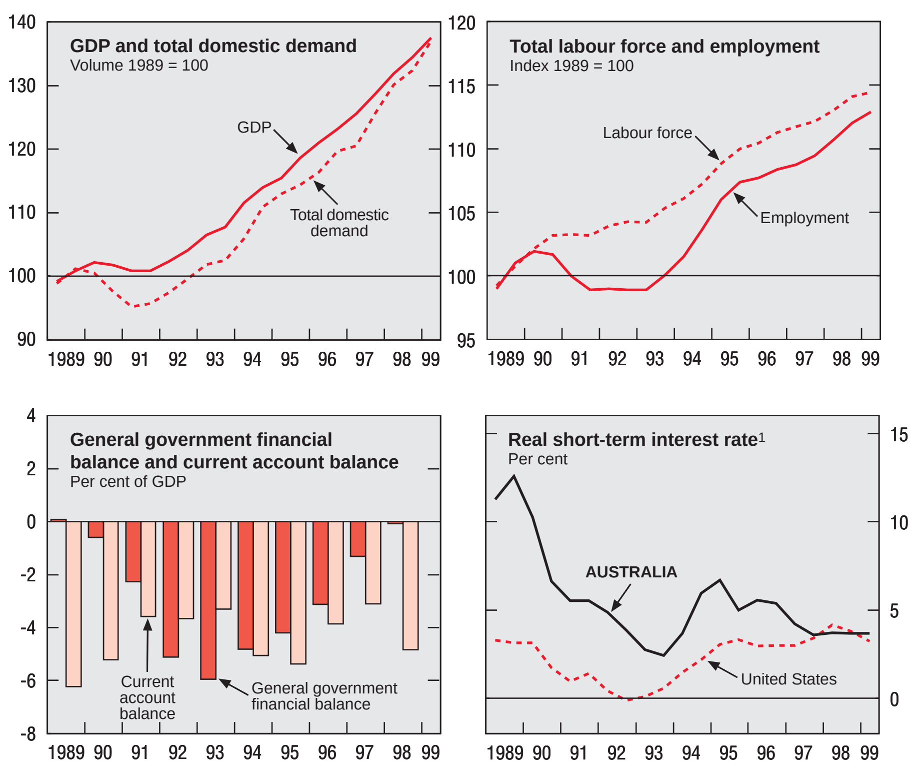
Organisation for Economic Co-operation and Development

How has the Australian economy performed?

The performance of the Australian economy since the onset of the East Asian currency and banking crisis in July 1997 has exceeded most expectations. Real GDP grew by 4½ per cent in fiscal year 1998-99, only slightly slower than the year before and substantially above its trend rate of some 3½ per cent over the past thirty years. By mid-1999, the current expansion had entered its ninth year, making it the longest upswing since the 1960s. It was accompanied by robust employment growth, a substantial reduction in unemployment, a pick-up in trend productivity and much lower inflation than experienced at any time since the early 1960s, factors which underpin the sustainability of the current expansion. However, the unavoidable negative effects on export demand of the weaker regional and global environment, the deterioration in Australia's terms of trade from falling world commodity prices and strong import growth induced by robust domestic demand led to a widening current external deficit, which rose to 5.5 per cent of GDP as a whole for 1998-99 and around 6 per cent of GDP by mid-1999.

The robustness of domestic demand at the time when the Asian crisis became apparent is an important factor which helped the Australian economy to overcome the negative impact on growth of the contraction of many of its major export markets. The basis for the continuation of the strong domestic demand had been laid by a judicious mix of sound macroeconomic and structural policies, which inter alia had brought inflation under control, reduced public sector borrowing and generated an acceleration of productivity growth. High rates of productivity growth have allowed substantial increases in real wages to be reconciled with broadly flat unit labour costs. These have underpinned price stability from the labour cost side while at the same time strengthening the purchasing power of households. Price stability and financial market reform have made credit readily available to the private sector at low interest rates, supporting both household consumption and private

Key aspects of economic activity



1. Deflated by the private consumption deflator.
Source: Australian Bureau of Statistics and OECD, *Main Economic Indicators.*

investment. Consumer spending was further encouraged by capital gains from rising house and share prices, boosted by the decline in interest rates since early 1995, with various measures of private saving declining somewhat.

The steep fall in world commodity prices which followed the weakening of global demand after the outbreak of the Asian crisis put downward pressure on the Australian dollar exchange rate. But the persisting low inflation environment allowed the economy to absorb the exchange rate depreciation and its potential inflationary effects without compromising the medium-term inflation target. The exchange rate depreciation stabilised export prices in Australian dollars and improved Australia's international price competitiveness, allowing exports to be diverted to more prosperous regions of the world, in particular the United States and Europe. The depreciation also tended to support import-competing sectors, limiting the adverse effect of the global downturn on economic activity. The negative impact on the current external account was contained further by increased government savings as a result of fiscal consolidation. Model simulations confirm the substantial contribution made to the favourable macroeconomic performance during the Asian crisis by the particular combination of expansionary monetary policy and fiscal retrenchment adopted by the authorities.

Mainly on account of a declining rate of stock building and weakening fixed investment, especially in the mining sector, economic growth is projected to slow to around 4 per cent in 1999. These factors and a decline in private consumption growth contribute to a further slowing in economic growth in 2000, to around 3 per cent. Business investment should begin to rise again in 2001 as the rundown in mining investment slows, pushing economic growth back up to around 4 per cent. Growth in activity around these rates should support continuing strong growth in employment, resulting in a reduction in the (year-average) unemployment rate to around 6½ per cent in 2001. This decline in the unemployment rate could result in some small rise in wage pressures. At the same time, international recovery, especially in Asia, should result in firmer prices for imported goods and services in the consumer price index (CPI). Together, these factors underpin a small rise in underlying inflation to around 2½ per cent in 2001. Headline inflation, however, will rise considerably more owing to the introduction of the tax package in July 2000. This is assumed to add 2¾ percentage points to the price level in the year after its introduction. The improved outlook for the international economy should strengthen export growth and Australia's terms of trade, cutting the external current account deficit to around 4¼ per cent of GDP in 2001. ■

What are the risks to the outlook?

A major upside risk to these projections is that private consumption expenditure may not slow by much if households continue to enjoy large capital gains on housing and, to a lesser extent, on equities. This could encourage households to go on borrowing to finance growth in consumer expenditures in excess of disposable incomes. Another domestic risk is that the introduction of the goods and services tax (GST) in July 2000 could raise underlying inflation expectations owing to the difficulty of distinguishing GST-related price increases from underlying inflation. This could increase wage demands and make consumers less resistant to rising prices although the effects should be offset by the income tax cuts and other compensation measures. Although the outlook for the international economy has improved markedly in recent months, there are still some significant risks. In particular, a sharp decline in the US stock market could result in a much harder landing than assumed, cutting growth across the globe. There is also the risk that Asian countries may not complete the structural reforms that are necessary to improve the functioning of their capital markets, with the result that the recent burst of growth could be short-lived. This would undercut Australia's export performance and terms of trade, delaying progress in reducing the external current account deficit until the domestic economy slowed further. ■

What about monetary and fiscal policy?

Economic growth has been supported by the expansionary monetary conditions of the past year or so, in spite of some real effective appreciation of the Australian dollar since late 1998. This is the more so given the sharp competition between financial intermediaries which has resulted in a continued narrowing of interest rate margins and has entailed a further downward drift in major indicators of the real cost of credit in 1999.

Now that the Asian crisis is largely over, and given that there has been some increase in medium-term inflation risks, a readjustment of monetary policy to a less expansionary setting has been considered appropriate. Hence, the Australian cash rate, which had remained at 4¾ per cent since the cut in December 1998, was increased by 25 basis points on 3 November 1999, in response to an improving external trading environment and the likelihood that the slowing in growth of GDP in Australia would be milder and less protracted than originally expected. The general challenge facing monetary policy over the year ahead will be to assess the extent to which the policy setting currently prevailing remains appropriate as circumstances change. Growth is projected to be sufficient to generate further declines in unemployment over the year ahead. The authorities will need to remain vigilant to the risk that medium-term inflation pressures may increase further given the overall strength of the economy. Another risk is that of second-round effects flowing from the GST. The Reserve Bank has indicated that it will abstract from the initial price-level impact of the GST, but it will be important to ensure that this one-off price-level impact is not incorporated into ongoing inflation.

In view of Australia's large current account deficit and with monetary conditions supportive of growth, it is appropriate that fiscal policy remains geared to preserving the budget consolidation achieved in recent years. Adjusting for one-off factors, the general government underlying cash surplus is officially forecast to rise in fiscal year 1999-2000 by 0.5 percentage point of GDP to 0.8 per cent of GDP, despite economic growth falling below trend. However, Australia's involvement in East Timor, which was not anticipated when the Budget forecasts were made, will reduce somewhat this rise in the budget surplus if not fully offset by additional measures. The introduction of the tax package in the following year (fiscal year 2000-01), at a budget cost of A$ 6.9 billion (1 per cent of GDP), offsets the consolidation that would otherwise have occurred, resulting in a small decline in the general government underlying cash surplus. This seems a reasonable price to pay for the long-term benefits of a more efficient tax system. Fiscal policy settings imply modest, but rising budget surpluses in subsequent years, notably for the Commonwealth government. Given the maturity of the present upswing, such policy settings would appear to be consistent with the Commonwealth government's medium-term objective of achieving budget balance over the business cycle. The medium-term framework should help to limit the risks of fiscal slippage over the period ahead. It will be particularly important that such slippage does not occur if Australia is to maintain its present sound fiscal position especially as experience has shown that large swings in budget balances can occur over the business cycle.

The Commonwealth government has also made further progress in the past year in establishing an institutional framework more supportive of ongoing prudent fiscal management. This reform process began with the Charter of Budget Honesty, which requires the government to lay out its medium-term fiscal strategy and short-term objectives in each budget, with both the strategy and objectives being based on principles of sound fiscal management, as set out in the Charter. The other major element of fiscal reform, accrual budgeting, came into effect with the 1999-2000 Budget. Accrual budgeting provides a more accurate view of the total activity of government and its long-term effects, supporting the principles of sustainability and sound fiscal management expressed in the Charter. The move to accrual budgeting is also a vital element of reforms aimed at achieving better value from public expenditures. For the first time, the full cost of providing public services will be apparent and managers will be held accountable for the performance of their agencies in contributing to the achievement of government objectives. It will also be easier to compare the costs of internal provision of services with the cost of outsourcing. With these reforms, fiscal institutions in Australia represent best practice in terms of assuring prudent and efficient fiscal management. ■

What is happening on the industrial relations front?

Achieving more flexible labour market regulations to enhance the economy's adaptability to external shocks and a changing economic environment has been a priority of recent Australian governments. A major step in this direction was the implementation of the Workplace Relations Act 1996 (WRA) at the beginning of 1997, which reduced the role of centrally-determined awards in Australian industrial relations and promoted the bargaining of wages and employment conditions at the enterprise level. The WRA limited the formerly comprehensive coverage of awards to 20 "allowable matters" as from 1 July 1998, designed to confine the role of the award system to a safety net of minimum wages and core conditions of work. These, and other changes being made to awards through the simplification process, are making awards less comprehensive and prescriptive. But given the enormous complexity of the old system and the legal uncertainties of the parties about award simplification,

Source: Office for National Statistics (ONS), *Labour market trends,* April 1999 and Department of Employment, Workplace Relations and Small Business.

the move to the new regime has proved to be a rather slow process, although decisions by the AIRC have assisted this process and it appears to be accelerating. And even though those awards which have been simplified impose fewer constraints on the operation of enterprises than before, the rather extensive coverage of the 20 "allowable matters" still implies some degree of complexity. Hence, regulatory flexibility of workplaces could be enhanced if the number of "allowable matters" were reduced further and their definitions and specifications tightened so as to provide a less comprehensive set of core conditions of employment. In this regard, the Government in June 1999 sought to enhance the regulatory flexibility of workplaces by proposing changes to the WRA to advance award simplification. Under these proposals, the definitions and specifications of the various allowable award matters would be tightened and the number of allowable matters would be reduced by removing elements which duplicate other legislative entitlements or are more appropriately decided at the workplace level. These changes, if approved, would clarify the original intent of the WRA, widen the scope for better quality and more innovative agreement-making and require the individual situation of the respective enterprise to be properly taken into account.

Progress has also been registered in promoting the spread of collective – and to a lesser extent – individual agreements at the enterprise level. But given the evolutionary approach to industrial relations reform, comprehensive agreements that determine all work conditions and pay requirements and completely replace awards are not yet widespread. In spite of their recent fast take-up rate, albeit from a low level, comprehensive enterprise agreements continue to cover a relatively small share of employees, estimated at less than 10 per cent. In fact, a large number of enterprise agreements retain links with existing awards. Many agreements deal only with a relatively narrow range of work conditions, although the key issues in the workplace relationship are generally covered by agreements. Hence, in order to move more quickly towards comprehensive and innovative agreements at the enterprise level, the Government proposed in June 1999 to simplify the regulatory requirements in the WRA for the formalisation of collective and individual agreements. The current Government has also restored a co-operative working relationship with State industrial relations systems, although more still needs to be done to achieve a nationally coherent workplace relations framework so as to reduce costs for governments and businesses. In this regard, discussion is underway on the use by the Commonwealth of its powers under the Australian Constitution for regulating corporations to underpin a unified workplace relations framework in Australia.

Following the announcement in the 1996-97 Commonwealth Budget, a new competitive market for employment services came into effect in

May 1998. At the heart of the reform is the introduction of the Job Network, which is a contestable employment placement market, with full competition between private, community and government contracted service providers and Employment National, a corporatised government employment services agency. Competition encourages a high level of service, and fees paid to Job Network organisations provide a strong incentive for them to perform. To ensure that highly disadvantaged jobseekers benefit from the assistance provided by Job Network, a differential fee structure applies with the highest fees being paid for those who are most at risk and hardest to place in a job and being paid in full only after a jobseeker has been off allowances for longer than six months. Although a final assessment has to wait until the results of a comprehensive evaluation are available in late 2001, early results are encouraging, in terms of outcomes achieved by clients.

In July 1998, the Government introduced its Mutual Obligation initiative for jobseekers aged 18-24 years on unemployment payments for six months. The initiative is guided by the principle that it is fair and reasonable to ask unemployed people to participate in an activity which both helps to improve their employability and makes a contribution to the community in return for payments of unemployment benefits. Young jobseekers are required to participate in an approved activity in addition to job search over a six-month period. Activities include Work for the Dole which was introduced in November 1997. This programme seeks to involve young jobseekers in a work environment and to foster appropriate work habits. Participants must work 24-30 hours per fortnight for six months, depending on their age, which allows them to both acquire work skills and continue search for a job. In 1999, Work for the Dole has been extended to young people who complete year 12 at school and who have received Youth Allowance for at least three months. Mutual obligation was also extended to 25-34 year olds who have received unemployment benefits for 12 months and the Work for the Dole programme expanded to accommodate those in this older group who are on the full rate of unemployment payment.

Whether the mutual obligation programmes represent a successful shift away from passive income support to more active labour market policy depends on the extent to which programme participants are provided with work experience and skills valuable enough to make them attractive to employers as potential employees. The requirement under Work for the Dole that programme-jobs must not compete with paid employment in the regular labour market remains a problem as it favours unskilled work with little opportunity for training, which may impede the integration of the unemployed into gainful work. A comprehensive examination of the employment and incentive effects of the scheme will be undertaken as part of an evaluation of mutual obligation.

The market for training has developed further with the introduction in 1998 of user choice and the strengthening of the institutional framework within which it operates. While the growth in structured vocational training is encouraging, more could be done to improve the integration of the vocational education and training system with broad education sectors. Many early school leavers remain at considerable risk of being locked into marginal labour market activities that may not lead to better skills and employment prospects. More needs to be done to reduce the incidence of early school leaving. Curriculum reforms to make school more relevant and useful for potential early school leavers, as planned in New South Wales, would help, as would better co-operation between Technical and Further Education (TAFE) colleges and high schools. ■

How is competition policy being implemented?

Developments in global markets, reinforced by reductions in import protection, have led not only to pressure for reform in labour markets and in education and training, but also in the infrastructure industries, which were dominated by Government Business Enterprises, and in product markets more generally. The National Competition Policy (NCP), agreed between governments in 1995, extended competitive conduct rules to all businesses, including Government Business Enterprises, set out competition principles and established a framework for implementing the NCP. The NCP has provided a coherent framework for reforms already underway in the major infrastructure industries as well as providing impetus to complete these reforms. An incentive for State and Territory governments to complete the reforms, most of which are in their domain of responsibility, is that the NCP payments from the Commonwealth government are conditional on satisfactory results. This puts pressure on the lower tiers of government to follow through on structural reforms. Considerable progress has been made in reforming infrastructure industries, and those customers that have gained choice of supplier have enjoyed substantial price cuts, especially for electricity.

The NCP is also providing impetus to other elements of the structural reform programme by requiring all anti-competitive legislation to be reviewed and to remove regulations that restrict competition unless they are demonstrated to be in the public interest and the objectives of the legislation cannot be obtained in another way. Almost 1 700 separate Acts or Regulations were identified for review. Most of the reviews that have not yet been translated into government reforms affect small businesses, making reform politically difficult. Such reviews include a number of agricultural marketing arrangements, retail trading arrangements, taxi licensing, the regulation of the professions (including retail pharmacy arrangements) and mandatory insurance arrangements. Even though many of these reforms are likely to encounter resistance from the groups that earn rents from these arrangements at the expense of the rest of the community, it is nevertheless important that progress be made in these areas. This will preserve the overall coherence of the NCP, contributing to a more efficient and dynamic economy, and make it clear that there are small returns from investing in lobbying efforts to earn rents through anti-competitive arrangements. Making progress in these areas may require gaining greater political acceptance by providing some form of assistance to those groups bearing significant initial costs and/or by phasing in the reforms. ■

What is the status of tax reform?

An element of structural reform long on the agenda in Australia, tax reform, has finally been agreed and comes into effect in July 2000. The main elements of the reform are the introduction of a 10 per cent Goods and Services Tax (GST) on all consumption items except most health and education, some supplies provided by charities and basic foodstuffs, abolition of the wholesale sales tax and a variety of other indirect taxes (although not all at the same time), and income tax cuts. There are also measures to reduce high effective marginal tax rates. The reform represents a substantial shift away from specific indirect taxes to a general indirect tax, levelling the playing field between different goods and services. In addition, tax revenue security will be better assured by GST than by the indirect taxes that it replaces, which were largely based on the production of goods (rather than services) which are in long-term decline as a share of GDP. Finally, the reductions in marginal income tax rates and marginal effective tax rates will improve work and saving incentives. While the tax reform package represents a substantial improvement over existing arrangements, some of the benefits of reform were lost in the compromise required to get the Senate's approval. An especially unfortunate aspect of the compromise is that the abolition of some harmful State indirect taxes has been delayed. For example, abolition of the tax on bank account debits has been delayed until 2005 at the latest. Once these taxes are abolished, Australia's indirect tax system will be much improved. The government is now working on business tax reform. This is intended to make business taxation more neutral between types of entity and between industries and to reduce the impact of the capital gains tax on capital transfer and mobility and impediments to venture capital investment in Australia. ■

Has reform contributed to growth?

The benefits of a comprehensive and consistent approach to structural reform have become apparent in Australia's productivity performance. Since the late 1980s, those sectors displaying the highest total factor productivity (TFP) growth (utilities, finance and insurance, communication services and wholesale trade) have been the focus of major structural reforms. TFP growth has picked up significantly in the latest productivity cycle (1993-94 to 1997-98), to an average of 2.4 per cent per year compared with a long-run average of 1.4 per cent. Capital productivity has turned up particularly sharply, growing by 0.8 per cent per year in the latest productivity cycle compared with a long-term decline. This reflects an improved quality of investment decisions, the shedding of old capital and the more efficient use of existing capital, as would be expected following the kinds of economic reforms made in Australia. The sectors that recorded the greatest improvements in trend labour productivity growth are labour-intensive, suggesting that labour market reforms, which have given firms greater scope to negotiate changes in working arrangements to enhance productivity, may have contributed to this outcome. Overall, with output growth having been strong, these productivity improvements do not appear to have been at the expense of employment and growth. ■

For further information

Further information on the Survey can be obtained from Helmut Ziegelschmidt (e-mail: helmut.ziegelschmidt@oecd.org, tel.: (33-1) 45.24.87.77); or David Carey (e-mail: david.carey@oecd.org, tel.: (33-1) 45.24.87.29). ■

For further reading

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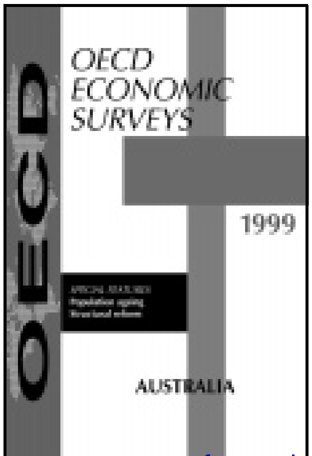

Economic Survey of Australia

- **Additional Information**: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco/eco/.

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