OECD Economic Surveys: Australia, November 2010

OVERVIEW

Summary

The Australian economy has been one of the most resilient in the OECD during the global economic and financial crisis. The impressive results, which are only partially due to links to fast-growing China and India, have shown that the economy was well-prepared to face major shocks. Years of sound policies left ample room for monetary and fiscal policy to act rapidly and forcefully when the crisis struck. A key to the good outcome was the interaction of appropriate macroeconomic policy with structural flexibility of markets, especially financial and labour markets. The strong policy response and encouraging outlook restored confidence rapidly, and exit from the stimulus is underway.

Prospects are promising but not without important risks for balanced growth. The rebound of activity, supported by the sustained vigour of Asian markets and higher terms-of-trade, seems sufficiently robust to stand up to the gradual monetary and fiscal consolidation underway. Medium-term prospects are also good, as potential growth will be boosted by strong investment in the mining sector and population increases underpinned by continued immigration. In this context, monetary policy needs to guard against the re-emergence of inflation pressures, as the economy enters the upswing with little spare capacity and inflation around the middle of the medium-term target. There are also possible downside risks from weaker growth in China and further financial turmoil. The risks from a widening current account needed to finance mining investments can be managed by continued careful hedging policies, sound use of capital inflows, promoting FDI, and boosting domestic saving. The resilience of the Australian economy in the crisis and its favourable prospects should not lead to complacency regarding structural policies. The flexibility of the economy needs to be maintained and policy should be directed towards medium-term issues, including those related to the mining boom, focusing on the following priorities:

Prudent management of commodity price cycles and emerging supply bottlenecks. To deal with the uncertainty of future commodity price developments and reduce risks of pro-cyclical fiscal policy, which had been a problem during the previous mining boom, spending decisions should be disconnected from resource tax revenues. One option would be to park resource revenues in a reserve fund, and adopt a structural spending rule. To alleviate supply bottlenecks, which will be amplified by the mining boom, reforms to boost housing supply are needed, the demand-driven immigration should be continued, and infrastructure capacities further expanded.

Structural reforms to strengthen productivity. Rising commodity revenues have hidden a decline in productivity growth in recent years. Productivity and efficiency of investment decisions would be enhanced by improved product market regulations, in particular in infrastructure. Rationalising public spending by removing production subsidies would speed up reallocation of resources to expanding sectors. Considerable room exists to reduce distortions and simplify the tax system, thereby stimulating growth.

Fair distribution and use of the benefits of prosperity. The reform of the resource tax to capture excessive mining-sector rents is welcome, but more could be done to enhance efficiency and equity. Increasing social inclusion and reducing the underutilisation of labour that affects marginal groups could improve wellbeing and labour supply. Given the multiple and inter-related characteristics of social exclusion - homelessness, health/disability problems, insufficient education and training, poor social networks - a comprehensive approach to service delivery is needed. Improving the tax-transfer system and targeting education policy more towards disadvantaged groups would boost employment and social inclusion.

Assessment and recommendations

Australia weathered the crisis well and its challenges relate to ensuring medium-term balanced expansion

1. The performance of the Australian economy has remained solid. It weathered the world financial and economic crisis better than most of the OECD and, indeed, avoided a recession. Unemployment has already fallen back to near its structural level, and the government balance sheet is healthy. Although these remarkable results were in part due to the dynamism of the Asian markets, they illustrate both the structural resilience of the economy, well-functioning financial and labour markets and the timely and strong policy response to the crisis. Managing the exit strategy is less problematic in Australia than in most OECD countries thanks to the sound fiscal position and favourable outlook, although policy vigilance is required as the new cycle starts with inflation around the middle of the medium-term target and little spare capacity.

2. Australia's key challenges are medium-term: ensuring a balanced expansion, especially in the context of the mining boom that has gathered pace. Strengthening supply especially in infrastructure, housing and labour markets is needed to ensure non-inflationary growth and smooth reallocation of resources. Continued structural reforms are also needed to reverse the weakening of productivity gains in recent years, partly hidden by income gains from rising commodity prices, to establish a solid basis for future growth.

Recovery from the crisis is well on its way and the outlook is good

3. After a mild downturn at the end of 2008, activity is picking up on the back of strong commodity exports and a rebound in domestic demand. The swift policy response, strong housing market and good outlook have maintained confidence. The rise in unemployment was relatively modest, partly because many firms reduced hours worked, rather than jobs, to forestall potential skill shortages, which had occurred in the past. Employment is already 3% above its pre-crisis level and the economy is approaching capacity constraints. Underlying (or core) inflation, having declined since late 2008, reached about 2½ per cent in the third quarter of 2010, around the middle of the inflation target band (2 to 3%). The new cycle begins with limited spare capacity and substantial price pressures in housing and utilities.

4. In contrast to most other OECD countries, the short term outlook is favourable. Rising private demand fuelled by business investment and restocking is expected to take over from public demand as the main driver of growth. Firms in the mining sector should benefit from the dynamism of Asian markets and the consequent more favourable terms of trade. Output is projected to grow at between 3½ and 4 per cent in the near term, above potential. Unemployment is likely to continue to decline, though only gradually because of the expected rise in working hours. Aided by the residual slack and wage pressures contained by immigration, inflation is set to remain within the target band. Risks to this outlook are balanced. Demand from Asia and the terms of trade could surprise in either direction, the rebound in domestic spending may be stronger than expected while the global recovery might prove weaker. In the medium term, prospects are good with potential growth among the strongest in the OECD sustained by population growth and mining investment. Supply bottlenecks, the rising current account, strong housing markets and uncertainties regarding world commodity prices are the main medium-term risks.

Table 1. Economic developments and projections

	2007	2008	2009	2010	2011	2012
	Current prices AUD billion	Percentage changes, volume (2007/2008 prices)				
Private consumption	635.9	1.9	1.7	3.3	3.2	3.2
Government consumption	192.9	3.3	2.8	5.2	2.1	1.7
Gross fixed capital formation	323.5	9.0	-1.1	7.0	6.6	8.5
Final domestic demand	1 152.4	4.1	1.1	4.7	4.0	4.5
Stockbuilding[1]	6.5	-0.4	-0.5	0.4	0.0	0.0
Total domestic demand	1 158.9	3.7	0.5	5.1	4.0	4.5
Exports of goods and services	217.6	3.1	1.0	4.7	6.1	6.5
Imports of goods and services	239.0	11.1	-8.3	13.3	8.1	8.4
Net exports[1]	-21.4	-1.6	0.7	-1.9	-0.4	-0.5
GDP at market prices	**10137.5**	**2.1**	**1.2**	**3.3**	**3.6**	**4.0**
GDP deflator	-	6.4	0.3	5.9	3.5	2.5
Memorandum items						
Consumer price index	-	4.4	1.8	2.9	2.8	2.9
Private consumption deflator	-	3.7	3.1	2.6	2.7	2.9
Underlying inflation		4.1	2.6	2.8	2.7	2.9
Unemployment rate	-	4.2	5.6	5.1	4.9	4.7
Household saving ratio[2]	-	1.9	5.1	2.2	2.5	2.9
General government financial balance[4]	-	0.4	-4.0	-3.3	-1.7	-0.4
Current account balance[3]	-	-4.5	-4.4	-2.3	-1.9	-2.6
Net general government liabilities[4]		-7.6	-3.8	0.4	2.7	3.6

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.

Source: OECD Analytical database for the historical period and *Economic Outlook 88* for the projections.

Strong supervision and prudent lending policies limited damage from the global financial turmoil

5. Australia's financial system has proved very resilient during the global crisis. This is partly due to solid domestic banking supervision, which was substantially reinforced after sizeable banking sector losses in the early 1990s, and low exposure to toxic assets. The initial drop in the stock market and the exchange rate and the increase in capital outflows were reversed in early 2009 as confidence rebounded. Although banks were exposed to rollover risks in foreign markets, they had focused on domestic lending, which held up relatively well, and had lower leverage than institutions in other OECD countries. Banks have remained profitable with stable capital ratios, and the largest Australian banks are now among the soundest in the world. No banks were bailed out, but the government did step in at the height of the crisis by issuing guarantees for bond issuance and deposits to boost confidence and ensure funding needs. Conditions have now returned to normal although credit growth remains sluggish.

Resilience was aided by a prompt monetary policy response, and a large, timely and targeted fiscal stimulus

6. The Reserve Bank of Australia responded to the crisis with a large, pre-emptive cut in policy rates, made possible by the high level of policy rates prevailing before the crisis. It did not wait for data

on the weakening economy, which comes with lags, but instead reacted to the risks of a large recession in the context of global uncertainties. The Reserve Bank also eased monetary conditions by increasing regular market operations and extending eligible collateral. Despite the rise in risk premiums, the cuts in policy rates were translated into lower market rates, aided by the prevalence of variable interest rate mortgages. Policy effectiveness was ensured by the soundness of the financial sector, which kept credit channels open, again in contrast to many other OECD countries. Consistent with a recovery in activity, somewhat high inflation and rising house prices, the Reserve Bank started to hike rates earlier than elsewhere, starting in October 2009 and bringing monetary conditions close to neutral by mid-2010. In November 2010, the Reserve Bank raised again its policy rates by 25 basis points to 4.75%.

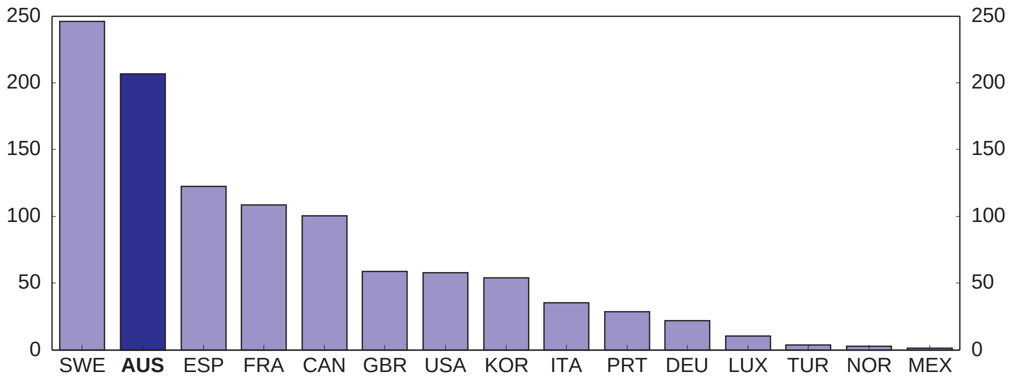
7. As Australia's automatic fiscal stabilisers are relatively modest compared with some other OECD economies, the response to the crisis called for significant discretionary measures. One of the largest fiscal stimulus packages in the OECD was made possible by the sound state of Australian public finances - successive surpluses had left public debt low. The fiscal stimulus was implemented rapidly and targeted to credit constrained households and public investment. It proved highly effective, with a sizable impact on output and confidence, although the required speed of implementation meant that some spending could have been more cost effective.

Fiscal consolidation plans are welcome, while monetary and financial policy will have to guard against excesses

8. The stimulus was wisely accompanied by a well-designed fiscal exit strategy. The pre-announced multi-year plan restricts the real increase in public spending to below 2% per annum, but lets the automatic stabilisers work on the revenue side, until a 1% of GDP surplus is reached. This might occur by 2015/16. *This gradual retrenchment plan is appropriate and should be carried out.* The implementation of the spending limit will initially be eased by the waning stimulus measures, but may be harder to maintain as time passes. *The quality of public interventions should be assessed, as there is considerable scope to rationalise assistance, especially to the automotive sector and for drought assistance. Rationalising such programmes, which would be beneficial in itself, would make the spending limit easier to obtain.*

Figure 1. International assistance to the automobile sector[1]

US dollars per capita PPP, 2007



1. The amount of subsidies to the automotive sector may not include all forms of government support and covers varying time frames across countries.

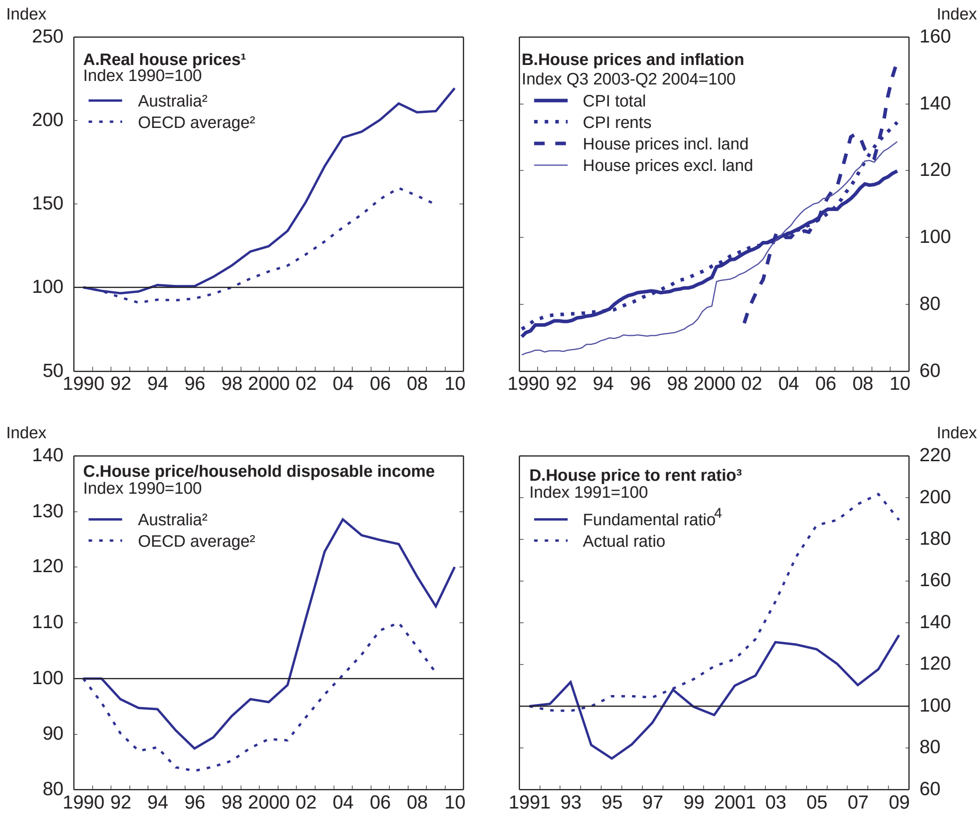
Source: OECD, Policy Responses to the Economic Crisis: Investing in Innovation for Long-Term Growth, June 2009; Grattan Institute analysis.

9. *The current stance of monetary policy, with interest rates to borrowers slightly above their decade average, is appropriate in the current economic context.* The monetary authorities need to ensure that inflation does not drift up, even as price and wage pressures may be increased by labour shortages and a gradually closing output gap. It is also important that people do not translate relative price changes stemming from supply shocks in specific sectors, notably housing and utilities, into higher

wage demands. With this background, *the Reserve Bank should remain vigilant and ensure that these sectoral pressures do not feed into inflation expectations, which have picked up slightly. It should continue to monitor price developments and tighten policy if demand pressures on productive capacities intensify or expectations worsen. In this context, communicating well the sources of price pressures is important.*

10. Persistently rising house prices have until now been driven by fundamentals. Nevertheless, caution is advisable, given the experience of other countries. Looking forward, there remains a risk of speculative behaviour, which requires continued prudence in lending standards, given the relatively high level of household indebtedness, and adequate macro- and micro-prudential rules on housing finance*. Consideration should be given to developing prudential measures that could be implemented to dampen future exuberance in house prices and lending, such as countercyclical capital buffers, adjustments to risk-weightings and limits on loan-to-valuation ratios. The Reserve Bank should continue to stress that house prices cannot forever outpace incomes. Given the prominence of loans at variable rates, lenders should be advised to base their mortgage credit criteria on medium-term average conditions, rather than exceptionally benign ones at a point in time*.

Figure 2. House prices



1. Nominal price deflated by the private consumption expenditure.
2. Simple average. For 2010, Australian house prices are estimated assuming that the annual price level is equal to its level reached in the first semester.
3. Latest data available: 2009 Q3.
4. Fundamental ratio is calculated assuming that in equilibrium, households should be indifferent as between renting and purchasing property after adjusting for after-tax mortgage rates, property taxes, maintenance costs, risk and expected capital gains (Girouard *et al.*, 2006).

Source: ABS; APM, REIA; OECD, National Accounts and OECD (2006), Girouard N, Kennedy M., Van der Noord P. and C. André, *OECD Economics Department Working Papers*, No. 475, “Recent House Price Developments: The role of fundamentals”.

The external vulnerabilities may arise from the expected widening in the current account deficit

11. The financing of rising mining sector investment is expected to widen the current account and, over time, increase foreign indebtedness, which may exacerbate current external vulnerabilities to sudden changes in market conditions. The risks associated with foreign indebtedness are currently well contained. Currency risks are negligible, as most of the country's foreign liabilities are either in Australian dollars or hedged. Moreover, the high degree of resilience of the Australian economy over many years despite several external shocks including the recent crisis, suggests that the vulnerabilities are at this point easily manageable. However, a considerable part of the high and rising share of liabilities is short-term debt, which might increase rollover risks*. External debt developments should thus continue to be closely monitored. External vulnerabilities could be contained by promoting domestic saving (see below), and ensuring that risks remain well hedged, that the funds are used for high-return projects, and that foreign direct investment (FDI) continues to be encouraged. The existing approval thresholds, for assessment of potential FDI, could be aligned to the more generous criteria applied for the United States.*

Reforms are needed to boost housing supply

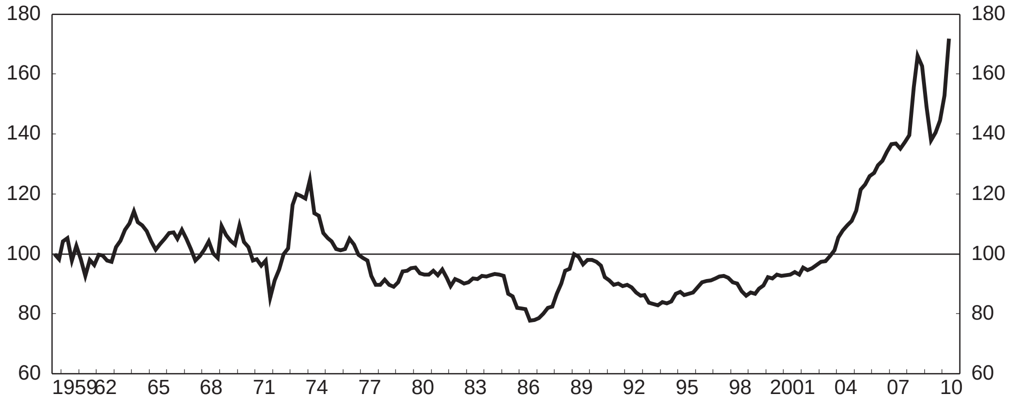
12. Housing supply is failing to keep up with strong demand growth, driven largely by immigration. Price-to-income and price-to-rent ratios exceed levels in other countries and historical averages in Australia, but at this point seem to be broadly consistent with fundamentals. However, a rising share of the population is being priced out of the market. Measures should be adopted to stimulate supply and more efficient use of the existing housing stock, as recognised by the Council of Australian Governments. *More transparent, harmonized and less restrictive zoning and planning regulations across jurisdictions are needed. Rationalising infrastructure charges with nationally consistent principles would encourage more efficient land use and reduce delays and cost of negotiation between developers and local governments. Lower conveyance duties would reduce transaction costs and improve the use of the existing housing stock. Subsidies to demand benefiting first-home buyers should be phased out, and redirected to raising supply. Rebalancing tax incentives in the rental sector between small and large-scale investors would help increase the currently low proportion of apartment buildings in Australian cities. The progressivity of land tax affecting large developers should, for instance, be removed. The revenue losses implied by these changes can be offset by broadening the land tax, notably by ending existing tax exemptions on owner-occupied housing.*

The continued mining boom will complicate fiscal policy making

13. A key fiscal issue raised by the higher commodity wealth is the sharing of the rents from non-renewable resources (mainly mineral, but also gas), while ensuring their efficient exploitation. The use of the tax revenues derived from these resources should also take into account the uncertainty and volatility of commodity price developments. On the spending side, public investment is required to enhance infrastructure capacity to meet the greater needs of the mining industry and the concomitant pick-up of population growth. Domestic saving could be promoted to finance the increasing investment needs in mining and infrastructure industries. For this latter purpose, the government has planned to boost retirement savings, by gradually increasing the compulsory pension contribution rate from 9% to 12% by 2019-20.

Figure 3. Terms of trade

Index 1959 Q3 = 100

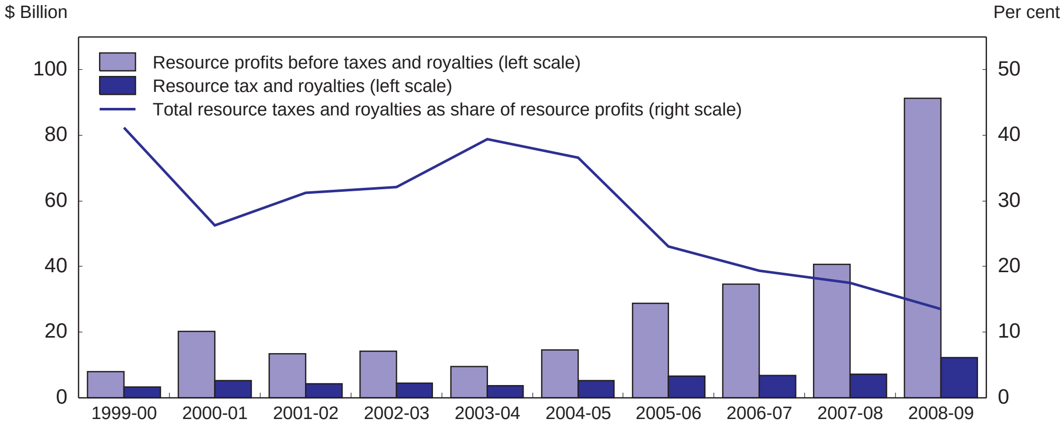


Source: ABS, cata 5206.

The proposed changes in resource taxation are welcome but should go further

14. Central to the government's mining-boom related fiscal strategy is to increase taxation of non-renewable resources and shift it from output-based royalties to rents. The proposed mineral resource rent tax (MRRT) on coal and iron ore operations, along with the extension of the petroleum resource rent tax, are justified on both equity and efficiency grounds. This resource rent tax is more efficient than the current royalties system as it raises taxation of finite and immobile resources. This will improve efficiency in the resource sector. The government has coupled the MRRT with a reduction in the corporate tax rate, which affects mobile capital. This switch will improve efficiency of the overall tax system and foster the development of the non-mining sector. However, the potential gains of the MRRT may be reduced by some of its characteristics. First, the proposed tax is set at a relatively low level and therefore the taxation of profits of mining companies is likely to remain much lower than before the mining boom. Second, the efficiency gains of the new tax will be mitigated by its coverage of only larger firms and certain sectors. As conceived, the MRRT is likely to distort investment incentives between mining projects of coal and iron ore and those on other resources that are not subject to the tax, regardless of their underlying merits. Moreover, mining ventures will remain subject to royalties, which carry particularly large disincentives for marginal projects. *Replacing the royalties by a well designed resource rent tax extended to all commodities and all companies irrespective of their size would be desirable. Royalties should also be eliminated, rather than credited to MRRT payers by the federal government,* to simplify the tax system and remove states' incentives to raise royalty rates further, with counterproductive effects.

Figure 4. Taxes and gross receipts: Resource extraction sectors[1]



1. Resource profits before taxes and royalties are measured using income less an allowance for corporate capital.

Source: Australian Government (2 May 2010), *The Resource Super Profits Tax: A fair return to the nation*.

Promoting retirement savings, investing in public infrastructure and cutting the corporate tax are welcome

15. The higher resource revenues from the MRRT are set to finance a number of welcome initiatives. The authorities plan to gradually increase the compulsory pension contribution rate and to improve the equity of the tax treatment of retirement savings for the currently disadvantaged low-income earners. Another set of measures aims at spurring investment through reduced company taxation, especially of SMEs. The cut of the statutory corporate tax rate from 30% to 29% by 2013 will bring it closer to the OECD average. Although modest, this efficiency-enhancing measure should be favourable to investments in the non-mining sector and help reduce the risk of a two-speed economy in the context of large terms of trade changes. Finally, the government plans to earmark some of the resources obtained from the MRRT for infrastructure financing, with the creation of the new Regional Infrastructure Fund, the assets of which are expected to reach AUD 6 billion in the coming decade.

More attention should be paid to shielding the budget from the volatility and uncertainty of commodity price movements

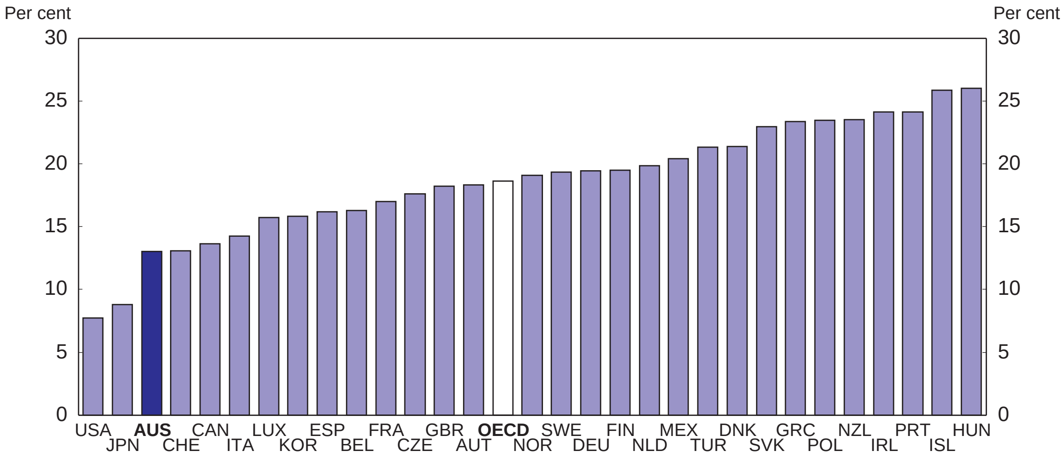
16. Australia is planning to spend all the expected resource revenues from the MRRT. These revenues are estimated assuming that resource prices gradually fall from their current high levels. However, should prices fall faster than expected, this policy could lead to a structural deterioration of the budget. Although changes in prices would trigger other adjustments to maintain the medium-term fiscal strategy of a balanced budget or a slight surplus over the cycle, these would have costs. Moreover, as the resource industry grows, it will become an increasingly important driver of the Australian business cycle, as is the case in countries like Norway and Chile. If resource revenues are spent as they come in, which occurred to some extent in the boom of the 2000s, fiscal policy risks being procyclical. *To avoid such risks, public spending decisions should be disconnected from the fluctuations in tax revenues caused by commodity price movements. While Australia's circumstances differ in important respects from other commodity producing countries, the authorities should nevertheless consider creating a reserve fund endowed with all resource tax revenues to assist in shielding the budget and the real economy from the effects of revenue volatility.* The creation of such a fund holds the promise of increasing transparency and strengthening fiscal management. The proposed fiscal council (Parliamentary Budget Office) should strengthen fiscal decision making, perhaps including with respect to the use of resource revenues. However, it must be carefully designed and its mandate must be clear.

Tax reform could spur growth

17. Considerable room remains for improving the quality and effectiveness of Australia's tax and transfer system, as noted in past OECD *Surveys.* Many weaknesses were addressed by the government-commissioned *Australia's Future Tax System* (AFTS), released in May 2010. It includes 138 recommendations, of which relatively few have been acted upon. As suggested by AFTS, *Australia's company tax should be reduced further*, higher labour participation promoted, the tax system simplified and its distortions reduced. These goals can be achieved by *broadening the base and raising the rate of the goods and services tax (GST), while lowering taxation on labour, notably the high effective marginal tax rates affecting low-income households. Going forward, the tax-free threshold on personal income tax could be increased to beyond the numerous allowances and pensions, in order to reduce the marginal effective tax rates arising from the complex interactions of the tax and transfer systems. The structure of transfers could also be streamlined (see below). Increasing the weight of the GST in total tax revenues, which in Australia is low by international comparison, would also help simplify and rationalise the states' taxation systems, which rely on many inefficient taxes, including on housing.* There are too many taxes (125), the bulk of which yield little revenue but cause large distortions, especially at the state level, and have high administrative costs. State royalties, payroll taxes, conveyance duties and insurance levies are highly inefficient, resulting in large marginal welfare losses. *They should be reduced, reformed or eliminated outright. Reform will need to be implemented over time, consistent with the fiscal strategy.*

Figure 5. Taxes on general consumption as a percentage of total tax revenue

2007



Source: OECD (2009), Revenue Statistics 1965-2008.

Responding to infrastructure needs is important…

18. Australia faces a shortfall in infrastructure, which could worsen with the demand pressures exerted by the mining boom, population growth and environmental concerns. To respond to this demand and avoid bottlenecks, the authorities have put bolstering infrastructure at the top of their policy agenda. This entails greater public spending, but also structural reforms to optimise public and private investment choices and the use of existing facilities. Measures have thus been adopted to better co-ordinate the infrastructure development at the national level. A new body, Infrastructure Australia (IA), has carried out its first audit on the basis of project submissions, identified the needs and established a priority list of investment projects. This is welcome. *Future audits should, however, be less supply driven. Recent efforts of IA to assess the demand for (or target of) services in each main infrastructure area should continue.* Such an approach would lead to clearer objectives and a more transparent monitoring of progress with infrastructure policy. IA has also pledged to follow an investment selection process based on rigorous cost-benefit analyses (CBA). These are fundamental for assessing infrastructure projects, although the final decision will depend on broader social, economic

and environmental considerations, which are ultimately decided by government. Transparency in this domain, however, needs to be further enhanced. *The results of all CBAs should be published, while audits and independent analysis of large projects should be more systematic.*

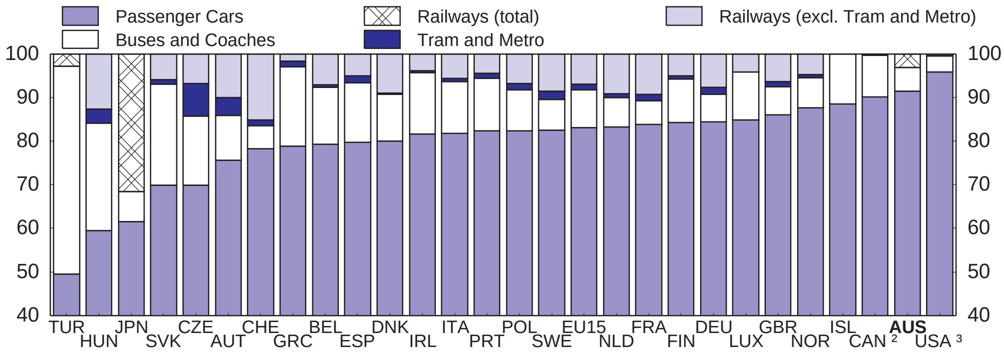
...and requires a better regulation to promote a more efficient use of equipment and well targeted investment decisions

19. Existing infrastructure could be used more efficiently and further regulatory reforms are required to promote more efficient infrastructure investment decisions in several sectors:

- Road congestion in large urban areas imposes rising costs to the community in terms both of well-being and productivity. *Introducing location-specific and time-varying congestion charges would help to achieve a more efficient use of road infrastructure in large cities. Public transport, which is less developed in Australia than in many other OECD countries, could also be expanded. In the road freight sector, the development of a pricing scheme for heavy vehicles, based on the mass transported, the distance travelled and the part of the network used, should be accelerated.* Institutional arrangements should better link revenue and spending for roads than is currently done in the budgetary process. *Road investment choices would likely be more efficient if road user charges were set in a more consistent and accountable way, and their spending managed by public firms run on commercial basis.*

Figure 6. Modal split of passenger transport on land

In 2005[1] (passenger-km)



1. Or latest year available.
2. Intercity passenger services only for rail and includes light trucks in cars.
3. Private cars include vans and recreational vehicles.

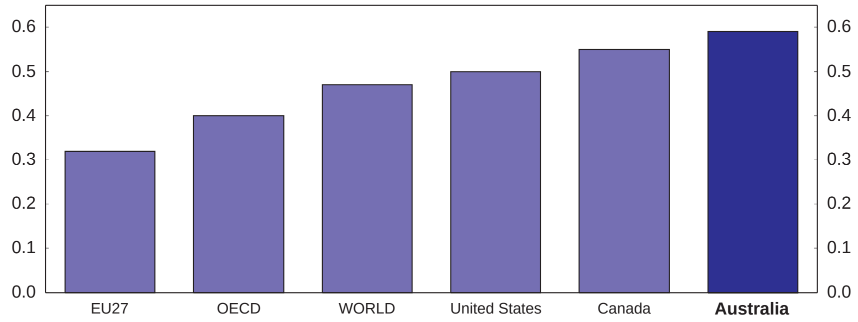
Source: DG Transport and Environment, OECD Environmental Data Compendium, 2006/2007.

- *Demand for electricity would be better managed if "smart meters" were installed more widely.* The current over-allocation of water resources leads to an effective undercharging for irrigation water, and hence to over-exploitation and poor investment decisions. *Water pricing in rural areas should ensure full cost recovery, including of environmental costs. Barriers to water trade between rural and urban areas should be lifted* to ensure more efficient use of water resources, widen supply options for urban water and reduce investment needs. *Putting an end to public monopolies of urban water management should also be considered, to attract private investors and promote innovation.*

- *Harmonisation of infrastructure regulations across states should continue, including in the energy sector.* However, the most important regulatory issues that need to be settled to ensure adequate development of infrastructure in the energy sector relate to the policy of reduction of greenhouse gas emission. In this domain, *uncertainties need to be lifted rapidly by the adoption of market mechanisms to set a price on carbon, thereby reducing emissions in an effective way.*

Figure 7. Carbon dioxide emissions from fuel consumption

Kilogrammes of CO2/US dollar, 2007[1]



1. Using 2000 prices and PPP.

Source: International Energy Agency, IEA (2009), CO2 Emissions from Fuel Combustion, International Energy Agency, OECD Publishing/IEA.

- In the telecommunication sector, the government's project of building a new fibre network, the National Broadband Network (NBN), holds the promise of delivering potentially large benefits. However, as the cost amounts to 3¼ per cent of GDP, it also entails substantial financial uncertainties. The authorities' strategy will improve Internet services for the entire population and promote a fairer competition between private firms on retail services. Part of the plan is to shut down the existing copper network and the country's main cable network. While establishing a monopoly in this way would protect the viability of the government's investment project, it may not be optimal for cost efficiency and innovation. Empirical studies have stressed the value of competition between technological platforms for the dissemination of broadband services. *It would therefore be preferable to maintain competition between technologies in the broadband sector and, within each technology, between Internet service providers.*

- The existing regulation guaranteeing third party access to infrastructure, the National Access Regime (NAR) developed in the mid-90s, raises a number of issues concerning the appropriate balance between efficient use of existing networks and stimulating private investments. The implementation of the NAR implementation over the past 15 years seems to vary across industry. *A detailed assessment would help draw lessons from the experience to date and fine-tune regulatory provisions.*

Labour market flexibility is critical to sustained growth

20. The strong terms-of-trade rise is likely to require structural changes, in particular reallocation of workers across sectors. *The implementation of the new industrial relations system, which strengthens wage bargaining at the enterprise-level and enhances worker protection, should be monitored closely to ensure fairness while promoting flexibility. Maintaining an open, demand-driven immigration policy will allow immigration to continue to play a key role in meeting rising labour demand, and in alleviating skill shortages. A more effective system of assessment and recognition of foreign qualifications and experience would help to make better use of immigrants' human capital.*

Raising labour supply would ease bottlenecks and help to tackle social inclusion, an important aspect of wellbeing in Australia

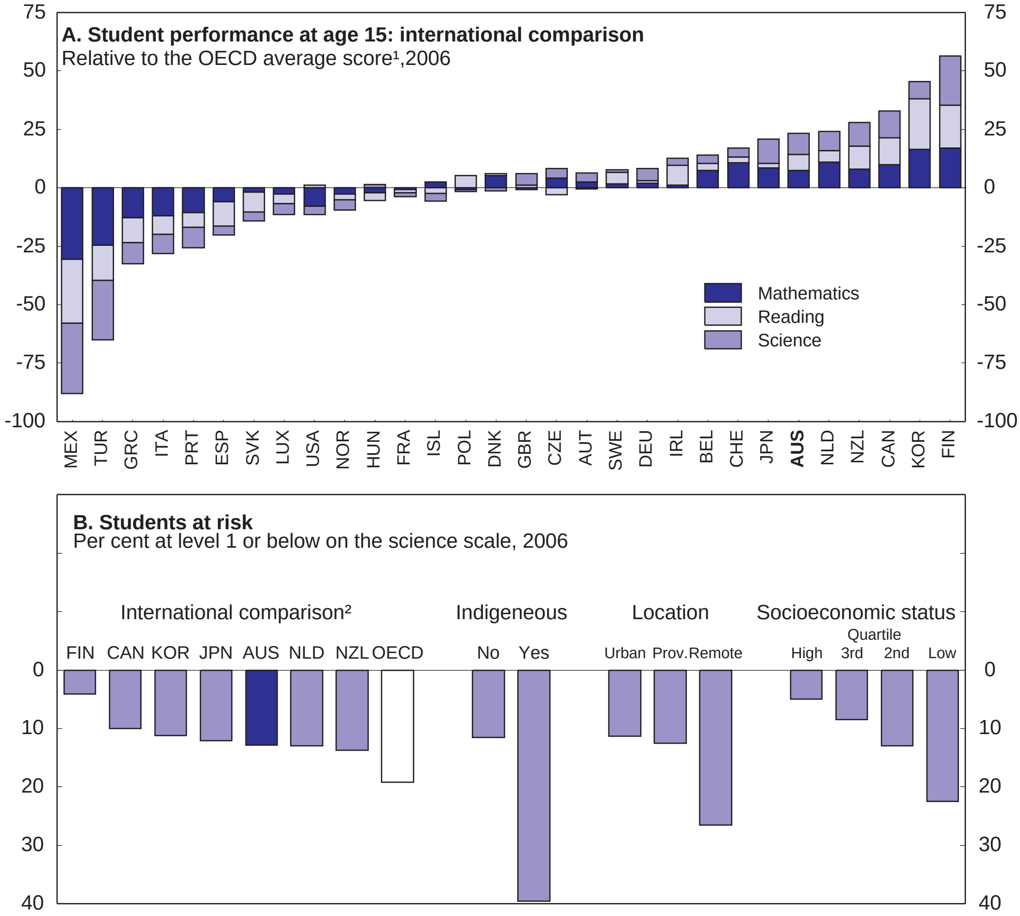
21. Despite relatively high participation rates, underutilisation of labour remains important, especially among such groups as lone parents, people with mental and other disability and indigenous people. Their relatively tenuous labour-market status leaves them exposed to risks of social exclusion. Increasing labour force participation would reduce such risks, but the multiplicity, inter-relatedness and complexity of the issue call for a comprehensive strategy.

Reforms in tax-transfer, education policies and labour market institutions would boost both labour market participation and improve social inclusion, but should be subject to fiscal constraints

22. The transfer system could better tackle poverty, while strengthening incentives to work. Recent reforms towards more individualised employment services may help in this regard. *However, additional attention given to disadvantaged groups should not lead to worsening of services provided to less disadvantaged unemployed. Over time, the adequacy of Newstart Allowance should be examined, taking into account both fiscal constraints and community expectations. An option would be to increase the Newstart Allowance for the initial period of unemployment to provide a more adequate safety net, but job search requirements should be maintained and the impact on the incentive to work should be assessed. Streamlining of family benefits into a "single family payment" would increase incentives to work, especially for second earners,* by reducing the impact of cumulative withdrawal rates arising from multiple and often overlapping transfers. The effects of such a reform on "low wage" traps, which are prevalent in Australia, would need to be closely monitored. The introduction of a paid parental leave by 2011 is welcome. *Child care benefits could be made more conditional on employment and job search of parents, except if children face multiple disadvantages.* More account should be taken of the higher cost of service provision for very young children. *This can be achieved by moving towards a simple and adequate structure of child care benefits, set as a percentage of out-of pocket expenses. More effective job capacity assessment for people on disability, subsidies in line with recent policy announcements, would also enhance participation*. The new Disability Employment Services System ensures access to services for all job seekers with disability, attempting to provide the right assistance as early as possible and focussing on outcomes. *Given the already relatively high minimum wage, future increases should be moderate and take account of productivity developments to avoid exclusion of vulnerable and low-skilled workers. A system of in-work benefits could also be explored as part of changes to existing income support and tax arrangements to reduce disincentives to work.*

23. Although Australia's education system fares well internationally in terms of student achievement and intergenerational social mobility, gaps related to disadvantaged groups remain. Children from disadvantaged groups generally participate less in the important early childhood programmes, or have lower scores in tests. The government's commitment to provide universal access to early education for all children in the year before formal schooling by 2013 is welcome. Reforms to lift the quality of early childhood services are also being phased in and have the prospect of delivering significant benefits*. In the longer term and as fiscal circumstances allow, consideration should be given to continuing to improve the quality of, and access to, early childhood education, to three-year olds, focusing initially on disadvantaged groups.* Improvements in quality and equity in schools are also commendable. *Linking school funding more closely to differences in students' socioeconomic backgrounds would counteract disadvantages.* At the tertiary level, initiatives underway to reform the income support system for higher education students will help increase participation among students from low socioeconomic backgrounds. Finally, the recently announced strategy concerning vocational education and training (VET), which aims to provide new training in resources and related sectors, support apprenticeships, and improve the quality of VET through the establishment of a national regulator, are welcome. *More flexible apprenticeships, focusing more on the development and recognition of competencies rather than requiring a standard fixed duration, and simpler and more frequently updated training packages should be promoted.*

Figure 8. Education outcomes



1. The three skills are weighted equally in the total score. Data for the United States in reading proficiency is from PISA 2003.
2. Australia is compared to the six countries with the highest mean performance.

Source: OECD (2007), PISA 2006: *Science Competencies for Tomorrow's World*, OECD Publishing; OECD (2009), *Education at a Glance*, OECD Publishing and ACER (2007), "At Risk Students"; PISA 2006 *National Report: Fact sheets*, Australian Council for Educational Research.

Social inclusion calls for comprehensive service delivery

24. Improving the governance of policy actions aiming at combating social exclusion is key for enhancing outcomes, given the difficulties in providing effective service delivery for people with multiple disadvantages. *Closing data gaps and frequent reporting on social inclusion outcomes are essential for monitoring progress.* Comprehensive early intervention is important for reducing homelessness, which results from many and diverse interacting causes such as long-term unemployment, mental health problems, addiction and family violence. Housing affordability is also important for reducing social exclusion and homelessness. This aspect is currently being addressed through the provision of income and need-linked social housing at a low cost, or capped rent assistance subsidy for those on income support. However, social housing tends to be poorly targeted, raising equity concerns with regards to those renting privately, who receive less subsidy. In addition, the lack of portability of public housing entitlements can reduce mobility and incentives to work. *To promote equity, work incentives and efficient provision of social housing, consideration could be given to*

allowing public housing tenants to access rent assistance, while charging them rents that are close to, or even at, the market rent. Care should be taken that the new system ensures equity in access to social housing while it attempts to address efficiency concerns*. The generosity of the rent assistance system could also be improved by moving toward an indexation system, based for instance* on *the rent component of the CPI, provided that upward pressures on rents are contained.* On the issue of people with disabilities, comprehensive support services are needed to deal with a combination of homelessness, poor health and lack of social networks. Recent efforts to enhance comprehensive service delivery are therefore welcome. The disability service system remains too fragmented, inflexible and under-resourced, leading to large unmet demand. *A swift move to a person-centred approach to service delivery, as agreed by the governments under the National Disability Agreement, would reinforce the effectiveness of recent initiatives on early intervention and prevention. Better co-ordination of mainstream and specialist disability services is a government objective and remains critical in this regard.*

Chapter summaries

Chapter 1. Recovering from the crisis and addressing medium-term challenges

Australia weathered the world recession well, and economic prospects are, overall, favourable both in the short and medium term. Managing the exit strategy from the global economic and financial crisis is less problematic than in most of the OECD thanks to the sound fiscal position and positive economic outlook, although the new upswing starts with inflation around the middle of the medium-term target and little spare capacity. Over the medium term Australia needs to ensure a balanced expansion in the face of a mining boom and potentially volatile terms of trade movements, and strengthen supply to ensure non-inflationary growth. This chapter assesses recent performance of the economy, the main sources of its resilience, the outlook, and monetary and fiscal policy stances. The chapter then highlights some key medium-term policy challenges: bolstering weakening productivity, boosting housing supply and further reducing risks associated with a likely widening of the current account to finance mining investments.

Chapter 2. Enhancing the effectiveness of fiscal policy

Although the budgetary outlook remains strong, Australia's fiscal policy will be challenged by a number of efficiency issues and the expected rise in volatile mining revenues. In contrast to many OECD countries, low public debt and good growth prospects leave ample fiscal space to respond to future shocks. However, there is scope to improve efficiency of public interventions as the authorities have started implementing their fiscal exit strategy. The new mining boom is an opportunity for the Australian society, but it raises questions on sharing the rents from increased mineral wealth; on how to use the expected higher tax revenues from the exploitation of non-renewable resources; and on how to deal with uncertainty generated by commodity price movements. Volatility can lead to biases in fiscal policy; this was the case during the mini-boom of 2000s. The second part of this chapter assesses the fiscal measures adopted and planned so far to deal with this challenge. Furthermore, although Australia has one of the lowest tax burdens in the OECD, the system includes numerous taxes with low yields and high administrative costs. Some taxes and the complex transfer system can also blunt incentives to work and thereby weaken growth. The detailed review of the system released in 2010 identified many of these problems. However, most of its recommendations are not in the pipeline for implementation. Tax reform is analysed in the last part of this chapter.

Chapter 3. Meeting infrastructure needs

Adequate and well-functioning infrastructure is a key ingredient to growth and wellbeing. The benefits to activity of efficient spending in energy, water, transport and communication sectors go well beyond their contribution to capital accumulation. Good infrastructure facilitates trade, bolsters market integration and competition, fosters the dissemination of ideas and innovations and enhances access to resources and public services. These benefits are particularly important for Australia because of its size, the geographical dispersion of its population and production centres, and its remoteness from other markets. Nevertheless, Australia has an important infrastructure deficit. This is in part due to underinvestment in the 1980s and 1990s, while the rebound in capital spending at the beginning of the 2000s has been insufficient to deal with capacity shortages exacerbated by the strong demand generated by the mining boom, expected population growth, technological progress and environmental concerns. To ease these shortages, the authorities have put bolstering infrastructure to the top of their economic policy agenda. This entails greater government expenditure in this area, but also structural reforms to optimise public and private investment choices and the use of existing facilities with better regulation. This chapter reviews the state of Australia's infrastructure and the government's action programme.

Chapter 4. Enhancing labour utilisation in a socially inclusive society

Australia faces the mutually reinforced challenges of boosting labour supply and promoting social inclusion. Labour underutilisation is especially prevalent among groups such as lone parents, people with disability, and Indigenous Australians. These are also groups at greatest risk of social exclusion. Thus better integration of these groups into the labour market would enhance inclusion. In general, labour utilisation can be increased by training, improving the functioning of labour market institutions, reforming the tax and transfer system, and maintaining labour market flexibility. Beyond labour market policies, the multiplicity, inter-relatedness and complexity of social inclusion problems call for a comprehensive and integrated approach focusing on individual needs. The elements of the strategy include an education system that better promotes equity and integrated service approaches to help people with disabilities and the homeless. Recent efforts in all these areas by the government are welcome.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Australia were reviewed by the Committee on 11 October 2010. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 22 October 2010.

The Secretariat's draft report was prepared for the Committee by Claude Giorno and Vassiliki Koutsogeorgopoulou under the supervision of Piritta Sorsa. Research and editorial assistance was provided by Ane Kathrine Christensen and Josette Rabesona.

The previous Survey of Australia was issued in October 2008.

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