

# OVERVIEW

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## **Priorities for an Incoming Government: Opportunities and Challenges**

You are starting this second term of government with an economy that is performing strongly and approaching full employment. But it is not delivering in some areas and for some groups. The economy also faces a number of short to medium-term risks and is subject to several long-term trends that are driving pronounced and challenging structural change.

During this second term, we expect the Government will have to deal with the implications of capacity constraints, especially pricing pressures, as the economy pushes up against full employment limits. But you also may have to respond quickly to large negative shocks from a volatile global economy in what looks like being an extended period of heightened uncertainty.

Inevitably, there will be increasing pressure on the Government to respond to peoples' concerns over economic and social change, and to meet their growing expectations of government, with various 'protective' initiatives. The challenge will be to put in place the policy settings needed to respond to the major long-term trends, and maintain a capacity to respond quickly to emerging shocks, while sensibly easing the transitional costs of structural adjustment.

While this brief has been updated for some of the earlier agreements with the Greens and Mr Wilkie, we have not updated for the latest agreements with Mr Windsor and Mr Oakeshott. We will need to discuss further with you the implications of the parliamentary reforms and the operation around minority government, including establishing the Parliamentary Budget Office and facilitating the Greens and independents' access to Treasury and Finance analysis and costings, as well as the commitments in relation to the proposed Tax Summit. In particular, we would propose that Treasury, in consultation with Finance and PM&C, make a submission to the Special Parliamentary Committee tasked with advising the Parliament on the structure, resourcing and protocols of the Parliamentary Budget Office. Changes to the Charter of Budget Honesty Act and the Public Service Act are likely to be required.

### **1. Significant achievements in your first term of government**

Your first term of government produced a number of significant policy achievements. You implemented a highly successful emergency response to the most challenging global financial and economic crisis since the Great Depression — a response that assisted Australia to withstand the economic and financial shocks better than most other advanced economies.

You articulated, and delivered on, a disciplined fiscal strategy. Continued delivery of your deficit exit strategy will be a key, but very difficult, priority.

The Government also commenced an ambitious economic reform agenda that built on your previous election commitments and, in many cases, included issues that we had highlighted in our first incoming government briefing to you. Many of these issues have proved more challenging than envisaged, in part because of deteriorating fiscal circumstances, but their importance has not diminished. A continuing priority will be to bed down the reforms you have commenced.

- A substantial re-shaping of employment services and enhancements to skills programs were achieved. Significant reform of the higher education sector, school reforms

through COAG and the introduction of a national curriculum are being implemented. Your Government's election commitments build on these reforms.

- The National Health and Hospitals Network reforms were significant and have the potential to drive efficiency and help contain growth in expenditure. But a significant implementation task remains.
- The new Intergovernmental Agreement on Federal Financial Relations was a key achievement, and continued progress in ensuring a cooperative and collaborative relationship with the states will be crucial to delivering the Government's election commitments and the reforms commenced in your first term.
- Steps have been taken in progressing the Government's social inclusion agenda, including articulating the gaps and addressing Indigenous disadvantage. Many of your Government's election commitments address issues in this area, including in the areas of mental health and more support for people with a disability.
- Helping embed the G20 as the premier forum for global economic cooperation and navigating the intensification of Chinese investment flows into Australia were major economic and foreign policy achievements. The G20 recognises the importance of China and India to the global economy, but it is important that we deepen our engagement with these countries given the increasing links.
- Tax reform priorities, including the Minerals Resource Rent Tax (MRRT), the cut in the company tax rate and measures to build superannuation adequacy, were announced and now require implementation – we will need to discuss with you very early on the Tax Summit and the handling of the implementation of your existing tax commitments.
- Progress was made in improving the operation of financial markets with the transfer to ASIC of the supervision of trading on financial markets and the restrictions on short selling, and in enhancing consumer protections with the passage of the Australian Consumer Law, and the national approach to credit regulation.

## **2. Looking to the future**

When we briefed you shortly after the 2007 election, we were forecasting a fiscal position that provided considerable scope for 'purchasing' a large number of difficult reforms. Today, in very different fiscal circumstances, it is clear that reforms will have to be largely 'budget-neutral'. Budget-neutral reform is never easy, in large part because it more obviously involves losers as well as winners.

We see a number of important challenges and opportunities that the Government will need to address. This will require discipline and resilience in building the case for change with a compelling narrative, prioritising reform options, and sustaining the prosecution of announced policy.

But the Government will not be able to address them all, and in some cases only the initial steps will be practicable in this second term. It therefore will be important to focus on delivering an achievable program of policy reforms that fits with your Government's overall policy agenda. Balancing priorities with delivering on your Government's election commitments, while taking into account what is achievable and what cannot be avoided, could see you focusing on:

- continuing to repair public finances by delivering on the medium-term fiscal strategy, consistent with your key election theme (see Attachment A, which sets out Treasury and Finance's advice to you and the independent MPs on the impact of your election commitments);
- developing a narrative on the need for tax reform, particularly in the context of the Tax Summit, to respond to the challenges to tax system sustainability identified in the *Australia's Future Tax System (AFTS)* review, helping to lay the ground work for reform as fiscal circumstances permit (see Attachment B);
- delivering on the Government's proposed population strategy by laying the foundations for planning, clear policy frameworks and investments consistent with fiscal, environmental and social sustainability (see Attachment C);
- rapidly implementing your election commitment to transition to a Carbon Pollution Reduction Scheme (CPRS), affirming that a carbon price provides a credible, certain and least-cost approach to climate change mitigation (see Attachment D);
- taking further the steps commenced in your first term, and reinforced by your Government's election commitments and agreements with the independent MPs, to implement the roll out of the national broadband network, as well as to address glaring failures in the housing, electricity, transport and water markets (see Attachment E);
- developing other productivity and workforce participation strategies to lift the supply potential of the economy and enhance social inclusion, including your Government's election commitments on schools (see Attachment F);
- initiating a comprehensive financial sector review in order to take stock of the lessons of the financial crisis and draw together the work currently being undertaken both here and internationally (see Attachment G); and
- further entrenching the role of the G20, while broadening and deepening the underpinnings of Australia's bilateral economic relations with China and India (see Attachment H).

While the recent global financial crisis was a reminder of the need for well-designed regulation to deal with certain market failures, many of the policy challenges ahead can only be addressed by making intelligent use of markets or market-based mechanisms.

The Charter of Budget Honesty, enacted thirteen years ago, has served successive governments well, and has proved to be a robust framework, even under the difficult economic circumstances experienced during the global financial crisis. It is clear, however, that certain provisions have not stood the test of time, in particular those governing the process for costing of election commitments. This has the potential to undermine the Charter's purpose of improving fiscal policy outcomes. A review of the Charter, as part of the establishment of the Parliamentary Budget Office and implementing your agreement with the Greens and independents PMs, would allow these issues to be considered.

### **3. The economic outlook is positive but challenging**

We expect the Australian economy to return to full capacity over the next year. While there is still some near term weakness in parts of the economy, and a risk of further weakness as fiscal

and monetary stimulus is withdrawn, conditions should strengthen. The medium-term outlook is expected to be underpinned by an emerging, if somewhat variable and at times uncertain, global recovery and the gathering mining boom.

Employment is expected to grow strongly. But with the labour market reaching full capacity and the strong incomes boost from the terms of trade feeding into demand, there are upside inflationary risks that will require coherence and consistency between the stance of monetary and fiscal policies. The terms of trade are at record levels, primarily reflecting strong commodity prices. These are likely to underpin exceptionally high levels of business investment in coming years.

On the other hand, household spending will likely make a weaker contribution to growth than in the last expansion phase. In part, this is because monetary policy, by increasing interest rates and the exchange rate, will ensure that the household sector ‘makes room’ for the investment boom. Tighter fiscal policy, and measures to boost labour force participation and productivity, could play a useful role in complementing monetary policy, reducing the size of the required increases in interest rates and the exchange rate.

For a given fiscal policy setting, there is also scope for government to improve the quality of its own spending programs in a way that takes pressure off interest rates and the exchange rate. Thus, for example, there is a strong case to source offshore a larger share of the defence capital through ‘off-the-shelf’ acquisitions —taking advantage of the relatively high exchange rate and avoiding adding to skill shortages and wage pressures in already tight areas of the labour market.

### **International macroeconomic risks are real and ongoing**

While there are some downside risks associated with the private sector recovery as the stimulus is withdrawn, most key risks around the outlook relate to global economic and financial fragility. It is not clear that the global financial crisis and consequent policy responses have resolved, in any sustainable way, the causes of the global financial imbalances that emerged in the 1990s. These imbalances were characterised by historically high rates of saving in the Middle East and Asia financing an expanding US current account deficit.

Other risks are posed by the Australian economy’s increasing exposure to commodity prices. While the terms of trade may continue to surprise on the upside, there are also downside risks if the global supply of resources responds more quickly than expected or if international market volatility persists. And even if those downside risks do not materialise, it is sobering to reflect on the fact that we have not managed previous commodity booms well.

The sovereign debt problems in Europe are likely to continue to be a source of volatility in global financial markets, with a risk of damaging contagion. US economic growth is also slowing as the impacts of stimulus and stock building fade and consumers remain cautious. While a ‘double dip’ recession cannot be ruled out, even one quarter of negative growth would adversely impact confidence. A period of deflation is possible. The ability and willingness of authorities in the United States, Europe and Japan to respond to financial market stress or weak macroeconomic growth is constrained by already near-zero interest rates, high fiscal deficits and public sector debt levels that are testing the limits of sustainability.

China also has the challenge of withdrawing stimulus to avoid overheating and a proliferation of non-performing loans, while avoiding sapping too much momentum from the economy in

the event that global demand weakens substantially. Investment spending is likely to be most impacted by this stimulus withdrawal, posing particular risks for Australia's raw material exports.

### And the international risks highlight domestic vulnerabilities

In thinking about these risks, the salient lessons from the experience of the recent financial crisis include the importance of sustaining overall economic policy credibility, a strong fiscal position, responsive monetary policy, a flexible exchange rate, flexible labour markets, a strong but flexible financial sector and the ability to move quickly to implement an appropriate and well-targeted government response.

Australia starts from a position of relative strength in all these areas. Here, interest rates are only slightly below historical average levels. Net public debt is set to peak at a very low level. And our private financial institutions have strong balance sheets. These facts suggest that we are well-placed to weather any future shocks to world financial markets. But our ability to weather such shocks does not depend on these facts alone. Critically, it depends on Australia continuing to enjoy the confidence of global capital markets. Maintaining policy credibility is therefore essential.

A key risk for the Australian economy is our reliance on short-term external debt, largely intermediated through the banking system. The global financial crisis highlighted the potential for global financial markets to fail and for access to finance to be disrupted. Among Australian financial institutions, there has been some shift away from short-term funding since the crisis, but exposure to financing risk remains significant.

While there is considerable work being done in a number of areas, both domestically and internationally, to improve existing arrangements, **there is a clear need for a comprehensive review of the financial sector regulatory framework** (Attachment G). Such a review could draw together outcomes of the work currently being undertaken both here and internationally, and consider broader, more systemic issues, including the lessons from the financial crisis and the balance between the dual objectives of stability and safety, on the one hand, and competition and efficiency on the other.

Highly indebted households, together with high dwelling prices, further heighten the vulnerability of the economy to shocks. While household finances are in good shape overall, and arrears rates and other financial stress measures remain much lower than in the early 1990s, households are more exposed than previously to adverse shocks.

## 4. Delivering on the fiscal strategy is essential

The latest fiscal projections, presented in the *Pre-Election Economic and Fiscal Outlook 2010 (PEFO)*, show the budget returning to surplus in 2012-13. The updated preliminary fiscal outlook, after taking into account your election commitments, is largely unchanged from that published in the PEFO (Attachment A).

The timing of the return to surplus is predicated on restraining real payments growth to 2 per cent a year and receipts recovering in line with strengthening economic conditions. But there are risks.

Revenue is sensitive to movements in the terms of trade and there is a real risk that plausible levels of volatility in the terms of trade (even in the absence of significant changes to the

outlook for the world economy) could cause large movements in tax receipts, possibly delaying, or even eliminating, the prospect of a return to surplus without corrective action.

On the other side, unexpected further strength in the terms of trade could drive the budget into surplus more quickly than currently expected.

Failure of the Senate to pass the private health insurance rebate savings, health reforms and the recent revisions to the tax package (incorporating the MRRT) also have added to the structural pressures on the budget position in the medium-term.

In the medium to long term, spending pressures associated with changing demographics also will affect the budget. Analysis in the *2010 Intergenerational Report* showed these pressures are likely to push the budget increasingly and significantly into deficit over the next 40 years if corrective policy action is not taken.

The immediate priority is to return the budget to surplus in a timely manner, delivering on the deficit exit strategy.

But if the budget is to guard against the risk of a faster-than-anticipated fall in the terms of trade, and make room to deliver on further reform, then it will be necessary to take further steps to strengthen the structural position of the budget.

## **5. Long-term trends will continue to shape the economy and other policy dimensions**

At the same time as we are dealing with short to medium-term macroeconomic risks and implementing an appropriate medium-term fiscal strategy, we need to tackle more aggressively a complex mix of long-term trends that will significantly impact on Australia's future: the rise of China and India; an ageing and growing population; climate change; and technological change.

Our emphasising these challenges will be no surprise to you. They were strong themes of advice to you in your first term of government.

### **Globalisation, and China and India's re-emergence, continues**

Notwithstanding the disruption of the financial crisis, the global economy is continuing to become more integrated, with increasing cross border trade, more interlinked capital markets, increasing technological transfers and greater global competition. The continuing re-emergence of China and India is also a driving force for global competition.

To date, the re-emergence of China and India has provided significant impetus for global growth. It will substantially alter the pattern of world GDP over coming decades (Chart 1) and see a shift in the global balance of economic power. China and India are the key drivers of the shift in global strategic weight towards Asia — from which Australia is a key beneficiary. India is projected to grow at an even faster rate than China in the coming decades, reflecting demographic factors and greater scope for catch-up.

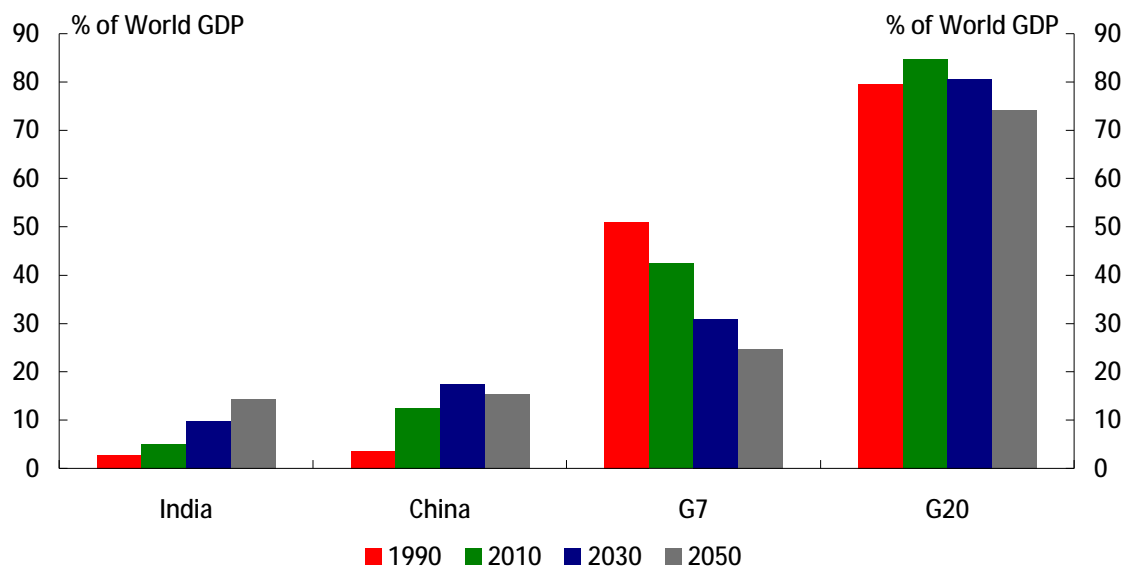
The G20's elevation during the financial crisis is emblematic of this shift. **Entrenching the G20 as the world's premier forum for international economic cooperation and broadening and deepening the underpinnings of Australia's bilateral economic relationships with**



**China and India** are two international economic policy challenges that your Government faces (Attachment H).

The Australian economy is in a strong position to respond to the challenges and opportunities of continued globalisation, particularly with Australia's proximity to fast growing Asian economies and our complementary trade links with both emerging market and established economies.

**Chart 1: Shares of global GDP**



Source: International Monetary Fund and Treasury estimates.

The resource boom can, however, exacerbate current external and internal vulnerabilities to sudden changes in market conditions and complicate the conduct of macroeconomic policy. Capital market integration also has increased the speed and extent to which international economic shocks in one part of the world are transmitted to other regions and Australia.

The increased demand for Australia's resources is leading to an expansion in the domestic mining sector and related parts of the construction and other support industries, and possibly in the non-traded sectors as a consequence of demand driven by increased national income. For an economy at or near full capacity, this requires a relative decline in trade-exposed sectors like manufacturing and tourism. Ad hoc measures to limit these adjustments would achieve little. But a sustained increase in the working age population — supported by population growth — could, in part, ease the structural adjustments arising from a strong terms of trade.

The way in which these structural adjustments play out also will be influenced by the extent to which a structurally tighter fiscal policy and measures to lift labour force participation and productivity can be marshalled to take some pressure off monetary policy. To the extent they can be marshalled, short-term interest rates and the exchange rate will be lower than otherwise and the contraction in the non-resources sectors share of the economy will also be smaller.

A number of policy settings will also require adjustment; tax in particular. As a medium-sized open economy, and with increasing integration of international capital markets, it will be important to **shift taxes away from domestic investment towards other less mobile tax bases** such as land, resources and consumption. This will only be worth doing if



these immobile bases are taxed efficiently through broad-based and relatively neutral taxes. These were among the key themes of the AFTS report (Attachment B).

### **The population is ageing**

An ageing population will have consequences for government finances, economic growth and living standards. The 2010 Intergenerational Report (IGR) illustrated that, while the rate of ageing has reduced somewhat compared with previous IGRs, the proportion of traditional working age people is still projected to fall markedly, reducing the average rate of labour force participation.

Participation and, most particularly, productivity enhancing policies are key to ameliorating the economic impacts of ageing. Higher levels of immigration, to the extent that migrants are younger on average than the resident population, have ameliorated, and could continue to ameliorate, the speed of population ageing and the decline in the labour force participation rate. But this amelioration cannot be sustained indefinitely.

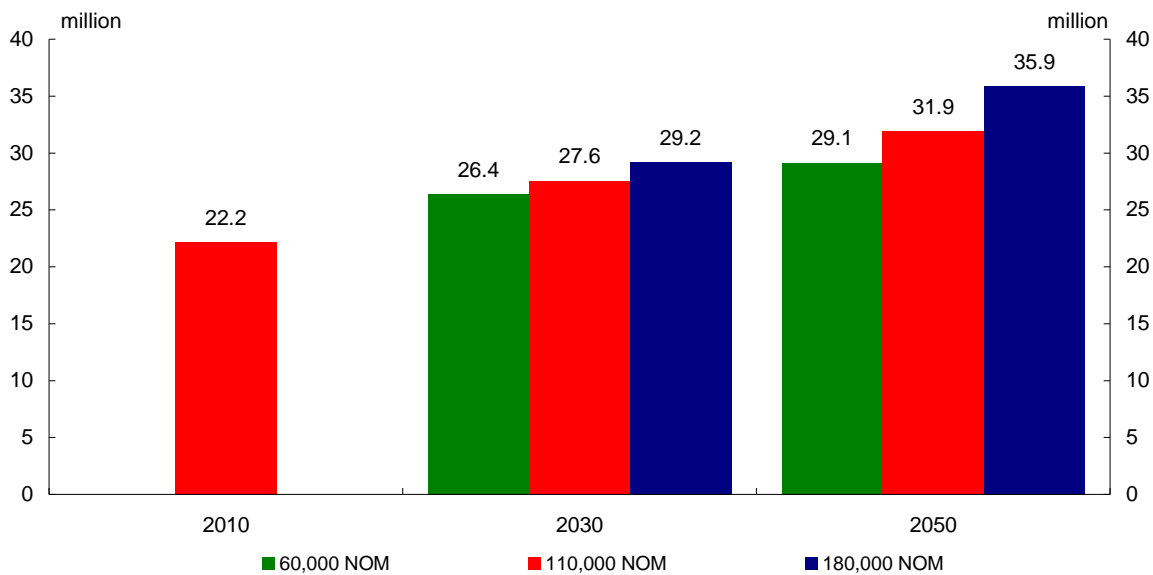
### **And population growth is inevitable**

The Australian population will continue to grow strongly over the next 10 to 15 years.

Even if net overseas migration (NOM) were to average only 60,000 a year over the next 40 years (a level of NOM exceeded in 25 of the past 30 years, and significantly below the 40 year average of around 100,000), Australia's population by 2050 would still be expected to grow to about 29 million (Chart 2). Given the powerful global forces driving the Australian economy, net immigration figures well in excess of that low number are probably inescapable.

The IGR projection of 36 million people by 2050 already factors in a significant reduction in NOM from its current high levels to 180,000 people per annum from 2011-12. According to ABS preliminary estimates, NOM appears to have peaked at almost 300,000 in 2008-09. DIAC forecast that NOM is likely to have fallen to around 230,000 in 2009-10 and further to around 195,000 by 2011-12 under current immigration settings.

**Chart 2: Population projections based on alternative levels of NOM<sup>(a)</sup>**  
(IGR 2010 life expectancy and fertility assumptions are held constant)



(a) The IGR 2010 population projection was based on a NOM assumption of 180,000. NOM of 180,000 is projected to average 0.6 per cent of the resident population over the next 40 years (0.8 per cent of the resident population in 2010), which is around the average observed over the last 40 years. NOM of 110,000 was the assumption used in the IGR 2007 and NOM of 60,000 is the level needed to achieve a population of 29 million by 2050.

Strong population growth is not necessarily unsustainable. It need not adversely affect the environment, the liveability of cities, infrastructure and service delivery, provided the right plans and policies are put in place now in anticipation of it.

But there is evidence that recent rapid rates of population growth have exceeded the strategic capabilities of the different tiers of government and raised community concerns about social cohesion in some areas. There should also be considerable concern about the evident lack of forward planning, refusal to make appropriate use of price signals and (partly for those two reasons) chronic under-investment in infrastructure and poor environmental outcomes. These are factors that many of your Government's election commitments have recognised.

The Government's proposed **population strategy** is an important initiative (Attachment C). Such a strategy should:

- incorporate a long-term migration framework that focuses on improving Australian wellbeing in all its dimensions;
- provide a regular public report on population growth, composition and geographical trends; and
- facilitate the co-ordination of policies such as in relation to cities, infrastructure, regional development and the environment — that are fundamentally relevant to population.

This is about more than simply building new infrastructure. It is about investing in the right kinds of infrastructure and using existing infrastructure more efficiently. This requires appropriate regulation and pricing, private investment, and contestable and competitive infrastructure markets (Attachment E).

## The extent of climate change, and pressure for its mitigation, will increase over time

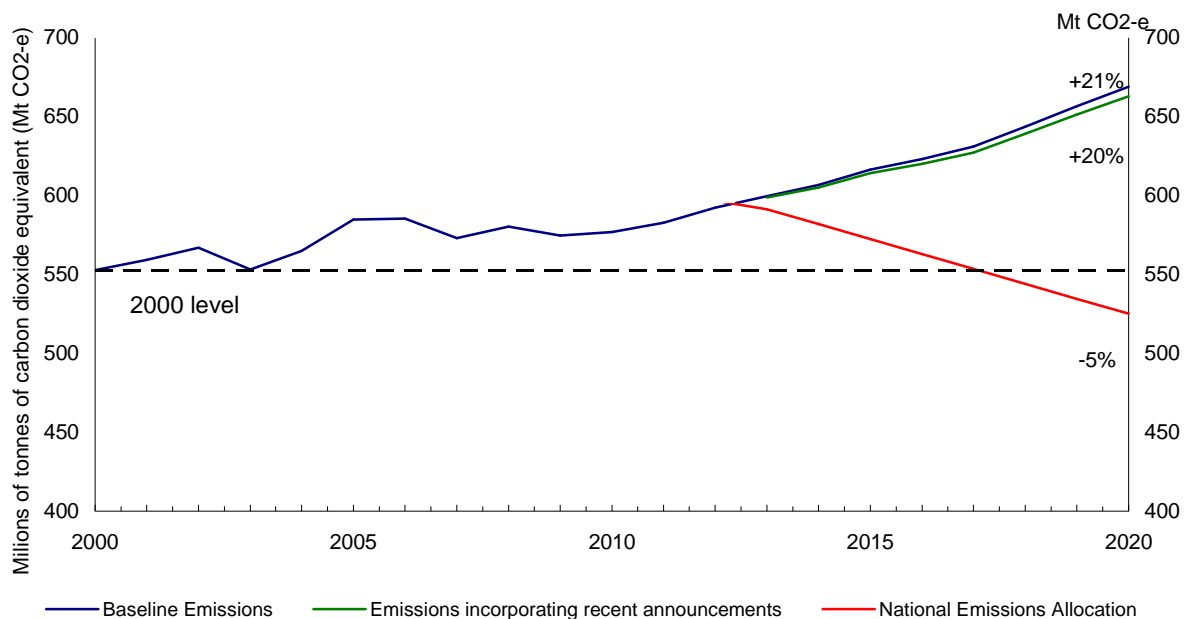
Climate change is likely inevitable and the impacts of unmitigated climate change on Australia are likely to be severe. Climate change is a global problem and it is in Australia's national interest to continue to pursue a comprehensive international agreement. Your Government has committed to continue to build support for global and domestic carbon markets.

**Whatever approach is taken to limit national emissions, it is in Australia's national interest to rely overwhelmingly on market-based mechanisms** — in respect of both mitigation and adaptation.

Your Government has agreed to establish a climate change committee. The Government has also committed to considering a CPRS once there is greater clarity on the climate change actions of major economies, and once community consensus for a CPRS has been built.

As you know, the mitigation task to achieve your commitment to reduce national emissions to 5 per cent below 2000 levels by 2020 is significant. It cannot be achieved without a carbon price if damaging economic and budget impacts are to be avoided. Direct action initiatives alone will not do the job. Chart 3 shows that preliminary estimates of the abatement achieved from the Government's announced election commitments are well short of the abatement required. Further steps will be required (Attachment D).

**Chart 3: Australia's emissions and the contribution of announced election commitments**



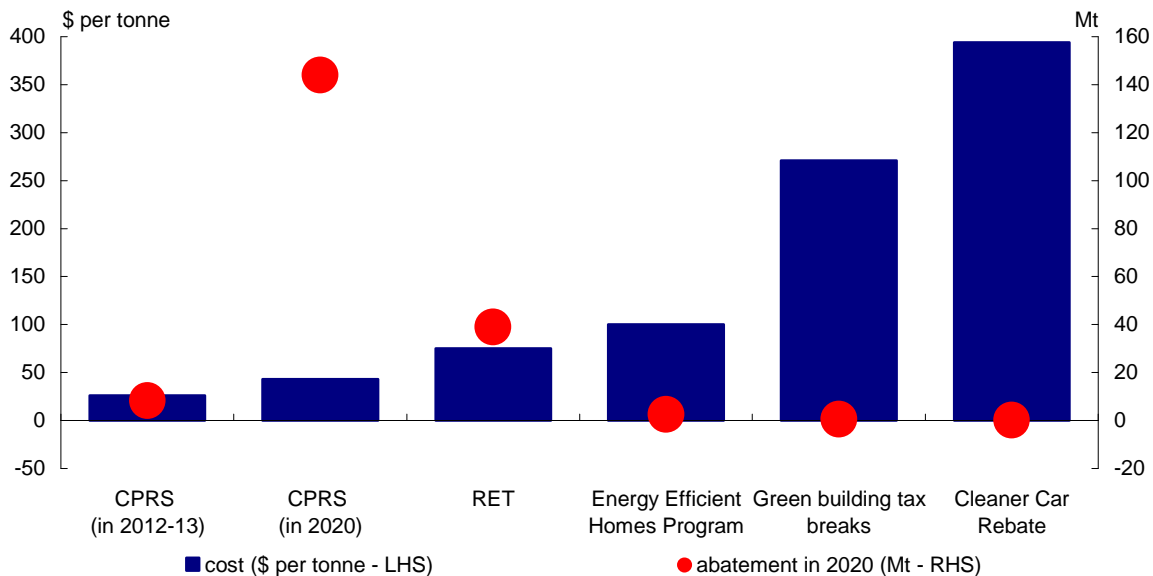
(a) Estimates of costs and abatement are heavily dependent on policy design. Due to lack of information, some assumptions have been made to enable an estimate to be derived. Any changes to policy design will change the abatement and costs. Source: Department of Climate Change and Energy Efficiency — preliminary indicative estimates.

Market based mechanisms are the most cost-effective way of achieving abatement. Pricing carbon will drive large-scale abatement through long-term investment in low emissions technologies and changes in behaviour by both producers and consumers across the economy. Market based mechanisms can achieve the necessary abatement, at a cost per tonne of emissions that is far lower than alternative direct action policies (Chart 4). Many of the direct action measures cannot be scaled up to achieve significant levels of abatement. For those that

can be scaled up, the cost per tonne of abatement would rise rapidly, imposing further costs on taxpayers and consumers.

All of this serves to underscore the conclusion that the sooner an emissions trading scheme can be implemented the better. Too much time has already been wasted — for which the Australian community will necessarily pay a high price.

**Chart 4: Indicative abatement and cost estimates for various emissions policies**



Note:

- (a) Estimates of costs and abatement are heavily dependent on policy design. Given limited information, some assumptions have been made to enable an estimate to be derived. Any changes to policy design will change the abatement and costs.
- (b) These estimates are intended to provide an indicative comparison only, and present either average costs over the period to 2020 or marginal costs in the case of the CPRS and RET.
- (c) Cost estimates for Energy Efficient Homes, Green Building Tax Breaks and the Cleaner Car Rebate are partial and reflect only fiscal costs. They also do not account for any energy cost savings that arise.

Source: The Treasury and Department of Climate Change and Energy Efficiency.

In the building of community consensus, the Productivity Commission (PC) could play a role in increasing the understanding of comparable carbon constraints that apply in major economies. This would include commissioning the PC to undertake detailed work on estimating the cost of action in these economies.

Even with significant mitigation action, effective policy frameworks to manage climate change that is already inevitable will be required. A PC examination of the costs and benefits of various adaptation options, to identify the highest priority reforms and the role of market-based approaches in facilitating adaptation, would be a worthwhile first step.

### Technological change and innovation will continue to support improved living standards

Technological advances transform business, trade and peoples' lives. These advances will continue to be a key determinant of long run income growth. As incomes rise with higher productivity growth, demands for health services, better environmental outcomes, and other 'superior' goods will also increase. The distribution of opportunities in society may change, though in which direction is uncertain.

Developments in information and communication technologies (ICT), in particular, will also have implications for the structure of the Australian economy, from the continued emergence of new products, industries, and production processes and through increased competition and greater specialisation. They are likely to continue to intensify competition in the services sector, which has previously been somewhat sheltered from international competition.

These developments also have implications for the way in which government services are provided. There will be an opportunity to make the tax and transfer system and other interactions of individuals with government more transparent and simple (Attachment B).

A skilled workforce, openness to investment and trade, together with competitive and flexible product and labour markets, are the key requirements to support and drive the adoption of new technologies and innovations.

The Government's National Broadband Network (NBN) initiative has the potential to deliver two key objectives:

- a more competitive, and hence more efficient and productive, telecommunications sector, particularly through addressing Telstra's vertical integration; and
- a 'transformational' infrastructure resource for the economy and the community — enabling new and enhanced ways of delivering business and government services and facilitating communication. No doubt there will be future applications made possible by the NBN that deliver significant benefits but which we cannot predict today.

However, implementation of the NBN also carries significant risks, including financial risks for the public balance sheet and risks around competition and efficiency in telecommunications and related markets. **The Government's response to the NBN Implementation Study will set the parameters for the outcomes in these areas for decades to come** (see Attachment E and the 'other significant policy issue' brief on NBN). It therefore warrants very careful consideration by Cabinet in coming months.

### **The resulting structural adjustments will generate concerns**

Structural adjustment to these significant longer term drivers of the economy, as outlined above, will entail costs for some, and transitional change for many. The most effective and credible policy responses will be those that allow structural adjustment, while protecting the most vulnerable and disadvantaged. This will not be an easy balancing act.

Many of the concerns apparent throughout the election campaign — about the sustainability of population growth; about infrastructure, congestion and the Australian 'way of life'; about cost-of-living pressures; about disparities among various regions and sectors of the economy; and about the pace of change — are manifestations of the costs of structural adjustment, both perceived and actual.

Many of the policy options to deal with structural adjustment will have cost of living implications, which, in itself, will be an impediment to reform. It is our firm view, however, that it is optimal for markets to be allowed to operate freely, letting the true costs flow through to consumers, with an appropriate safety net provided for disadvantaged groups.

In an economy at or close to full employment, responding to these pressures by policy interventions to advantage particular activities, sectors or groups of individuals, or by

inhibiting the structural adjustment needed, will simply come at the expense of other activities, sectors or individuals, and will reduce overall wellbeing.

## 6. Major market, social and government failures also require attention

A range of continuing, and in some cases chronic market, social and government failures, manifest themselves in less than optimal outcomes for individuals' decisions concerning work, for productivity generally and for particular markets and sectors, such as housing and water. There are also pockets, or categories, of severe and often entrenched social disadvantage.

These failures will increase the costs, or reduce the benefits, of the major long-term trends identified above. For example, failures affecting housing supply, transport, infrastructure and aged care services increase the costs and reduce the benefits of population growth. Failures in water markets increase the costs of climate change. These failures constitute major policy challenges in their own right.

### Labour participation outcomes in Australia lag other advanced countries

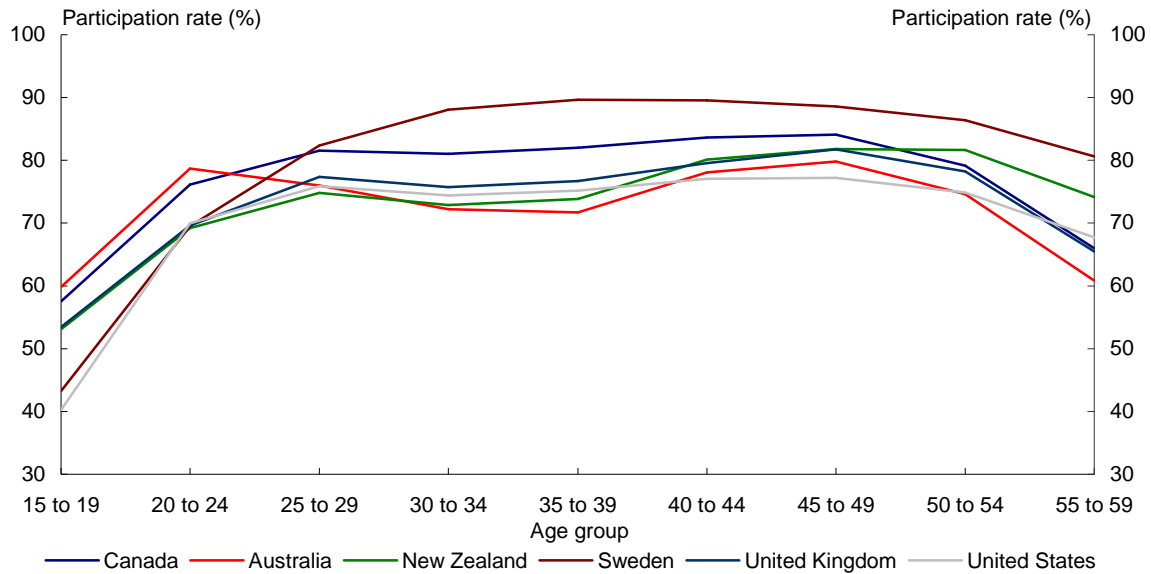
For many Australians, the choices about whether to work and how long to work are affected, usually for the worse, by the tax and transfer system and its design. These effects interact with other barriers to participation, such as the availability and cost of child care, or poor education outcomes. Those affected often will include some of the most disadvantaged individuals in society.

Your Government's election commitments focus primarily on unemployed jobseekers, particularly the long-term unemployed. Specifically, your Government has committed to strengthening the jobseeker compliance regime and to trialling the provision of relocation assistance of up to \$6,000 for jobseekers who move to take up an ongoing full-time job or apprenticeship. In addition, you announced increases to the financial rewards for trade apprentices completing their training.

While there are no simple solutions to address wider concerns about labour force participation choices, comparisons of participation rates in Australia with other OECD countries for specific groups, such as females of prime working age (Chart 5), indicate that **there are specific aspects of the tax and transfer system that could be reformed to improve labour participation outcomes** (see Attachments B and F). These include reducing disincentives to participation for single parents and secondary earners arising from the design of child care and family tax payments.

**Continuing reforms in the education sector will also be an important element of improving labour market outcomes and the opportunities available in general to individuals.** Recent reforms to schools policy and higher education support this objective. Your Government's election commitments on schools policy build on these reforms through a range of medium-term initiatives that seek to deliver improved outcomes through enhanced school autonomy, the introduction of teacher and school performance incentives, and the improved integration of trade training in schools. **There is considerable scope also to improve the responsiveness and efficiency of vocational education and training (Attachment F).**

**Chart 5: Female participation rates by age 2008**



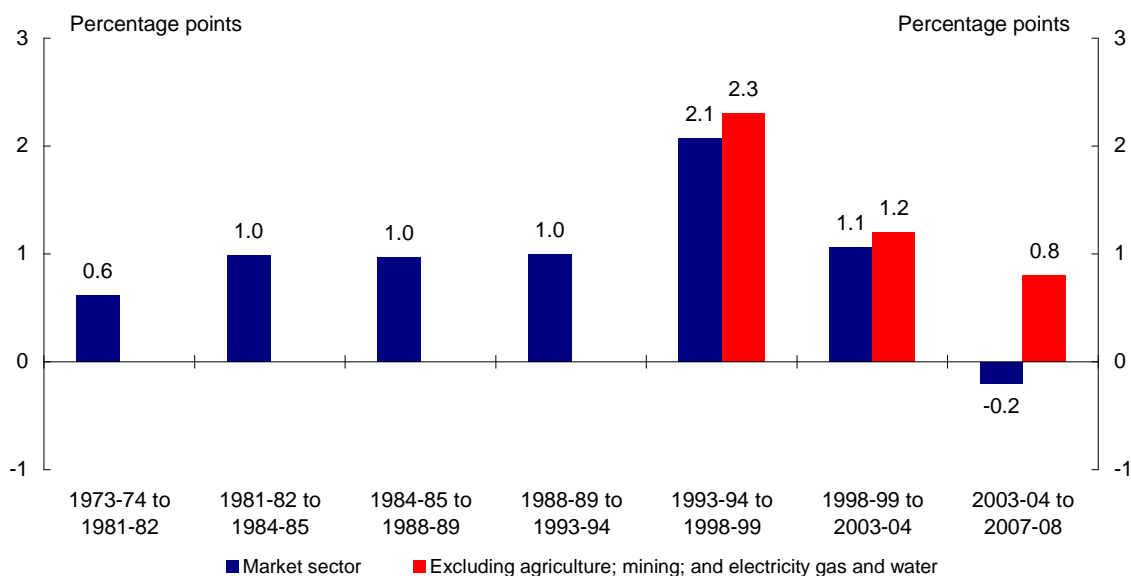
Source: OECD data.

A close watch will also need to be kept on the labour market: while the evidence to date is that the labour market continues to be flexible, it will be important to guard against any developments that might put that flexibility at risk.

### Australia's productivity performance has deteriorated in the last decade along with reform efforts

The economic reforms of the past quarter of a century contributed to a surge in Australia's productivity growth in the 1990s. Productivity growth has, however, slowed in recent years, with multifactor productivity declining by around 0.2 per cent a year in the most recent cycle (Chart 6). This productivity slowdown is evident even if certain sectors with one-off and measurement issues are excluded.

**Chart 6: Multifactor productivity growth rates within cycles**



Source: ABS and Productivity Commission.



Common themes of past economic reforms have been to open labour, capital and product markets to greater competition, improve regulatory frameworks addressing market failures (for example, competition policy) and increase the economy's structural flexibility. More recently, these have been complemented by a focus on improving education outcomes and infrastructure. While these reforms overall have transformed Australia, the terms of trade boost and low unemployment appear to have reduced the appetite for further reform.

There is a need to reform state taxes and to get industry assistance focussed on dealing with market failures and not propping up inefficient industries at the expense of the broader community. There is also a pressing need to improve housing, water and other market outcomes (Attachment E). And there is scope to improve productivity in areas dominated by government service delivery or funding of services.

The operation of various markets needs to be kept under close scrutiny to ensure that the **regulatory frameworks** are keeping pace with developments in the economy. The oligopolistic markets in key sectors such as financial services, energy and retail should also be monitored to ensure that **competition** is robust and cost increases are appropriate.

*Further market reform requires a well-functioning federal-state relationship*

Many of the earlier reforms were achieved through cooperation with the States and Territories. A well functioning federal financial relations framework will be central to the delivery of many of your election commitments in the education and health space, and to support the participation and productivity enhancing reforms identified in this brief, such as enhancements to water, housing and infrastructure.

In the Government's first term, you were able to progress reform through COAG's broad business deregulation and competition agenda. Reasonable progress has been made, and this agenda generally should be completed.

Some progress also was made in clarifying roles and responsibilities and improving accountability arrangements between the Commonwealth and the States through the new framework for federal financial relations. However, further action is needed to consolidate these reforms and ensure that they facilitate improved service delivery.

The states have indicated that they have reached, or are reaching, their capacity to deliver nationally significant reform in the context of such an intensive reform agenda. There may be merit in narrowing the scope of the reform agenda to focus on a smaller number of priority reforms. This will ensure that resources are targeted at the successful delivery of those reforms that are expected to produce the greatest enhancement to productivity and participation.

*Bedding down and advancing health reform*

The National Health and Hospitals Network (NHHN) reforms have the potential to drive efficiency and help contain growth in expenditure. A significant implementation task remains, however.

There is considerable scope for further health reform to promote more efficient, effective and responsive service delivery. Options could include consideration of a more appropriate balance between public and private contributions, clarification of the role of private insurance in the health sector and, in the longer term, a shift towards a single government funder for health care.

### *Water and housing markets*

Australia has sufficient water resources to sustain projected economic and population growth. But the allocation of those water resources — between users and for environmental purposes — bears little relationship to relative values and is unsustainable.

The Government has committed to fund the purchase of additional water entitlements to bridge any gap between environmental water obtained through Water for the Future and the new sustainable diversion limits. The future fiscal costs associated with this will be minimised and environmental benefits maximised, if infrastructure expenditure is allocated where the net benefits exceed that of directly purchasing water entitlements. Long-term sustainability in urban and rural water use will require a new, ambitious reform agenda, in partnership with the States, with binding performance-oriented timetables.

Without **further reform of water pricing, trading and infrastructure**, poor water policy will increasingly undermine economic growth, inflate the costs of sustaining even moderate population growth and result in even further irreparable environmental damage (Attachment E).

Access to adequate housing affects all Australians and is integral to a decent life. It is part of what enables full participation in society. However, the ability of many Australians to purchase or rent affordable housing has fallen over the past decade, and housing supply and allocation suffer from market inefficiencies and distortions.

These problems cannot be addressed other than by **correcting various market failures (planning, development and infrastructure provision) and regulatory failures (tax, transfers and governance)**. These failures prevent the most efficient allocation of housing resources. There is also a need to ensure that Australians in need can access housing through government intervention in the market in a way that does not discriminate between like tenants nor discourage workforce participation.

### *State taxes*

As identified in the AFTS review, **reforming state taxes** also presents an opportunity to deliver a significant increase in the long-term productivity of the Australian economy (Attachment B). Taxes levied by the States include some of Australia's worst designed and inefficient taxes. Key reforms include: stamp duties, which should be abolished; payroll and land taxes, which should be reformed; and the progressive, phased introduction of road congestion pricing.

State tax reform must be considered and progressed in the context of overall Commonwealth-State relations and, if pursued, would need to be a major focus of the COAG agenda for the next term.

### **Significant areas of social disadvantage continue to exist**

A full employment economy will place an increased focus on the direction of social policy. Indigenous Australians, the long-term unemployed, those suffering mental illness or a physical disability, and recently arrived humanitarian migrants can face disadvantages that inhibit their progress within society, even in generally prosperous economic conditions.

These groups can experience health, education and employment outcomes substantially below those in the general community. The costs of these poor outcomes increase when they lead to

intergenerational disadvantage within families. The gap in outcomes is particularly stark for Indigenous Australians. There are strong links between mental illness, disabilities, and entrenched disadvantage. Improvements to the financing and delivery of services could improve the wellbeing of the disadvantaged, including by increasing labour force participation.

Older Australians, particularly those requiring aged care, also can face social disadvantage that can inhibit their independence and social inclusion. Progressing structural reforms to the aged care system should consider the need for improving the social inclusion of this group.

The Productivity Commission has commenced an inquiry into a long-term care and support scheme for people with a severe or profound disability not associated with ageing (due in July 2011) and an inquiry into the future delivery of aged care (due in April 2011).

**A continued focus on ‘closing the gap’ between Indigenous and non-Indigenous Australians and sustainable reform of disability services, mental health and the aged care system remain major challenges in advancing the social inclusion agenda.**

Addressing these issues within the fiscal strategy will require consideration of, for example, the reprioritisation of existing spending and service approaches.

## Impact of the ALP's Policies on the Fiscal Outlook

The Treasury and the Department of Finance and Deregulation's assessment of the costs of the Australian Labor Party's policies and their impact on the underlying cash balance is set out in the following table.

Indicative underlying cash balance

	2010-11 \$m	2011-12 \$m	2012-13 \$m	2013-14 \$m	Total \$m
<b>2010 PEFO underlying cash balance</b>	<b>-40,689</b>	<b>-10,384</b>	<b>3,503</b>	<b>4,546</b>	<b>-43,024</b>
<i>UCB to GDP ratio</i>	<i>-2.9</i>	<i>-0.7</i>	<i>0.2</i>	<i>0.3</i>	
<b>ALP policies</b>					
<i>Final update of the net budget impact of election policies statement<sup>1</sup></i>					
<i>Total impact of measures</i>	123	-546	353	132	62
<i>Impact on public debt interest</i>	3	-7	-12	-1	-18
<b>Underlying cash balance</b>	<b>-40,563</b>	<b>-10,938</b>	<b>3,843</b>	<b>4,677</b>	<b>-42,980</b>
<b>Adjustments by Treasury and Finance to the underlying cash balance</b>					
<i>Adjustments to Final update statement</i>					
<i>Remove impacts included in PEFO</i>					
Building Better Regional Cities	0	61	71	71	203
Housing Affordability Fund	0	-11	-41	0	-52
National Rental Affordability Scheme	-1	-9	-46	-90	-146
<i>Adjusted costings</i>					
Trade Apprentices - Income bonuses	11	-3	15	30	52
Connecting Health Services to the Future	2	-11	-10	18	-1
<i>PDI impact</i>	0	1	2	2	6
<b>Revised indicative underlying cash balance</b>	<b>-40,550</b>	<b>-10,910</b>	<b>3,834</b>	<b>4,708</b>	<b>-42,918</b>
<i>UCB to GDP ratio</i>	<i>-2.9</i>	<i>-0.7</i>	<i>0.2</i>	<i>0.3</i>	
Net impact of ALP policies on the PEFO	139	-525	331	162	106

1. ALP release - Final update of the net budget impact of election policies statement of 20 August 2010.

The *Charter of Budget Honesty Act 1998* (the Charter) provides for the Secretary to the Treasury and the Secretary of the Department of Finance and Deregulation to release publicly the PEFO within 10 days of the issue of the writ for a general election.

The 2010 PEFO published an updated fiscal outlook that included, to the fullest extent possible, all decisions taken by the Government before the issue of the writ. The PEFO also presented economic forecasts based on the March Quarter National Accounts. These forecasts were used to underpin the revised expense, capital and revenue estimates.

The PEFO was based on external reporting standards, as required under the Charter.

The update to the fiscal outlook published in this paper is based on the PEFO. The Departments have maintained the economic projections and assumptions set out in the PEFO. In preparing advice on the public debt interest costs as part of this process, the Departments used the technical assumptions on interest rates used in the PEFO.

The Departments have revised the PEFO fiscal outlook only to reflect the cost of the ALP's policies and the associated change in public debt interest costs. To prepare this material, the Departments:

- wrote to the Prime Minister on 29 August 2010 to confirm their understanding of the ALP's policies and to clarify some costing assumptions and the financial implications and funding sources for a range of election commitments not included in the ALP's release of 20 August 2010. The Prime Minister responded on 30 August 2010;

- costed those policies and commitments not previously costed under the Charter on a ‘best endeavours’ basis using broadly the same methodology as for Charter costings. Additional information provided by the ALP was used to finalise these costings.
  - One hundred and four of the ALP’s election commitments had previously been costed by the Departments under the Charter prior to polling day on 21 August 2010.
  - The eleven remaining election commitments that had not been costed under the Charter prior to the election have now been costed.

The revised fiscal outlook is preliminary as it does not take account of parameter variations to estimates of payments and receipts that would be made by agencies in the case of a full fiscal update such as the 2010-11 Mid-Year Economic and Fiscal Outlook (MYEFO).

### **Adjustments to budget impact of election commitments**

The ALP released the *Final update of the net budget impact of election policies* on 20 August 2010 setting out the impact of the ALP’s election commitments on the fiscal outlook. The ALP announced in this statement that its election commitments would result in a cumulative improvement in the underlying cash balance of \$44 million over the four years to 2013-14.

The Departments’ assessment is that the ALP’s policies would result in a cumulative improvement in the underlying cash balance of \$106 million over the four years to 2013-14.

The difference between the two estimates of the fiscal outlook reflects:

- the inclusion by the ALP of three measures already built into the PEFO baseline – adjusting for this has a small net positive impact on the underlying cash balance;
- the Department of Finance and Deregulation’s costing of the Trade Apprentices – Income Bonuses policy using current forecasts for apprentice numbers;
- an adjusted profile for the Connecting Health Services to the Future; and
- the change to public debt interest costs reflecting the revised budget position.

On the basis of the advice received from the Prime Minister on 30 August 2010, the Departments are satisfied that, with one exception, the funding for the commitments that were not included in the ALP’s release of 20 August 2010 can be met from within the existing forward estimates. The exception is the proposed offshore migration processing facility. That proposal cannot be costed at this stage because the details of the policy are yet to be settled.

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## A tax reform agenda

### Key conclusions

The tax and retirement income system is not broken, but it is fragile in parts and needs renovation to address current and future pressures. The challenges to the durability and legitimacy of the tax system include: declining sustainability and efficiency of some existing taxes; managing the increasing complexity/inequities of the tax system; and structural tensions from changes in society (population issues), the environment and technology.

The Australia's Future Tax System (AFTS) review provides a conceptual framework for thinking about tax reform over coming years. The main constraints to reform are the tight fiscal circumstances and (obviously) constraints in the political realm. A narrative for reform needs to be built around: sustainability of the system; opportunities to make tax less onerous; and support for a dynamic economy.

Key areas of reform that might be developed next are promoting governance, initiating steps in State tax reform, further reducing the taxation burden on capital income, promoting participation and reducing complexity.

### Existing Government policy

The Government provided an initial response to AFTS when the review was released and in the following resource tax and consequential modifications. These 'first steps in a 10-year agenda' touched on many of the reform themes in AFTS. There is a substantial implementation agenda over the next several years, including the Minerals Resource Rent Tax, the company tax measures, the superannuation measures and the tax governance changes announced during the campaign. The Government has indicated that this will be the focus of its second term.

### Priority areas for reform

The AFTS review looks forward over the next 40 years to provide a conceptual framework for thinking about reform of the tax and transfer system. A key task for the Government is to consider which of the outstanding reforms should be prioritised for development, if not in this term, then the next. Given that tax reform often involves either 'losers' or substantial fiscal costs, careful and substantial work to underpin the case for reform will be required. Some reforms may only be possible when there is a stronger fiscal situation — but reforms should be 'ready' for that eventuality.

This brief suggests a prioritisation of reform areas which provide the greatest potential contributions to economic performance and to the functionality of the tax system.

*State tax reform:* Taxes levied by the States include some of the least efficient and worst designed taxes in Australia's tax system. The AFTS recommended reforms were estimated to yield a long-term increase in GDP of 1.7 per cent.

Over time the States have not been able to undertake significant reforms to their taxes and they periodically engage in destructive competition. The fiscal equalisation process does not promote reform. The key substantive State taxes that need reforming include:

- stamp duties on insurance, housing, commercial property and motor vehicles (abolish);
- payroll and land taxes (reform or replace with more efficient taxes); and
- road pricing (introduce).

The AFTS vision of a cash flow tax in replacement of various state taxes is a long-term option.

Any moves in State tax reform must be considered and progressed in the context of overall Commonwealth-State relations. So if reform of this magnitude were to be seriously pursued, it would need to be a key focus of the COAG agenda for the next term.

*Capital income:* In a world of increased capital mobility, taxes on domestic investment and production (such as company income tax) have an increased impact on decisions by businesses on where to invest. As such, AFTS concluded that taxes should move away from more mobile tax bases, such as capital, towards less mobile bases such as land, resources and consumption. Further, the pattern of taxes on savings and investment income is a mess — too high in places and too low in others.

The Government has indicated that implementation of the Minerals Resource Rent Tax and the cut in the company tax rate will be a focus for its next term.

*Renovation of existing taxes:* The trust taxation provisions are also a significant area of complexity and uncertainty. The practical operation of the system is degrading and is ultimately not sustainable — we support the AFTS recommendation that the trust rules should be updated and rewritten.

The superannuation system is increasingly leaking revenue, with Self-Managed Super Funds now the tax minimisation vehicle of choice. Better enforcement and acceptance of the Cooper recommendations are part of a solution to plug some structural holes.

*Participation:* An inevitable feature of Australia's targeted tax and transfer system is that it creates some disincentives to participate in the workforce. This reduces the level of economic activity by limiting the labour supply in an otherwise fully employed economy. It can also harm some of the most disadvantaged individuals in society in welfare traps. Some of the worst disincentives to participate apply to secondary workers in families, single parents, people in public housing and those on the Disability Support Pension (DSP) who nevertheless have some capacity to work (see Attachment F). There are many options to reduce such disincentives, including changes to child care, rent assistance, activity tests, income tests and taxes.

Participation needs to be looked at in a broad wellbeing framework and more needs to be done to properly understand all of the drivers of people's decisions.

*Complexity:* The AFTS review found that the capacity of users of the tax system to deal with its complexity has been over-reached. This reflects the desire of successive governments to use tax as an instrument of social policy and industry assistance, with insufficient weight given to the compounding effect on complexity. The recommendations in AFTS to improve the design of the four main tax bases and to move to abolish other taxes provides the



framework for reducing complexity in the tax law. Ongoing efforts are needed to support initiatives to simplify tax compliance for the bulk of personal income taxpayers, for example through measures such as the pre-filling of tax returns.

The AFTS analysis is also instructive in thinking about the constant pressures to tinker with the tax law to address the many specific issues that arise. At a minimum, the continual pressure for such changes from narrow interest groups needs to be resisted. Simplicity needs to be given a greater weight in policy decisions and further erosion of key tax bases needs to be avoided.

### **Policy solution or pathway forward**

These five areas provide the basis for development of a further tax and transfer system reform agenda for the Government. At the time of the release of AFTS, the Government indicated that its response was ‘the first wave’ with other recommendations being subject to ongoing public debate. The Government could seek to focus that debate on these areas during its second term, with a view to moving towards a second wave of reforms. The emphasis would be on making the case for reform and seeking to build a consensus on a reform agenda, including through the progressive release of policy discussion papers.

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## **A comprehensive population strategy**

### **Key conclusions**

Without a sharp and significant reduction in net overseas migration (NOM), the Australian population will continue to grow relatively strongly over the next 10 to 15 years, particularly given powerful global factors driving the Australian economy. Policy must plan for this to ensure the sustainability of such population growth.

Migration can provide Australia with the opportunity for both economic and cultural growth. There is a need for a population strategy that focuses migration on improving Australian living standards, while taking into account Australia's capacity to absorb the associated rates of population growth, and humanitarian and family reunion obligations.

Infrastructure, cities, housing and environment policies should be based on effective policy settings taking into account the range of relevant policy objectives for these issues, including sustainably accommodating population growth.

### **Planning for inevitable population growth**

The IGR 2010 projection of 35.9 million people by 2050 already factors in a significant drop in NOM from a peak of almost 300,000 in 2008-09 to 180,000 a year from 2011-12. Even with this sharp drop in NOM, the average annual rate of population growth does not fall to the 1.4 per cent average of the previous 40 years until 2021.

Even if NOM were to average only 60,000 a year over the next 40 years (a level of NOM exceeded in 25 of the past 30 years, and significantly below the 40 year average of around 100,000) Australia's population by 2050 would still be expected to grow to about 29 million. Given the powerful global forces driving the Australian economy, net immigration figures well in excess of that low number are probably inescapable.

It is expected that much of the population growth will occur in cities, in line with Australian and worldwide experience over the last century. Over the next 20 years, around two-thirds of the increase in Australia's population is projected to occur in capital cities. The choices of people and businesses to locate in cities is driven by the productivity growth of urban areas that generates economic opportunity and access to services. The ability of government to counteract these long-established forces through regional policy would appear limited.

### **Possible elements of a sustainable population strategy**

The Government's commitment to a comprehensive population strategy that builds on community consultation has the potential to galvanise improvements in managing population growth.

Well managed population growth can improve Australian living standards and assist Australia to adapt to an ageing population. However, population growth can exacerbate existing policy concerns associated with the current lack of forward planning, under-investment in infrastructure and inadequate environmental settings. This is especially likely to be the case when the rate of growth exceeds what is planned for by different tiers of government.

Australia's capacity to accommodate a growing, yet sustainable population, depends crucially on planning and investing for that population now. As the States make many of the pertinent policy trade-offs regarding population, careful consideration needs to be given to Commonwealth attempts to influence their decisions.

A population strategy needs to establish a credible set of principles for:

- a long-term migration framework to guide the aggregate size and composition of the annual migration program, with the program designed to support growth in Australian living standards and assist with meeting the labour force needs of the economy;
- ensuring population growth can be effectively managed through:
  - establishing principles that guide policy settings needed in key areas to ensure sustainable outcomes (such as management of the environment and water) and the role of different tiers of government in response to population growth; and
  - guiding the investment and planning for the future needs of the population given its projected size, geographical location and demographic composition.

This is about more than simply building new infrastructure. It is about investing in the right kinds of infrastructure and using existing infrastructure more efficiently. This requires appropriate regulation and pricing, private investment, and contestable and competitive infrastructure markets.

A regular independent report (by Treasury or a body like the Productivity Commission) outlining 20-year aggregate, geographic and demographic population projections could inform the planning and investment of all three tiers of government.

Ensuring the IGR is linked to these independent projections and is perceived to be an independent assessment of the sustainability of government policies would aid credibility. A recommended change would be to release the IGR every three years as a Treasury rather than a Treasurer document.

The population strategy should acknowledge upfront that policy responsibility for key areas remains embedded in line agencies with portfolio ministers. There may be a rationale for more formalised communication between Commonwealth agencies and between the Commonwealth and the States on planning for population growth and change.

The extent to which regional policies can influence settlement patterns, however, is likely to be limited. Historical experience shows regional settlement policies are expensive and ineffective, and result in an inefficient allocation of resources. This will particularly be the case in a full employment economy where any short-term employment and economic gains of one locality will inevitably come at the expense of another.

Policies that directly ensure regional areas are adequately served by infrastructure, manage external costs generated by cities (such as congestion) or reduce the cost of moving from one region to another are likely to generate the most efficient and lasting outcomes.

**Next steps**

- A Cabinet submission proposing the scope for the development of a population strategy and a consultation process, including by taking into account the issues identified by the three population advisory panels.
- A joint cabinet submission from the Treasurer and the Minister for Immigration and Citizenship canvassing the options for a long term migration framework, to be considered alongside a population strategy submission.

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## Climate change — Market based mechanisms

### Key conclusions

The Government has committed to reduce national emissions to 5 per cent below 2000 levels by 2020, with more ambitious targets depending on the extent of international action. Without a carbon price, the 5 per cent target cannot be met without significant budgetary or economic costs. Early introduction of a pricing regime will support strong, long-term growth by steadily transforming the economy instead of imposing sharp, more costly adjustments in the future.

The Government has agreed to establish a Climate Change Committee consisting of members who acknowledge that reducing carbon pollution by 2020 will require a carbon price. The Government has also announced:

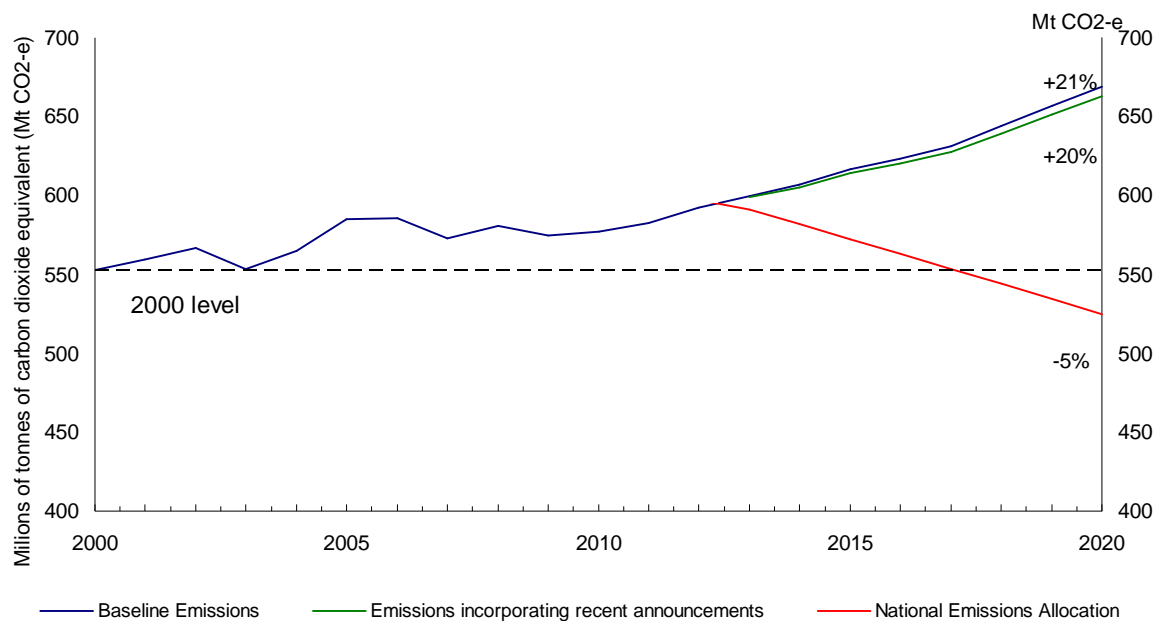
- it will consider the implementation of carbon pricing via a Carbon Pollution Reduction Scheme (CPRS) after assessing if there is sufficient international action at the end of the Kyoto period in 2012;
- measures to boost support for electricity transmission and energy efficiency in buildings,
- a cleaner car rebate, and
- the establishment of a Climate Change Commission and a 150-strong Citizens' Assembly to build support in the community.

### The emissions reduction challenge

The emissions reduction challenge is significant. The sooner that emissions are reduced below 'business as usual' levels, the more likely it will be that we can achieve a smooth and orderly transformation of the economy.

Direct action measures alone cannot do the job without imposing significant economic and budget costs. Department of Climate Change and Energy Efficiency preliminary estimates of the abatement achieved from the announced election commitments (Chart D1) shows the abatement challenge of moving to even the 5 per cent reduction target.

**Chart D1: Australia's emissions and the contribution of announced election commitments**

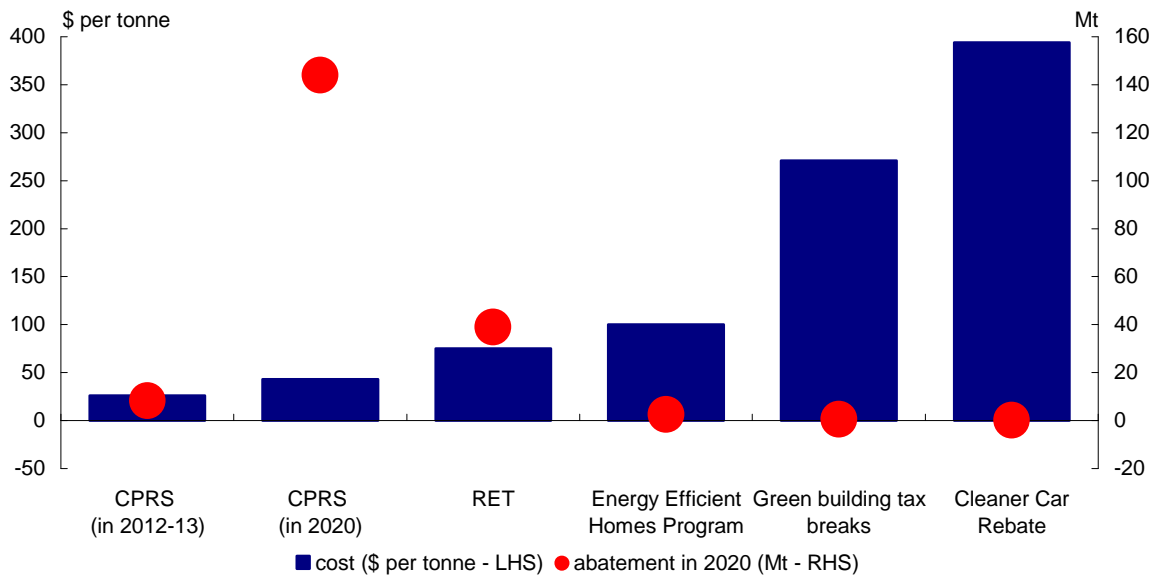


Note: Estimates of costs and abatement are heavily dependent on policy design. Due to lack of information, some assumptions have been made to enable an estimate to be derived. Any changes to policy design will change the abatement and costs.  
Source: Department of Climate Change and Energy Efficiency — preliminary indicative estimates.

The longer Australia delays implementing a comprehensive carbon pricing regime, the more costly and disruptive will be the change. There are also real and present costs associated with ongoing uncertainty around the climate change policy framework, particularly in the electricity generation sector.

Interim policies should be consistent with a move to a future carbon price. Many of the alternative policies will, however, only achieve small abatement outcomes at high costs per tonne of abatement, far in excess of current CPRS carbon price projections. These higher costs will be felt by taxpayers directly or indirectly through higher costs to consumers and businesses from hidden regulatory imposts. A market-based mechanism achieves the necessary abatement at a cost per tonne of emissions significantly lower than other policies (Chart D2). Moreover, many of the direct action measures cannot be scaled up to achieve significant levels of abatement, and for those that can be scaled up, the cost per tonne of abatement would rise rapidly.

**Chart D2: Indicative abatement and cost estimates for various emissions policies**



Note:

- (a) Estimates of costs and abatement are heavily dependent on policy design. Given limited information, some assumptions have been made to enable an estimate to be derived. Any changes to policy design will change the abatement and costs.
- (b) These estimates are intended to provide an indicative comparison only, and present either average costs over the period to 2020 or marginal costs in the case of the CPRS and RET.
- (c) Cost estimates for Energy Efficient Homes, Green Building Tax Breaks and the Cleaner Car Rebate are partial and reflect only fiscal costs. They also do not account for any energy cost savings that arise.

Source: The Treasury and Department of Climate Change and Energy Efficiency.

## Enhancing community support and starting the economic transformation

While concerns exist about the cost of living impacts of a CPRS, there are options to progress towards and build community support for a market based approach. An expanded role for the proposed Climate Change Commission could include informing the community, not just on the climate change science, but also on the impacts on Australia of climate change and the benefits of alternative mitigation options.

A low fixed-price CPRS or similar levy on the energy sector could work as a critical first step towards implementing a fully operational CPRS. This, combined with a clear outline of the ‘trigger point’ for a low fixed price to be replaced by a CPRS, would help build community consensus for carbon pricing by allaying concerns regarding the impact of a carbon price on household costs and its broader impact on emissions-intensive businesses. Depending on the level of fixed price chosen, there could be an opportunity to use some of the revenue raised to fund other climate change policies.

It will also be important for Australia to continue to engage internationally on climate change mitigation and to push for a robust international agreement.

In terms of building community consensus, the Productivity Commission (PC) could also play a role in increasing the understanding of comparable carbon constraints that apply in major economies. This would include commissioning the PC to undertake detailed work on estimating the cost of action (through carbon pricing or other mitigation measures) in these economies. This work would be complex and would be likely to take considerable time, so should be seen as a priority.



Even with significant mitigation action, we will also require effective policy frameworks to manage the climate change that is already inevitable. A PC examination of the costs and benefits of various adaptation options to identify the highest priority reforms and the role of market-based approaches in facilitating adaptation would be a worthwhile first step. All levels of Government must implement measures and appropriate regulatory approaches to enable private participants to respond efficiently to this challenge.

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## **Improving our cities and infrastructure**

### **Key conclusions**

There remain significant opportunities for addressing inefficiencies in key infrastructure, water and housing markets and in improving the planning and functioning of our cities. Important reform streams yet to be completed include heavy vehicle road user charging and telecommunications/broadband reform, while reform of the water industry needs to be reinvigorated.

More can also be done to improve the regulatory and governance frameworks for the efficient provision of national infrastructure. Reform of Infrastructure Australia (IA) would be a significant first step, reinforcing the need for rigorous cost-benefit analysis of project proposals and enhancing the pipeline of ready projects for investment.

### **Reforming IA and enhancing the infrastructure pipeline**

IA was established in 2008 to drive the development of a long-term, coordinated approach to national infrastructure planning and investment and to identify projects with high overall benefits. IA has made considerable strides in this direction. Its funding, however, expires in 2010-11 and this presents an opportunity to consider ways to enhance its role, including:

- improving coordination of infrastructure investment across levels of government and ensuring rigorous cost-benefit analysis of projects;
- establishing an enhanced national infrastructure pipeline to provide a portfolio of potential investments for the private sector (including superannuation funds); and
- continuing to develop and assist in the implementation of national transport strategies and participating in the development of capital city strategic plans.
  - IA found it difficult to identify ready-to-deliver, nationally significant infrastructure investment proposals for the Government to consider as part of the recent fiscal stimulus packages. This highlighted a lack of rigorous, coordinated long-term planning, especially on the part of the states and territories.
  - : The situation has not changed. While many projects are under development, the list of national priority projects that IA has identified as ‘ready to proceed’ in its June 2010 report to COAG contains no new, major projects.

### **Financing the Government’s spending on infrastructure**

IA’s pipeline will identify key infrastructure priorities but leaves open the issue of how they will be funded. Regulatory reform will be critical to ensure the pricing signals necessary to promote private sector investment in infrastructure. Such an outcome is clearly desirable to ensure that scarce resources are allocated to their most efficient use.

IA’s pipeline may identify projects that merit direct government support where they would not proceed without it, either because the private sector cannot capture a positive externality or because it cannot quantify or manage the risk associated with the project (such as patronage risk). The States and Territories are primarily responsible for funding public

infrastructure, but inevitably the Australian Government also will be involved as a result of its broader tax base. The capacity of the Government to finance infrastructure will be limited by the current fiscal circumstances. Once a surplus has been delivered, however, there may be an opportunity to revisit the level and manner in which the Government invests in infrastructure.

## Continuing reform in key infrastructure markets

Completing reforms to regulation, governance, planning and pricing in key infrastructure markets will ensure more efficient use of existing infrastructure while also facilitating better investment outcomes.

- An early priority should be to finalise the Government's response to the *National Broadband Network* (NBN) Implementation Study for the roll-out of the NBN and to seek passage through the Parliament of related regulatory reforms.
  - These measures will transform the structure and competitive dynamics of the telecommunications sector. However, there are risks for financial and competition outcomes and consequently the Government's response to the Implementation Study will require careful consideration.
- Maintaining the momentum of *energy market reform* will be important for ensuring that electricity and gas markets can respond efficiently to the long term growth in demand for energy in a carbon-constrained world. Moreover, a more settled climate change policy will overcome the present uncertainty that is causing delays to investment in new, lower emission electricity generation sources (Attachment D).
- Key priorities in the *transport sector* include the continuing work to reform heavy vehicle road user charging, addressing urban transport congestion and delivering on COAG's agreement to establish single national regulators for each of heavy vehicles, rail safety and maritime safety.
- Australia has sufficient *water resources* to sustain projected economic and population growth. However, urgent and ambitious reforms are required to improve the allocation of those resources between users, as well as for environmental purposes, and to avoid significant costs for the economy and the environment.
  - The commitment to bridge any gap between environmental water recovered under Water for the Future and what is required to be returned by the Murray Darling Basin Authority will likely present significant fiscal risks. These will be minimised and environmental benefits maximised if infrastructure expenditure is allocated where the net public benefits exceed those of directly purchasing water entitlements.
  - The Government should supplement reforms in the Murray Darling Basin with additional work with the States to develop a new, more ambitious reform program with binding timetables, particularly in pricing urban water, structural separation of public urban water monopolies and implementation of third party access regimes for water, sewerage and stormwater systems.

## **Cities and housing**

Australia's cities have high but declining standards of amenity, low population density, growing congestion, worsening housing affordability and low levels of industry clusters. Many of these outcomes result from fractured and ineffective governance arrangements.

Getting it right with cities has significant potential, not just from a pure economic perspective, but also from a social and environmental perspective. Getting it wrong is likely to be very costly economically, socially and environmentally.

To get cities right, existing impediments to the implementation of city strategic plans must be addressed. Governments must ensure better integration across relevant agencies and functions, with current failures in these areas imposing significant costs, delays and risk on aspiring home owners and undermining urban infill targets. Additional priorities include the improved prioritisation, provision and financing of urban infrastructure and, in the case of larger cities, better provision of public transport, particularly along strategic corridors.

While these issues are primarily the responsibility of the States, the Australian Government could contribute and expedite reform through developing the National Urban Policy Reform Agenda, and implementing COAG's Capital City Strategic Planning Systems and the Housing Supply and Affordability Reform agenda, which involves an examination of:

- options for reforming government processes such as planning, zoning and strata titling;
- government requirements that increase building costs such as those building, energy efficiency and environmental regulations that impose net costs on the community;
- the ways more consistent and transparent infrastructure charges increase developer certainty;
- the ways underutilised government land could be reallocated to uses such as housing; and
- the impact that State taxes have on the housing market (see 'A tax reform agenda' at Attachment B for stamp duties and land tax proposals).

The Australian Government provides significant recurrent funding to help Australians in housing need. An incoming government should enhance the effectiveness of this assistance by:

- examining how to better target around \$2.8 billion a year of Commonwealth Rent Assistance so that Australians in genuine need can access appropriate housing; and
- examining whether a renegotiated National Affordable Housing Agreement (around \$1.2 billion a year) should include a per dwelling funding basis for public housing and how it could deliver greater equity between public housing residents and CRA recipients.

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## Labour force participation and skills

### Key conclusions

As Australia emerges from the economic downturn and the unemployment rate decreases, we can expect to see labour supply constraints re-emerge. This will be exacerbated in the longer term by the ageing population.

With these capacity constraints, short-term policies that inhibit the ability of the labour supply to adapt could distort the efficient reallocation of labour. Targeted policies should aim to support more of the most socially disadvantaged into work, as well as to increase labour force participation in the medium to longer term by drawing additional people into the labour market.

Policy responses could include:

- measures to boost labour force participation, by removing policy distortions that prevent the efficient allocation of labour or that act as a disincentive to participate, as well as through using appropriate temporary and permanent migration. Distortions can include Commonwealth tax and income support settings, as well as their interaction with services such as child care and public housing; and
- policies to ensure that the workforce, or those at risk of social and economic disadvantage, have the education and skills to meet the demands of employers and drive increases in labour productivity.

### Increasing labour force participation

The Government has committed in the short-term to strengthening the jobseeker compliance regime and to trialling the provision of relocation assistance of up to \$6,000 for jobseekers who move to take up an ongoing full-time job or apprenticeship. In the medium to longer-term, removing policy distortions and disincentives that currently exist in the tax-transfer system will be an important element of increasing labour force participation (Attachment B). This is particularly the case for females of prime working age (ages 25-54), where existing policy settings are contributing to Australia's low participation rate compared to a number of OECD peers. Increasing labour force participation in this relatively large cohort could significantly affect overall labour supply.

The structure of family and child care payments and the complexity of multiple payments result in lower than desired or achievable participation. The interaction of these policies with other changes driving adjustments to the price and availability of services, such as the national quality agenda for early childhood education and care, needs to be examined.

A range of options are likely to exist to make either modest or more substantive changes within a broader tax-transfer reform agenda that contribute towards increasing labour force participation. Given the sensitivity to, and the cost of implementing such reforms, they may only be achievable if there is a stronger than expected fiscal situation.

Building on AFTS, we intend to undertake a detailed analysis of tax-transfer issues and interactions in relation to participation, to develop options and a pathway to reform.

## Education and training

Ongoing increases in educational attainment across successive generations will continue to support higher participation. In its national policy leadership role and as a key funder of education and training, the Government has a central responsibility for continuing to drive attainment of high quality skills. A flexible and responsive national education and training system will allow educational institutions to adapt quickly and efficiently to the changing skill requirements of the Australian economy.

Government reforms to schools policy and higher education have made strides towards achieving this outcome. Your Government's election commitments on schools policy build on those reforms through a range of medium-term initiatives that seek to deliver improved outcomes through enhanced school autonomy, the introduction of teacher and school performance incentives and the improved integration of trade training in schools. The Schools Funding Review, due to report in late 2011, will provide a further opportunity to drive reform in schools policy, but it will need to be consistent with the fiscal strategy.

**Vocational Education and Training (VET):** The VET sector (with the exception of Victoria), suffers from tight supply-side constraints that prevent providers from responding effectively to shifts in student and industry demand. This is exacerbated by rigidities in the market and limited contestability of funding.

Continued action should be consistent with the reform direction articulated in the 2010-11 Budget to assist the States to make system-wide reforms. This includes introducing of an entitlement model for VET for young people and others who wish to up-skill and making the system more responsive to employer and student needs. The Government should press on with negotiations with individual states, including clarifying its priorities and level of financial commitment.

**Apprenticeships:** During the election, you announced increases to the financial rewards for trade apprentices completing their training. There is a strong case that the Australian Apprenticeships model is in need of wider reform: apprenticeships take too long, with an outdated focus on time served rather than competency. The Government has recently appointed an Expert Panel to review the system, supported by the National Centre for Vocational Education Research. It is expected to report in early 2011.

## Increasing participation for socially disadvantaged groups

Despite a near full-employment economy, certain socially disadvantaged groups such as people with disabilities, long-term unemployed and Indigenous Australians will continue to find it difficult to move into sustainable employment. Quite often, it is the presence of multiple disadvantages, such as ill-health in combination with low education and skills, which particularly impact on the chances of finding permanent employment.

While substantial support and commitments currently exist for these groups, current fiscal circumstances suggest that substantial new initiatives in this area will be difficult to take forward in the short term.

Existing reforms to the Job Capacity Assessment announced in the 2010-11 Budget and changes to the impairment tables currently being developed, will go some way towards slowing the flow of people onto Disability Support Pension, a benefit from which very few people currently return to work. The development of a Government response to the

Productivity Commission inquiry into Disability Care and Support, which will consider the interactions with employment services and income support of any proposed scheme for people with a severe and profound disability, may provide an opportunity to also pursue medium-term options for broader reform of payments for people with disabilities.

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## **Comprehensive review of the financial sector**

### **Key conclusions**

Although Australia's financial system performed well through the turmoil of the Global Financial Crisis (GFC), it is experiencing significant changes. The GFC, along with increasing integration with international financial markets and developing technologies, presents substantial challenges.

The GFC highlighted the vulnerability of Australian borrowers and some retail and wholesale investors. It also showed systemic risk originating from outside the prudentially regulated sector. Existing concerns about competition in financial markets have been exacerbated through consolidation and the exit of key market participants. International regulators responding to the GFC are proposing far reaching regulations, to which Australia has committed.

In response to these issues, many countries are reviewing their financial regulation frameworks and are making substantial changes. Australia has not undertaken a comparable review since 1997 and we strongly urge you to make this a key priority in your second term.

### **Reviewing and reforming Australia's financial system**

A number of streams of work are already underway:

- exploring options to address the funding threat posed by global financial turmoil on consumer and business access to credit;
- identifying ways to improve competition in the financial sector;
- implementing the G20 regulatory responses to the GFC that will require financial institutions to meet international benchmarks to access funding and compete internationally; and
- developing government responses to a number of current reviews of financial products and services, investor protection, Australia as a financial centre, taxation and superannuation.

There is merit in establishing an inquiry that draws together the existing work streams and considers broader, more systemic issues. This includes considering the lessons from the GFC and the balance between the dual objects of stability and safety, and competition and efficiency. The best time for such an inquiry to commence is once markets have stabilised and G20 outcomes have become clear.

### **Next steps**

We could develop draft Terms of Reference, enabling the Government to commission either an independent expert, or panel, to conduct the inquiry.

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## **International engagement: The G20, China and India**

### **Key conclusions**

China and India are the key drivers of the shift in global strategic weight towards Asia, from which Australia is a key beneficiary. The G20's elevation during the GFC is emblematic of this shift, with G8+ architecture securing little substantive engagement from China and India.

The Government has been strongly supportive of the G20, with Australia working actively to entrench the G20 as the premier forum for global economic cooperation. Entrenching the G20 as the world's premier forum for international economic cooperation and continuing to deepen the institutional underpinnings of Australia's economic relationships with China and India are key international economic policy challenges.

### **China and India are important to Australia's economic prospects**

China is clearly important to Australia's economic prospects. It is our largest trading partner and its demand plays a key role in driving price movements of our major exports, most notably coal and iron ore. We are China's largest supplier of iron ore. China is an increasingly important source of foreign direct investment and Australia gains from this investment. China is already a major investor in our resources sector.

However, our importance to China as a supplier of strategically important commodities and as a politically stable, resource-rich destination for investment gives us some profile and influence.

Australia-China investment concerns have abated over the past year as both governments have adapted to the reality of closer economic engagement. [REDACTED]

India is also a rising economic powerhouse and has recently become Australia's fourth largest export market. With a favourable demographic base and strong infrastructure needs over the coming decades, Australia stands to benefit significantly from India's emergence.

### **Entrenching the role of the G20**

The G20 provides a forum in which Australia can engage with its key economic partners as well as play an influential role in global decision making. China is playing an increasingly significant role in the G20 [REDACTED]

It is in Australia's interests to cement the G20's role as the pre-eminent forum for international economic engagement. This will require ensuring that it delivers on its commitments and demonstrates that it can work cooperatively to address longer-term, post-crisis issues. A key risk is that the agenda becomes too broad, making it difficult to finalise agreement among members and for Finance Ministers and Leaders to drive the agenda.

China's approach to the G20 will be critical to its ongoing significance. As Chinese growth continues, China will become more confident, active and forceful in asserting its position.

[REDACTED]

A close bilateral economic relationship is important to ensure a deep understanding of the Chinese economy and to better understand and influence Chinese attitudes to major international economic policy issues that affect our interests. It is also important to ensure that the trade and financial flows which have been so beneficial to Australia can continue to grow.

### **Next steps**

A whole of government approach is needed in handling China issues.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

To ensure China stays engaged in the G20, we need to continue our efforts to ensure that the global policy response to the rebalancing of growth is one that includes actions from all major economies and does not single out China.

Advancing Australia's economic engagement with India is critical for similar reasons.

[REDACTED]

Nurturing the bilateral relationship, through regular visits by Ministers and senior officials and greater policy cooperation, will help the Australian mission to build its influence in a challenging environment.

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