

Chapter 1

Adjusting to the mining boom and Asian development

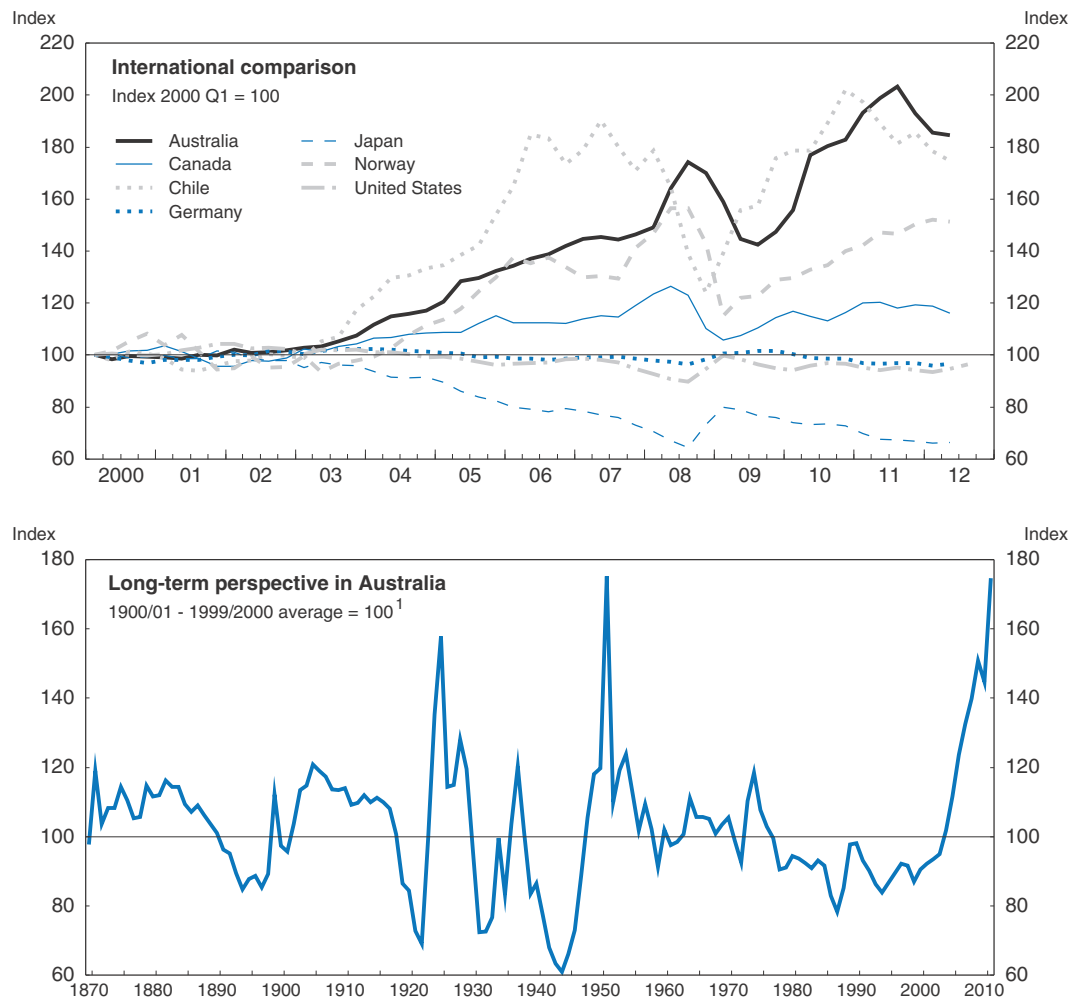
Australia has been adjusting to substantial economic structure changes linked to historically strong terms of trade, the boom in the mining sector and a very high real exchange rate. All these developments are linked to rapid growth in Asia, especially China, and the resulting demand for raw materials. They have had far-reaching effects on the economy through sharp income growth, strains on productive capacity that could affect macroeconomic stability and substantial structural changes, both sectorally and regionally, due to the geographical concentration of mining activities. Since the beginning of the recent mining boom, the challenges of the so-called multi-speed economy have taken centre stage in the Australian economic debate.

The country's adjustment to the mining boom has so far produced favourable results, even as it has imposed significant strains, in particular in the non-mining tradable sectors. The development of Asia offers challenges and opportunities beyond terms-of-trade developments, as the gradual emergence of a huge middle class with potentially large demand to be satisfied will expand markets and open new ones. To take full advantage of these ongoing changes, a smooth reallocation of resources in the economy should be encouraged. The medium-term fiscal strategy should take better account of the likely increase in the economy's volatility and its greater dependence to the fluctuations of the terms of trade. Tax reforms have a useful role to play in facilitating the ongoing structural adjustments, while it is essential to maintain a flexible labour market.

The effects of and response to the shock

The shock to the economy from the rising terms of trade is large, not only from a historical standpoint but also in comparison with other countries (Figure 1.1). This is the third sharpest terms-of-trade increase for an OECD country since 1960, after those of Chile (between 2001 and 2011) and Norway (between 1998 and 2008). Moreover, the rise would appear longer-lasting than similar episodes in Australia in the past. While boosting income and output growth, the shock is also a potential source of strains, both in terms of macroeconomic management and the impact on resource allocation.

Figure 1.1. **Terms of trade**



1. Calendar year prior to 1900, financial year thereafter.

Source: RBA and OECD, OECD Economic Outlook Database.

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The macroeconomic effects of the shock were well managed

The global commodity price boom has increased Australia's comparative advantage in the resource sector. The most immediate direct effect was a boost to mining export revenues and a shift of Australian exports from the United States and Europe towards Asia, and in particular China. Capital expenditure in the mining sector has tripled since 2003, to about 4% of GDP in 2011, and it is expected to double again to more than 8% of GDP in FY 2012/13 (ABS, 2012). As a result, export capacity can be expected to expand by 50% by 2015 for iron ore and by 20% by 2013 for coal (Christie et al., 2011). A tripling of export capacities in the liquefied natural gas (LNG) sector, which accounted for half of aggregate mining investment projects at end-2010, is also expected (Connolly and Orsmond, 2011).

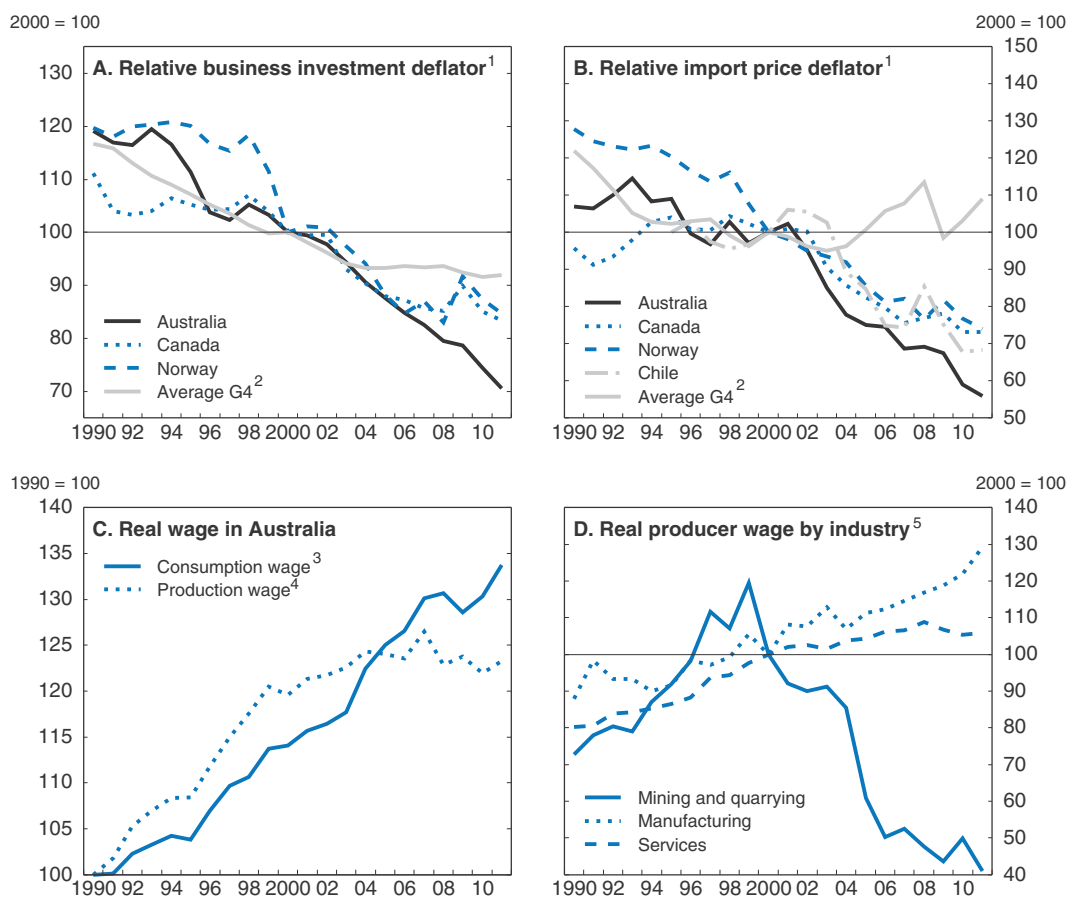
The commodity price boom also had substantial repercussions on the overall economy through rising incomes, and through spending by the mining sector and by states rich in natural resources. Roughly half of the increase in income and capital investment by mining firms benefited the economy directly, for example, through purchases of local goods and services (Connolly and Orsmond, 2011). However, this was concentrated sectorally, since the sectors that benefited directly from the expansion of the mining industry and, in particular from the investment boom, accounted for about 7% of GDP in FY 2010/11 (Gruen, 2011). Coupled with the high exchange rate, this has deepened sectoral growth disparities, thereby accentuating the potential for a two-speed economy. The mining industry and related sectors, which represented around 17% of GDP in 2011, contributed 12% on average to non-farm GDP annual growth before the boom, which increased to 27% between 2004 and 2007, and over 50% in FY 2010/11.

The boom also had spillover effects on the economy. Incomes are boosted by lower import prices and exchange-rate appreciation (Figure 1.2, panels A and B). A *second effect* is related to the fiscal policy, because of an immediate redistribution through tax cuts or new public expenditure of most of the additional tax revenue derived from the terms-of-trade gains, especially during the first phase of the boom between FY 2002/03 and FY 2007/08 (OECD, 2008). A *third effect* was massive job creation in the service sector. As predicted by theory, this has been the sector most favoured by the combination of domestic demand generated by higher incomes and the substantial changes in relative prices, including weaker growth of real production wages (Figure 1.2, panels C and D).

A growing number of firms in the tradable non-mining sector, from manufacturing, tourism and education sectors, need to adapt, primarily because of their declining competitiveness and rising real exchange rate (Figure 1.3). Manufacturing export growth has come to a standstill since 2000. The comparison of production performance in this sector between Australia, Canada and Norway shows the differentiated influence of exchange-rate movements in these countries since the beginning of the mining boom. The real effective appreciation of the Australian and Canadian currencies has contributed to a more rapid decline in the manufacturing sector than in Norway, where the real exchange rate has remained stable. Moreover, growth in employment and capital investment has weakened in manufacturing relative to the rest of the economy since 2007, suggesting that strains on this sector have intensified (Figure 1.3).

While the appreciation of the real exchange rate has imposed significant pressures on some sectors, it is unclear how its level compares with equilibrium, which depends on the fundamental determinants of the currency and is difficult to measure in practice (Garton et al., 2012). On the one hand, purchasing power parity indicators show that, in 2011, the

Figure 1.2. Relative price changes



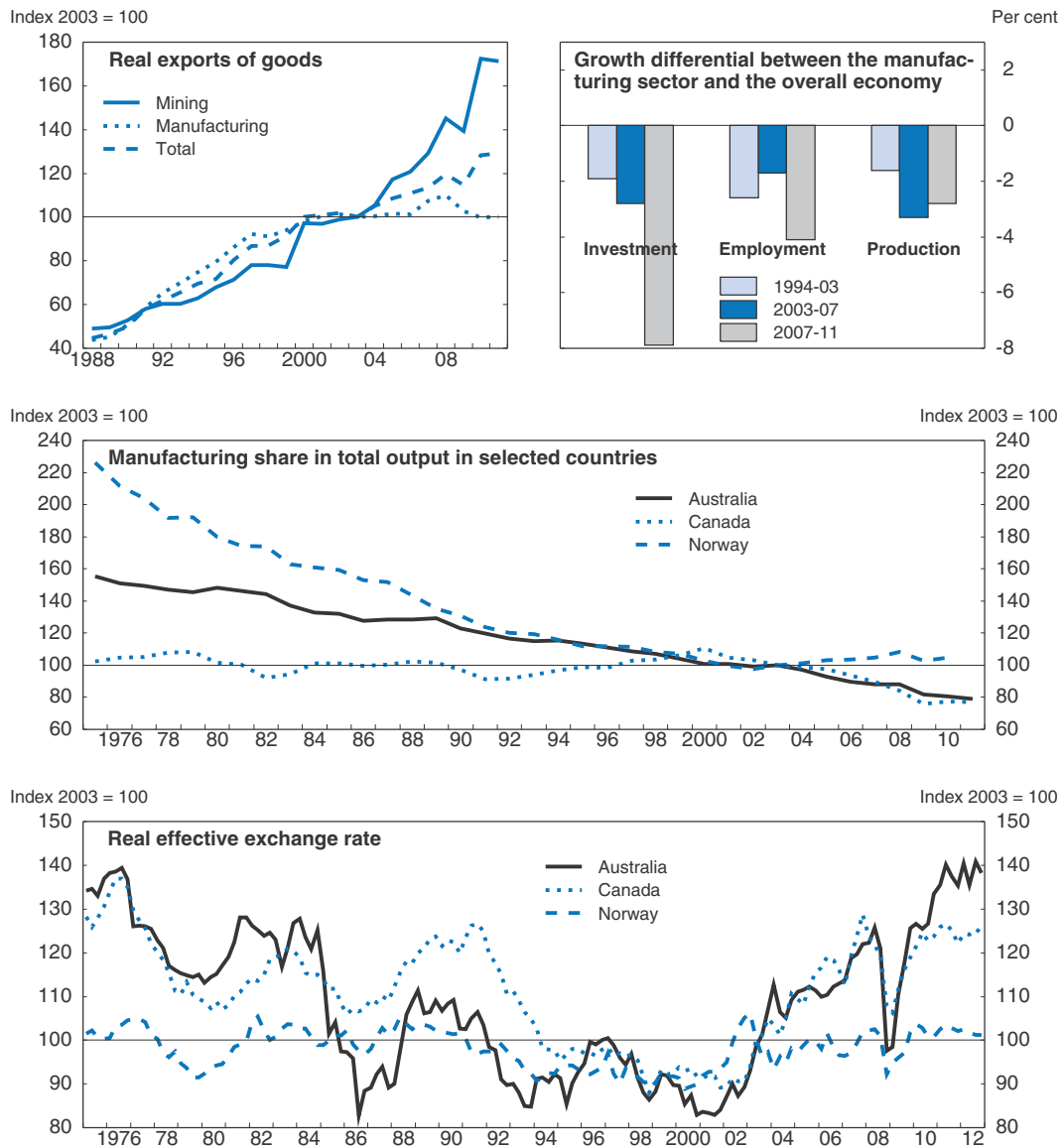
1. Deflated by the GDP implicit price index.
2. France, Germany, Japan and the United States.
3. The consumption wage is defined as the compensation per employee deflated by the private consumption price index.
4. The production wage is defined as the compensation per employee deflated by the GDP implicit price index.
5. Sectoral wages divided by industry output prices.

Source: ABS, Cat. No. 5204.0; OECD, *OECD Economic Outlook and STAN Databases*.


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price level (measured by the GDP deflator) was the third highest in the OECD after Norway and Switzerland, about 50% above the area average. IMF's estimate also suggests a possible overvaluation of the Australian real effective exchange rate by 10-20% from a medium-term perspective based on external sustainability and macroeconomic balance approaches (IMF, 2011). However, these estimates are subject to considerable uncertainties, as recognised by the IMF itself.

According to the RBA, the Australian dollar is somewhat overvalued, but not substantially so judging by the good overall performance of the economy (RBA, 2012). The real exchange rate equilibrium has most likely increased to absorb the additional demand which is generated by the higher terms of trade and the exceptional mining boom. This appreciation is also consistent with the higher rate of return on capital investment in the resource sector. Additional factors which have boosted the currency include the change in perception of risk-averse investors who seem to view the Australian dollar as a safe haven at a time when interest rates are higher than in many other OECD countries (see below).

Figure 1.3. **Manufacturing sector performance**

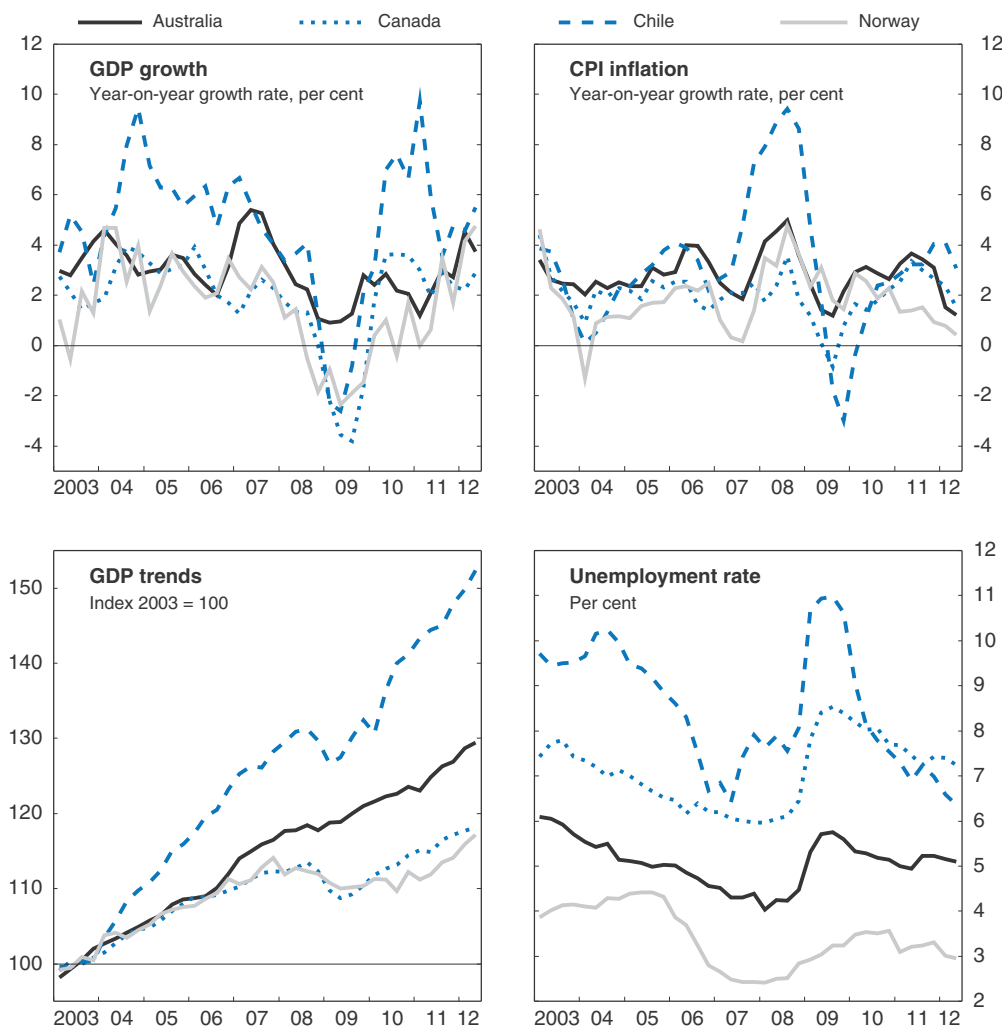
Source: ABS, Cat. Nos. 5204.0 and 6202.0 and OECD, OECD Economic Outlook Database.

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Thanks to the robust macroeconomic policy framework, including the flexible exchange-rate mechanism in force since 1984, the nominal exchange rate appreciation has curtailed the pressures exerted by stronger demand on relatively rigid short-term supply. This powerful stabilising force, together with flexible labour and more competitive product markets, contained inflation, maintained solid and stable growth and kept unemployment low. Overall, the macroeconomic effects of the recent terms-of-trade shock have thus been better managed than during similar past episodes, which were characterised by macroeconomic instability and higher inflation (Gruen, 2011).

The volatility of growth, unemployment and inflation has also been on average lower than in other OECD mining countries (Figure 1.4). Australia, Canada, Chile and Norway were subject to a similar terms-of-trade shock, albeit of varying intensity, but did not

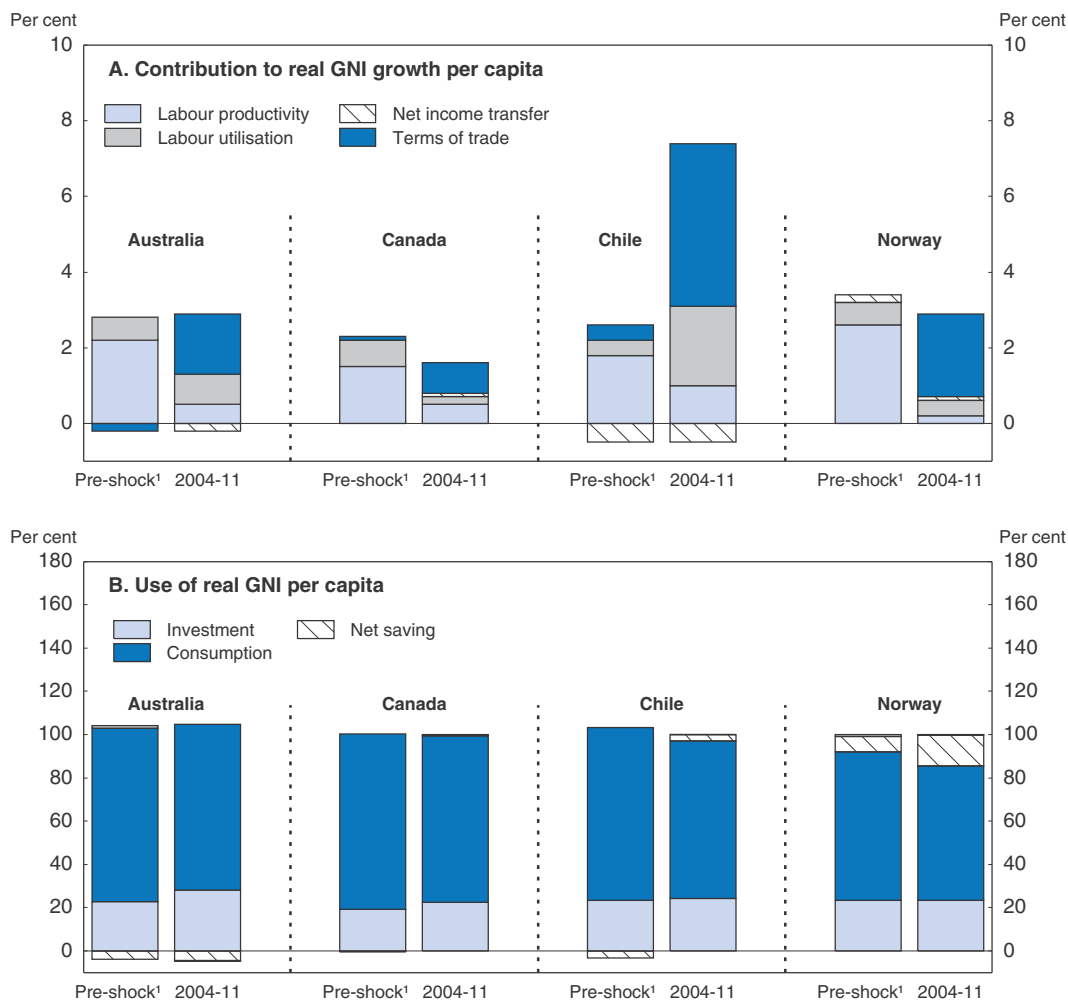
Figure 1.4. Economic performance of resource-rich OECD countries



Source: OECD, OECD Economic Outlook Database.

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manage the shocks in the same way (Figure 1.5). Australia and Canada, and to a lesser extent Chile, recycled the bulk of the additional income derived from terms-of-trade gains into the economy, whereas Norway saved a substantial proportion of it – over 14% of the gross national income (GNI) per year – in its sovereign fund (Figure 1.5, panel B). The greater stability of the Norwegian currency in effective terms is a remarkable phenomenon that contrasts with the appreciation of the Australian and Canadian currencies. The slight accumulation of net savings in Chile after 2004 (approximately 3% of GNI per year), in the wake of the creation of a sovereign fund in the early 2000s, also seems to have limited the currency's appreciation in comparison with those of Australia and Canada, despite Chile's sharper increase in the terms of trade. It is nevertheless difficult to fully establish a link between the volatility of the macroeconomic performance and the management of the mining boom of these countries, due to different exposures to the multiple shocks that have affected the world economy since 2003, as well as other factors.

Figure 1.5. **Gross national income and its use**

1. 1992-2003 for Australia, Canada and Norway; 1997-2003 for Chile.

Source: ABS, Cat. Nos. 5206.0, 6202.0 and 3101.0; OECD, OECD Economic Outlook Database.

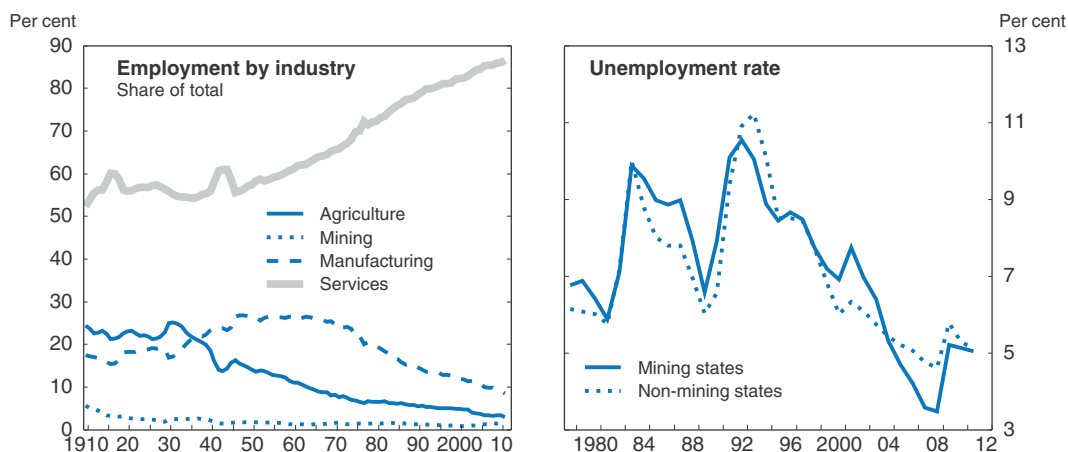
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Put in historical perspective, ongoing structural adjustment at the sectoral and regional level seems manageable

The sectoral employment adjustments triggered by the mining boom are neither unusual nor pronounced compared with massive past changes in labour allocation (Figure 1.6, left panel). Direct adjustments may remain slight over the next few years because the mining sector employs relatively few workers. However, employment restructuring in the exposed non-mining sectors may accelerate as efforts firms are forced to enhance competitiveness. The labour market vitality recorded in the initial years of the terms-of-trade shock and the immediate aftermath of the global financial crisis has indeed lessened since end-2010. Not all of this is due to the terms-of-trade shock: it also reflects weaker retail and housing sectors in the wake of households' greater caution following the decline in their stock of assets and rising global uncertainty (Stevens, 2011a).

The widening of the performance gap between mining and non-mining states, although quite moderate, may have reinforced the perception of the existence of a two-

Figure 1.6. Sectoral and regional labour market indicators



Source: RBA; ABS, Cat. Nos. 6202.0 and 6291.0.

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speed economy, even though this phenomenon is not new in Australia (Garton, 2008). During the decade preceding the commodity boom, mining areas were already exhibiting more vigorous growth than the rest of the country, because of faster population increase and a catch-up in living standards relative to New South Wales and Victoria (Table 1.1). Between 2003 and 2011, the growth differential between mining and non-mining areas has increased only slightly compared with the period prior to the boom. This partly results from the divergence of economic developments between the two main mining states, which have been much more favourable to Western Australia than Queensland. Queensland is far less specialised in the mining industry and its coal output was disrupted by natural disasters in 2011. This state was also struck by a substantial decline both in its large tourism sector, due to the high exchange rate, and in its real estate sector because of a shift in the behaviour of households and the region's relatively high house prices (Davies et al., 2012).

Much of the incremental demand in mining areas has also been satisfied by the other states and by foreign imports, as indicated by the sharp growth differentials in these regions between final demand and output. Labour demand in mining states has, for instance, been satisfied to a sizeable, but hard-to-quantify, extent by proliferation of fly-in fly-out commuting arrangements from non-mining cities, implying that the income earned in the mining sector has been spent in non-mining areas (Parkinson, 2011). Mining and non-mining states thus experienced a similar acceleration in employment growth on average over this period and regional unemployment disparities have remained low (Figure 1.6, right panel).

Great uncertainties surround future terms-of-trade trends

The form and extent of the transformations to come will depend on changes in the external environment, which are subject to multiple sources of uncertainty. First and foremost is uncertainty regarding commodity price trends, as the authorities acknowledge. They have adopted a relatively cautious attitude since the beginning of the mining boom, generally factoring a decline in the terms of trade into their budget projections, even if those terms are expected to remain significantly higher than in past decades. The latest

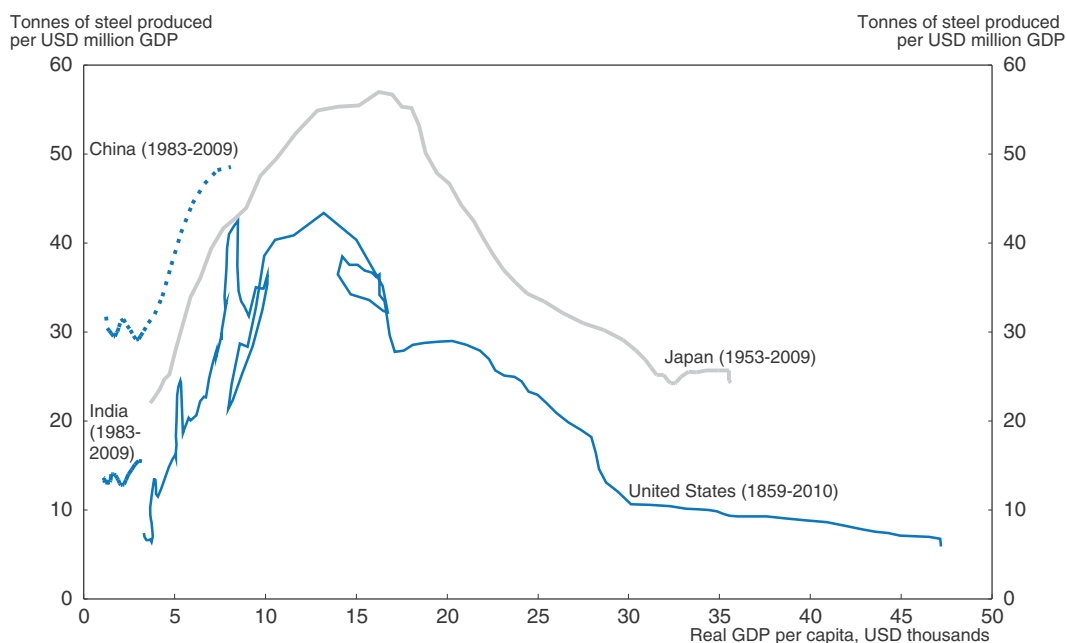
Table 1.1. **Economic performance in mining and non-mining states**

	Average annual growth rate		
	A	B	B-A
	Before the mining boom	After the mining boom	Difference
	1990-2003	2003-11	
Mining states			
Gross State Product	4.3	4.1	-0.2
Population	1.9	2.3	0.4
GSP per capita	2.3	1.8	-0.6
Employment	2.3	3.1	0.8
State final demand	4.1	5.6	1.5
Real gross domestic income per capita	1.6	3.4	1.8
Real household disposable income per capita	1.9	3.3	1.4
Consumer price index	2.3	3.2	0.9
Non mining states			
Gross State Product	2.8	2.4	-0.4
Population	0.9	1.3	0.4
GSP per capita	1.9	1.1	-0.8
Employment	1.1	2.0	0.9
State final demand	3.2	3.3	0.1
Real gross domestic income per capita	1.4	2.3	1.0
Real household disposable income per capita	1.6	2.3	0.8
Consumer price index	2.3	2.8	0.5
Mining/Non-mining state gap			
Gross State Product	1.4	1.7	0.3
Population	1.0	1.0	0.0
GSP per capita	0.4	0.7	0.2
Employment	1.2	1.1	-0.1
State final demand	0.9	2.3	1.4
Real gross domestic income per capita	0.2	1.1	0.8
Real household disposable income per capita	0.3	1.0	0.7
Consumer price index	-0.1	0.4	0.4

Source: ABS, Cat. No. 5220.0 and OECD calculations.


budget projections assume that the terms of trade will cumulatively decline by almost 11% by FY 2013/14 (MYEFO, 2012).

The uncertainties over commodity prices, mostly relating to the medium term, seem rather limited concerning the demand for mining products. In all likelihood, emerging countries, and especially China, are expected to maintain a robust demand. For instance, China's demand for mining products, which are vital to its industrialisation and urbanisation, could be expected to remain brisk despite likely short-term volatility, perhaps at least up to 2025, judging from the past experience of developed countries (Connolly and Orsmond, 2011; Findlay, 2011). Intensive demand for commodities tends to continue until households increase their demand for services, similar to what took place in the United States, for example, after World War II, and in Japan in the 1970s (Figure 1.7). Moreover, other Asian countries, such as India, Indonesia or Vietnam, may follow a similar trajectory to China's, with sharp growth in their demand for raw materials in the future (Hyvonen and Langcake, 2012). The mining boom could thus extend longer than the previous ones experienced by Australia, which generally did not exceed 15 years due to depletion of the natural resources in question (such as gold in the 1850s) or a weakening of the foreign demand that triggered the booms (Battellino, 2010).

Figure 1.7. **Steel production intensity and economic development**¹

1. 2010 prices converted at 2005 PPP exchange rates; 5-year moving averages. US iron production intensity prior to 1897. Japan steel production is by JFY prior to 1980.

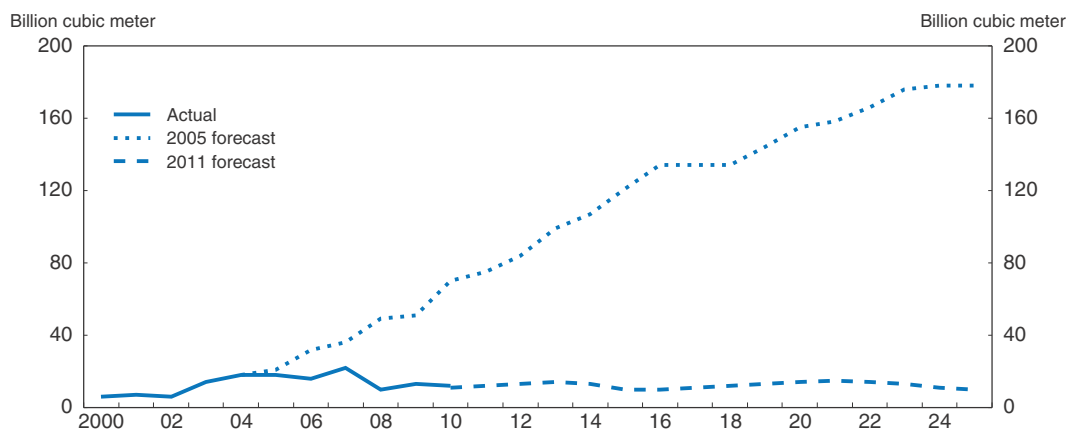
Source: Data provided by the RBA, based on The Conference Board's *Total Economy Database* (January 2011); IMF; The Japan Iron and Steel Federation; Johnston and Williamson (2010); Maddison (2009); US Bureau of Mines; US Geological Survey; World Steel Association.

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Australia is also in a good position to cope with the probable shift in commodity demand that might arise for environmental reasons (IEA, 2010). Expansion of its production of liquefied natural gas (LNG), which should soon hoist the country to second place among world exporters (after Qatar) ought to enable Australia to cope with a possible drop in demand for coal, which generates a lot of CO₂ (Jacobs, 2011). The LNG market has been expanding rapidly for several years.

Continued heavy demand for commodities is likely to result in global expansion of production, which will eventually reduce prices (OECD, 2010a). Supply has reacted vigorously in Australia, and numerous other countries are endeavouring to expand their capacity. Brazil has increased production of iron ore, which is not an especially scarce resource, and coal production is increasing in Indonesia, Colombia and South Africa (Connolly and Orsmond, 2011). Qatar could suspend its moratorium on developing gas fields which it adopted in 2009. Equilibrium in this market could also be altered by expanding production of non-conventional gas (coal seam, shale and tight gas). The United States has for instance become more than self-sufficient in natural gas, whereas just a few years ago it was expected to be a major LNG importer (Figure 1.8). Many other countries, including Australia and China, also have substantial non-conventional gas reserves that could be exploited, although methods for extracting these types of gas do pose environmental problems (Jacobs, 2011). Nevertheless, Australia's iron ore and coal reserves are abundant, diversified and of high quality, and its transport costs are low, which gives it an advantage for LNG. Moreover, Australia can guarantee a more secure supply than many other exporters which are less stable politically.

Figure 1.8. US net imports of liquefied natural gas



Source: Data provided by the RBA, based on the US Energy Information Administration (www.eia.gov/forecasts/aeo/er/).
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The pressure for structural adjustments is likely to intensify

Whatever the trend of commodity prices, economic development in China and elsewhere in Asia over the coming years will be a major source of challenges and opportunities for the Australian economy. The expected continued expansion of Asian economies will reduce the cost of Australia's remoteness from large economic markets. According to Quah (2011), the centre of gravity of global activity has shifted from the mid-Atlantic in 1980 to Bucharest in 2008, and it can be expected to lie between India and China by 2050. Although the large Asian markets will still be far away from Australia, they will be nearer than those of Europe or the United States, with positive effects on productivity and per capita GDP (Box 1.1). Apart from the raw materials sector, Australia should increasingly benefit from demand for its non-mining sectors as China, increasingly focused on bolstering domestic demand, generates a more diversified demand for goods and services

Box 1.1. Is Australia's geographical handicap going to diminish?

Because of its geographical remoteness from world markets, Australia suffers from an economic handicap relative to most OECD countries. This remoteness is reflected in trade flows and efficiency of businesses which, among other effects, are prevented from operating on an efficient scale and, more generally, from exploiting scale economies. In 2005, this handicap is estimated to have reduced per capita GDP by over 10%, as in New Zealand, compared with the average of other countries (Boulhol and de Serres, 2008). Moreover, this cost has diminished only slightly, because over time there has been scarcely any observable downward movement in freight costs in relation to goods prices.

However, the detrimental impact of this remoteness may decline, as the centre of gravity of world markets shifts eastward. These markets, although still very distant from Australia, will be nearer than those of Europe or the United States, so that according to Boulhol and de Serres (2008), the detrimental impact of this remoteness on the level of per capita GDP could decline by two percentage points by 2030 and by three points by 2050. This trend reflects the expansion of Australia's potential markets because of the sharp growth expected in China and the rest of Asia, according to OECD long-term projections (OECD, 2012a).

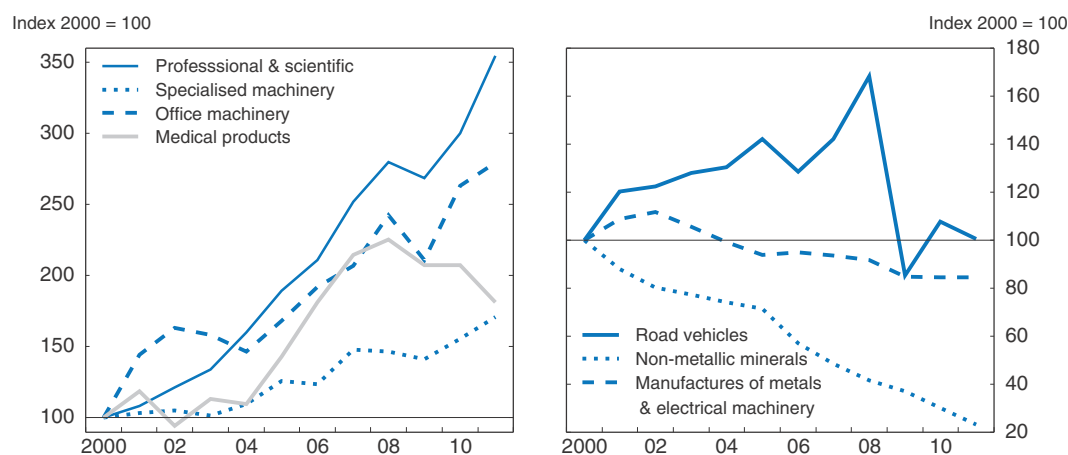
on behalf of an increasingly numerous middle class (Australian Government, 2011; Kearns and Lowe, 2011; Garnaut, 2011).

The rise in Asian countries' demand for tourism and education services in recent years attests to the emergence of such opportunities, but also to the need for adjustments to seize them. Exports of education services grew sharply between the late 1980s and the late 2000s, thanks to the vitality of demand from India and China, to become the third-ranking source of export income (after coal and iron ore) and made Australia the OECD's fifth-largest exporter of these services (Hall and Hooper, 2008). Similarly, tourism revenue from China and India doubled between FY 2000/01 and FY 2010/11, and will probably continue to grow strongly.


Nevertheless, a number of obstacles are impeding both of these sectors' capacity to take full advantage of these developments. These include real currency appreciation, rising competition, for example, the development of offshore education services by many Chinese universities, the adoption of more restrictive conditions on student visas since 2009, and the relative unsuitability of tourism facilities for the demand of the new Asian clientele, which is geared more towards large cities than rural areas (Hooper and van Zyl, 2011).

It is difficult to predict how Australian economy's comparative advantage will evolve, but shifts of resources, between major sectors and within sectors, seem inevitable. After the mining industry, it is possible that Australia will strengthen its comparative advantage in agriculture if demand for these products from large Asian countries increases as their living standards rise and/or their eating habits evolve (Jayasuriya and Panza, 2011). On the other hand, structural adjustments are necessary in manufacturing to preserve its international competitiveness and boost productivity (Chapter 2). Pressures exerted by countries with low labour costs on wide-scale production of standardised manufactured goods, such as automobiles or metallic construction materials should further intensify (Lowe, 2012). Accordingly, it is likely that preservation of a competitive manufacturing sector will hinge on its capacity to adjust by bolstering its high value-added segments, such as scientific instruments, medical products or specialised machinery, exports of which have been rising for several years despite the appreciating exchange rate (Figure 1.9).

Figure 1.9. **Manufactured export volumes**



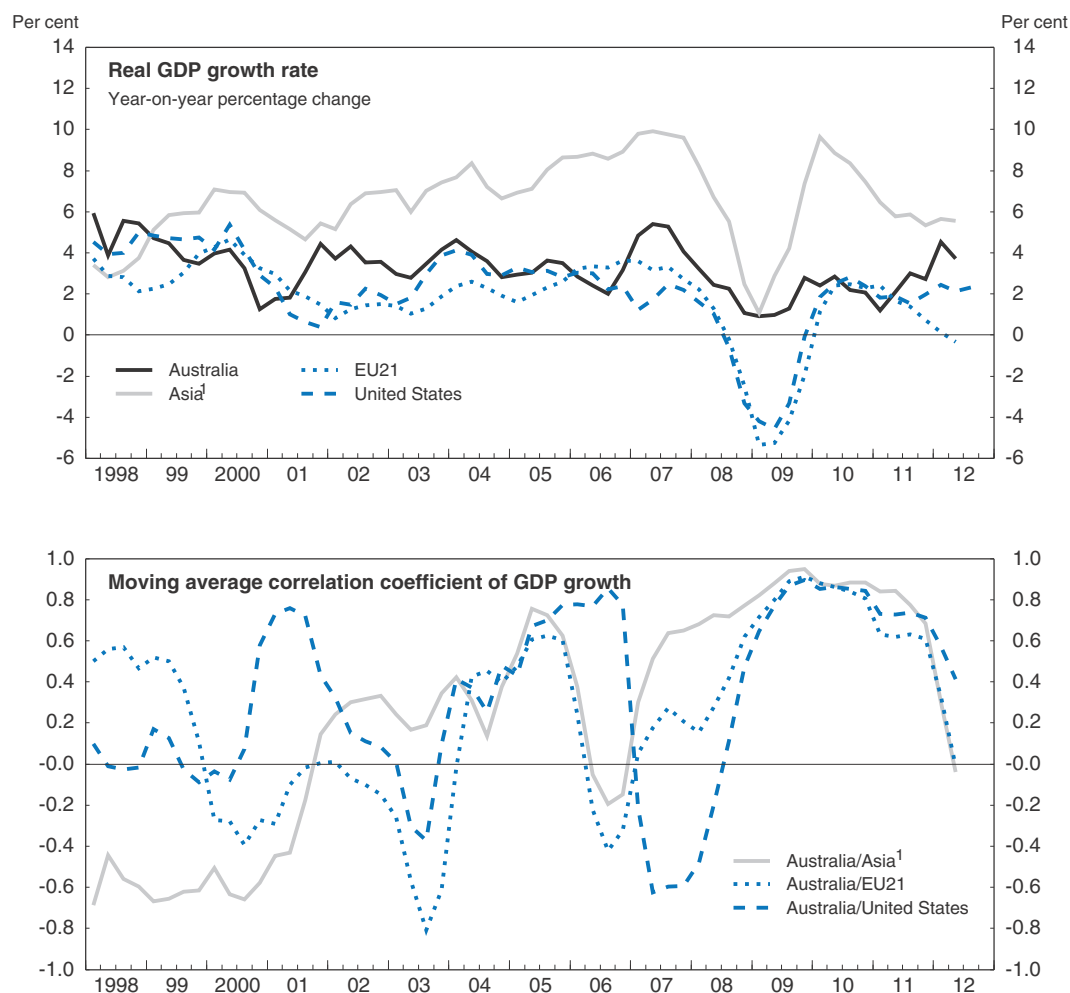
Source: ABS, Cat. No. 5302.0, Table 103.

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Australia could also preserve its comparative advantage in industries like food, beverage and tobacco and non-ferrous metals, both of which are closely linked to the natural resources of the country by including higher technology activities in these industries (OECD, 2012b).


The Australian economy is in its 21st year of uninterrupted growth, which reflects strong resilience to the sectoral shocks that followed the excesses of the information and communication technology (ICT) sector and real estate markets earlier in the decade. The reduced vulnerability to the 2008 shocks has also been aided by the growing trade links with Asia and particularly China, and the complementarity nature of these economies (Battellino, 2011). Moreover, Australia is less exposed than many other OECD countries to the competitive pressure exerted by emerging Asian countries because of the relatively small size of its manufacturing sector. In all, since the early 2000s there has been a growing synchronisation of business cycles in Australia and East Asia (Figure 1.10).

Figure 1.10. **Correlation of real GDP growth**



1. Asia aggregate is calculated using the 2010 nominal GDP weights at PPP rates of China, Japan, Korea and Dynamic Asia.

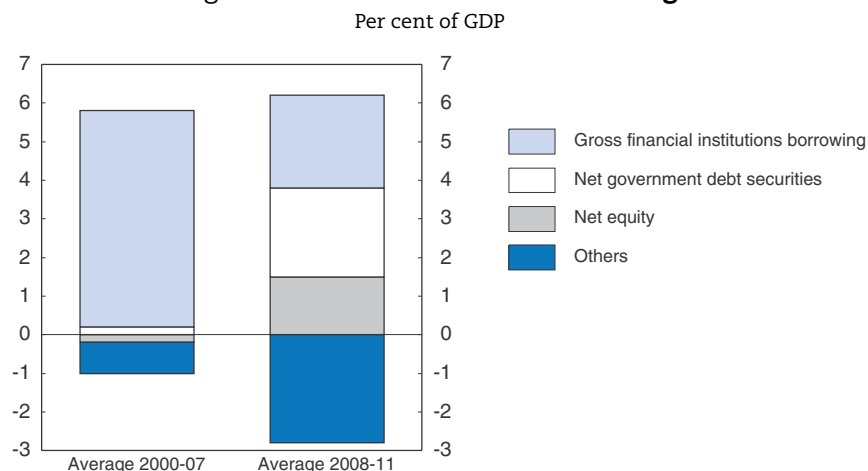
Source: OECD, OECD Economic Outlook Database.

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A second important consequence of the transformations underway will be to make the Australian economy more cyclical, due to the expansion of its mining sector. Commodity prices are intrinsically more volatile than the prices of many other goods and services because of the low short-term elasticity of supply for such products and the lack of substitutes, whereas their demand is closely tied to business cycles (Kearns and Lowe, 2011).

A third potential change in the country's medium-term economic development involves the movements and role of its exchange rate. Australia's good economic performance, its sound public finances and its favourable outlook have enhanced its appeal to international investors, as shown by the change in the financing of the current account deficit since the global financial crisis (Figure 1.11). Prior to the crisis, this deficit was covered almost entirely by bank borrowing abroad, whereas since 2008 there have been greater inflows of equity capital to finance mining investments and substantial purchases of government bonds (Eslake, 2012). Australia is in fact one of only seven countries in the world to have kept a triple-A rating for its sovereign debt. Although these developments stem partially from an intensification of carry trade operations, there are convergent indications suggesting that the purchases of government bonds also originate with sovereign funds and central banks looking to diversify their portfolios (Lowe, 2012). The fall in the terms of trade since their peak in the third quarter of 2011 did not much affect the currency, and yields on government bonds have decreased, falling to their lowest level since the late 1960s. Such a development, if continued, could contribute to a certain disconnection between movements of the Australian dollar and the terms of trade, which could reduce the exchange rate's stabilising effect on the economy.

Figure 1.11. **Current balance financing**



Source: ABS, Cat. No. 5302.0, Table 1.

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The economic policy challenges of this adjustment process

Australia's history shows that mining booms are periods of profound economic change giving rise to complex economic policy challenges (Battellino, 2010). Macroeconomic stability needs to be maintained and inflationary pressures kept at bay. It is also essential to preserve the economy's flexibility and not to distort the allocation of resources. On the whole, outcomes so far have been positive, particularly when compared

with past experience. However, the challenges that lie ahead to sustain such outcomes and push ahead with the country's adaptation should not be underestimated. The shocks facing Australia are on the whole positive, but the economy's structure must continue to adjust so it can harness the new opportunities created by developments in Asia. These changes also imply difficult adjustments for many households and firms, as the costs and benefits of the current transformations are not shared evenly. Economic policy can facilitate this process. Moreover, it must prepare to face new risks that arise with the fundamental changes underway associated to uncertainties relating to external development, including on the terms of trade, and likely higher volatility of the economy.

As stressed by the authorities, it is essential, first and foremost, not to resist the long lasting changes brought about by transformations in the external environment, even if there are uncertainties as to how long the mining boom will last (Stevens, 2011b). Many of the changes underway are the result of a transformation of the world economy, which is not a temporary phenomenon but is more likely to lead to long-term changes in Australia's comparative advantage (Gruen, 2011). Asia's development is an irreversible trend with consequences that go far beyond the mining boom. Nevertheless, the extent and duration of the high terms of trade and strong real exchange rate are uncertain, which adds to the challenges of the adjustments ahead.

The key is smooth reallocation of resources in the economy

With this in mind, the authorities' efforts to improve public information on how Asia's development is affecting Australia are to be commended and should be continued. While the economic impact of China's strong growth seems to be positively perceived, it is important to address concerns raised by the changes underway, as shown by growing pressure in some sectors for protection against foreign competition and trade unions' calls for greater job security. The government has published a White Paper (*Australia in the Asian Century*) in 2012, which provides a better understanding of the economic, social and geostrategic consequences of these changes. Australia cannot escape the many adjustments that have been made necessary by the development of Asia, but their ramifications must be examined, explained and dealt with to facilitate the transition ahead and make the most of the opportunities created by these changes (Australian Government, 2012a). Public policy measures to ease the reallocation process of resources will have to ensure that the burdens and benefits of the adjustments are widely shared.

The best response is to maintain, and if possible reinforce, the economy's flexibility to grasp new opportunities that lie ahead and minimise adjustment costs. The complex nature of the transformations underway makes it hard to predict which economic sectors will benefit from the changes. It is thus more effective to help workers and firms adapt rather than to protect jobs or businesses in specific regions or sectors. Public subsidies to maintain sectors exposed to the appreciating exchange rate – as in the automotive industry – may be to no avail, forcing other exposed sectors to adjust even more and, in the long term, slowing improvements in living standards (Box 1.2). It is also important not to needlessly postpone the required adjustments, as these are easier to implement when the economy is buoyant and resources are available to help, and in some cases compensate, the “losers” in the adjustment process.

Macroeconomic and structural policies play complementary roles in facilitating the smooth reallocation of labour and capital. It is important to preserve a stable macroeconomic environment by keeping inflation under control. There are enough

Box 1.2. Should protection of the automotive sector be maintained?

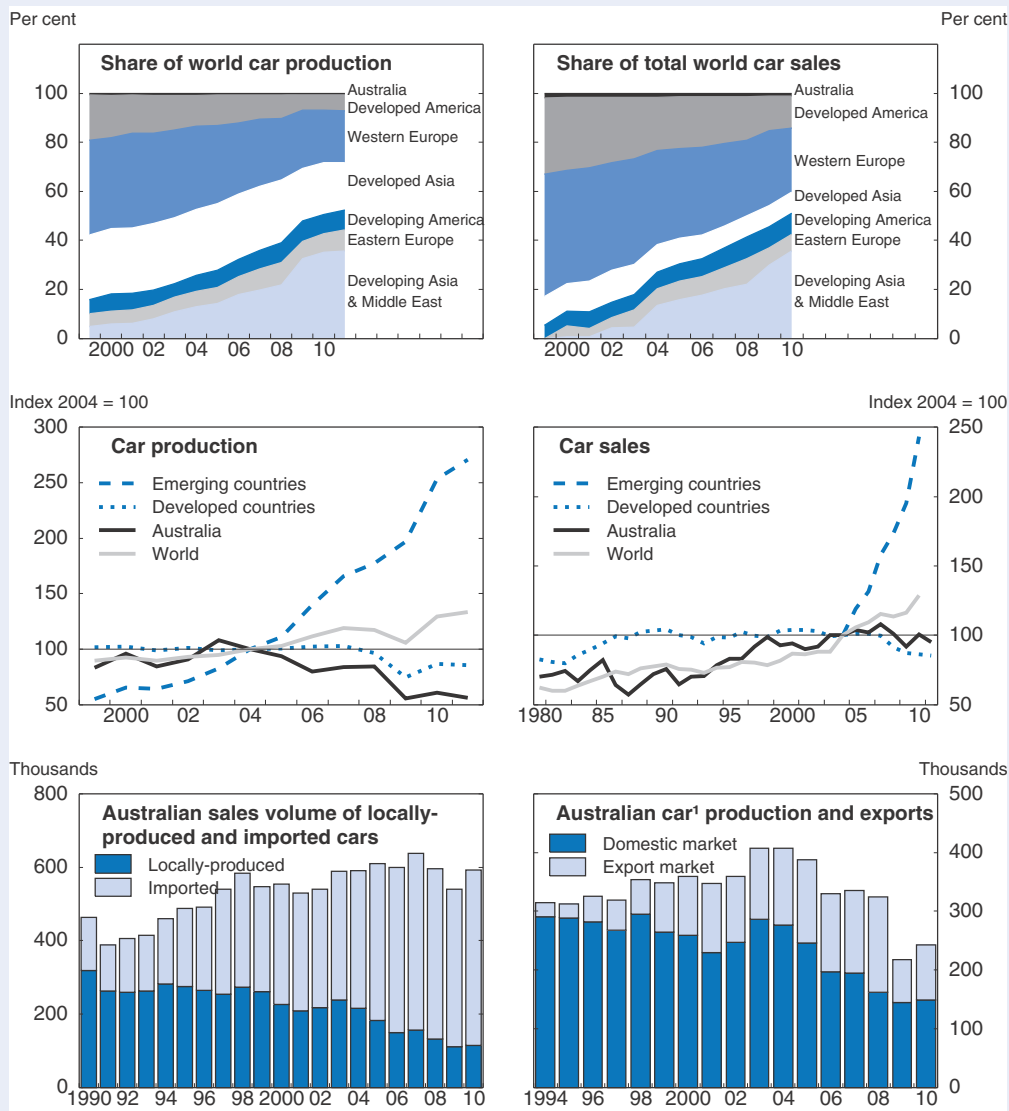
One of the Australian industries most negatively affected by the mining boom is the automotive industry. The exchange rate appreciation has damaged its competitiveness and threatened employment. To alleviate these pressures, the authorities have recently extended and, in some cases, increased their support to this sector, which is to be temporary. This box examines the pressures on the Australian car industry, including those related to the changes underway at the global level.

The Australian car industry, which has historically been developed through foreign investment mainly from the United States and Japan, is relatively small, accounting for less than 5% of Australian manufacturing value added and about 0.4% of total GDP and employment in 2009-10 (ABS, 2011). It has been exposed to rising competition from emerging economies since the end of the 1990s. While emerging markets represented about 15% of global car production in the early 2000s, this share rose to almost 50% in FY 2010/11, driven by the expansion of Asia, particularly China (Figure 1.12, panels A and B). Demand has faced similar trends. This rapid transformation has been influenced by: excess capacity in many developed countries (Haugh *et al.*, 2010), swift expansion of consumption and car sales in emerging countries and a rising efficient scale of production with the development of new low-cost car producers (Baker and Hyvonen, 2011).

In Australia, cheaper imports together with a change in consumer preferences led to an increase in imported vehicles from 30% of sales in the 1990s to more than 80% in 2010 (Figure 1.12). Output and employment of the sector have steadily declined since the beginning of the mining boom, as efforts of Australian car makers to offset their shrinking local market share by increasing exports were thwarted by the currency appreciation. As a result, some car companies closed over the last few years (for instance Mitsubishi in 2008) while others sent warning signals of serious difficulties (DIISR, 2010; Peter, 2012).


The Australian automotive industry was protected by high tariffs until the mid-1980s. Since then a series of tariff cuts, which were coupled with assistance packages to help the adjustment, have been implemented. The last tariff reduction from 10% to 5% on new cars, in 2010, was associated with AUD 5 billion (0.4% of GDP) aid through the Automotive Competitiveness and Investment Scheme. This programme was replaced in 2010 by the Automotive Transformation Scheme which extended funding from 2015 until 2020, at an additional cost of AUD 2.5 billion. Taking into account net tariffs and budgetary assistance, the motor vehicles sector received AUD 1.1 billion in FY 2010/11, equivalent to an effective rate of assistance of 8.5% of its value added; the manufacturing average is 4.2% (PC, 2012). This assistance rate has declined over the last decade. However, there are other forms of support, such as the 33% luxury tax (applied mainly on imports), *ad hoc* state government financial assistance and government procurement favouring domestic cars over imports.

Pressures have recently mounted in favour of even higher assistance and potential reversal of the declining trend of protection to the car industry. One rationale for such pressures relies on the traditional “Dutch Disease” argument and the implicit assumption that the current currency appreciation is temporary. According to this argument, the industry would be squeezed out and unable to recover when the exchange rate eventually falls back to a more competitive level. According to the proponents of this thesis, the economic cost of car industry collapse would be considerable because of its high spin-off benefits in terms of output, employment and innovation given its leading and strategic position in the manufacturing sector. Tariff reductions are also seen as a disadvantage for the Australian industry, especially compared to other developing and developed countries that do not follow the same policy. Another line of reasoning recognises the rather small weight of the automotive sector in the economy as a whole, but underlines its greater significance to states like South Australia and Victoria and to particular cities and regions within them (PC, 2008). The closure of automobile plants could thus imply important social costs at the local level.

Box 1.2. **Should protection of the automotive sector be maintained?** (cont.)Figure 1.12. **Automotive industry indicators**

1. Including SUVs.

Source: Australian Department of Innovation Industry, Science and Research; OECD, *Main Economic Indicators*; OICA (Organisation Internationale des Constructeurs d'Automobiles) and national automobile manufacturers sources.

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International comparisons of the level of aid to the automotive sector are difficult to establish. However, whether or not Australia is assisting its car industry more or less than other countries are, they are substantial and hamper (indeed, they are designed to limit) the adjustment of scarce resources to flow to highest value activities in response to economic shocks. In the current circumstances, support to the automotive sector is likely to force larger adjustments on other exposed sectors, such as tourism and education, which do not enjoy similar support, by bidding up the prices of capital and labour and increasing their tax burden (Corden, 2012). Moreover, the future of the automotive sector looks difficult in many advanced countries, judging by current global overcapacity and past trends.

Box 1.2. Should protection of the automotive sector be maintained? (cont.)

The car industry produces spin-off benefits to the rest of the economy, but these should not be overestimated. According to OECD estimates, one dollar of automobile output (including vehicle repairs) generates approximately 31 cents of value-added from the automobile industry, 43 cents of value added from other domestic industries and 26 cents from imports.* Given its size, the automotive sector might thus generate about ½ per cent of GDP of additional activity in the economy. However, such an estimate is likely to represent an upper limit, as it takes into account automotive-related activities such as maintenance and retailing, which would remain even if all cars were imported. Moreover, R&D spillovers generated by assistance to the car industry may also be relatively low, as it generally involves industry-specific modification of existing products or processes rather than new technology development (PC, 2008).

A case can be made in favour of government assistance when the closure of automotive firms might produce a shock difficult to absorb at the local or regional level. Under such circumstances, assistance should however aim to smooth and help the adjustment process rather than prevent it, as seems to be recognised by the authorities.

* These parameters have been estimated on the basis on the 2007 input/output tables using a similar approach as used by Gruen (2011) for the analysis of the mining industry.

uncertainties stemming from the transformations underway not to add new ones about prices. Structural reforms guaranteeing adequate economic flexibility are also important for macroeconomic policy. A more flexible labour market, for example, will give monetary policy more room for manoeuvre and facilitate adjustment by easing the near-term dilemma between inflation and unemployment. A prudent fiscal policy reinforces monetary policy and provides room to react to severe adverse shocks, as was the case in 2008-09.

The medium-term fiscal strategy should take better account of structural changes and be more cautious

The potential increase in the Australian economy's volatility as a result of the mining sector's expansion, its growing dependence on the emerging economies of Asia and uncertainties surrounding the development of the mining boom militate in favour of a re-examination of the medium-term fiscal strategy. Until now, Australia has been served well by the strategy in place since 1996. This strategy aims to maintain a budget surplus, on average, over the medium term, refrain from increasing the aggregate tax burden (relative to its FY 2007/08 level) and increase the central government's net financial worth over the medium term. Unlike many other OECD countries, Australia has carried out a cautious fiscal policy that enabled it to eliminate its net debt in FY 2005/06, which gave it substantial leeway to adopt a far-reaching stimulus plan in FY 2008/09 and avoid the recession experienced by most of OECD countries.

The persistently rising terms of trade and the mining sector's growing importance nonetheless raise new questions about the role of fiscal policy in the future. These questions centre on two main topics: i) the appropriate use of revenue derived from the mining boom; and ii) the role of fiscal policy as a counter-cyclical instrument in this new environment (Kearns and Lowe, 2011). A number of analysts have been concerned by the risks of recycling into the economy too much or too rapidly the additional tax revenue

stemming from the mining boom (OECD, 2010a; Stevens, 2011b; Corden, 2012). As discussed in the 2008 *Economic Survey of Australia*, during the first phase of the mining boom, between FY 2002/03 and FY 2007/08, the federal government redistributed the bulk of the incremental tax revenue derived from terms-of-trade gains, even though a comfortable budget surplus of 2% of GDP was maintained (OECD, 2008). The terms-of-trade gains could be reversed more quickly than the authorities now assume and, even if they remain high, they are likely to undergo strong fluctuations as a result of the inherent volatility of commodity prices. Faced with similar situations, countries such as Norway and Chile have found it useful to create sovereign wealth funds (SWFs) to manage their mining and mineral revenue to avoid excess volatility or a Dutch disease.

Assessing the advisability of creating a sovereign wealth fund in Australia would entail clarifying what purpose the fund would serve. As the examples of Norway and Chile illustrate, sovereign funds can further three broad categories of objectives, depending on their characteristics and how they work:

- Make intergenerational transfers of resources and guarantee the long-term sustainability of public finances.
- Moderate exchange rate appreciation to ease pressures on the exposed non-mining sector.
- Maintain sound fiscal policy as a macroeconomic stabilisation tool to smooth consumption and protect public accounts from sharper-than-expected declines in commodity prices.

In Norway's case, the sovereign fund seeks to achieve all three objectives, while in Chile the primary goal is to ensure sound fiscal management. In both cases, the funds are combined with a fiscal rule promoting prudent use of resource-related public revenues by de-linking spending from the fluctuations of natural resource revenues (collected through taxes, royalties and so forth). In Norway, revenues from oil and gas resources are invested in foreign assets and accumulated in a SWF fund now amounting to about 130% of GDP. Part of the fund's resources (4% of its value, corresponding to the notional real return on the assets) is spent each year. The Chilean stabilisation fund is much smaller, representing 5½ per cent of GDP in 2011, down from 13% of GDP in 2008. To smooth the use of revenues from its copper resources and avoid the risks of pro-cyclical fiscal policy during mining booms, a budgetary rule targets the structural equilibrium of public accounts, corrected for cyclical variations and fluctuations in copper prices. To this end, the authorities distinguish between permanent and temporary mining-related tax revenues based on an independent estimate of long-term equilibrium raw materials prices (OECD, 2010b).

There are no overriding arguments for permanently accumulating assets in an SWF in Australia

By contrast with Norway, which anticipates a sharp falling-off in oil and gas production in the relatively near future, Australia's natural resources are expected to last much longer (Table 1.2). There is therefore much less need in Australia to smooth assets across generations. According to World Bank estimates, despite the depletion of natural assets, savings in Australia along with investments in human capital have been sufficiently large to increase national wealth over time (World Bank, 2010). Although Norway's fund is not legally dedicated to financing pension (despite its name: Government Pension Fund Global), the assets it holds could clearly be used for that purpose. In Australia, the private-

Table 1.2. **Reserves of key resources**¹
Years of current production

	Resource life (years)	% of GDP	% of exports
Australia			
Iron ore	71	4	18
Black coal	98	3	15
Gold	33	1	4
Crude oil	12	1	4
Gas	55	1	4
<i>Total resources</i>		<i>10</i>	<i>45</i>
Weighted average	<i>70</i>		
Canada ²			
Crude oil	147	3	10
Gas	11	1	4
<i>Total resources</i>		<i>4</i>	<i>13</i>
Weighted average	<i>110</i>		
Chile			
Copper	114	17	55
Weighted average	<i>114</i>		
Norway			
Crude oil	8	11	35
Gas	26	7	21
<i>Total resources</i>		<i>18</i>	<i>56</i>
Weighted average	<i>15</i>		

1. Export and GDP shares in 2010 for Norway, 2009-10 for Chile and 2010-11 for Australia. GDP shares are for commodity exports. Resource life is based on production in 2008 for Norway and 2009 for Australia and Canada.

2. 2009 data.

Source: Bureau of Resources and Energy Economics; Geoscience Australia; Norwegian Petroleum Directorate; ABS Statistics.

sector superannuation pension funds play this role (Gruen and Soding, 2011). The superannuation assets of Australian households represented 100% of GDP at end-2010 and they are expected to reach 160% of GDP by 2050 with the projected increase in pension contributions from 9% to 12% between now and 2020. The Australian pension system is underpinned by mandatory contributions (concessionally taxed) with restrictions in place to ensure that savings are not withdrawn until retirement age. Furthermore, the predominately defined contribution nature of the Australian system guarantees pension financing for future generations, irrespective of commodity price trends. In Australia, the redistribution of mining-sector income in the economy has not reduced national saving rate, which is higher than the average for the large OECD countries but lower than in Chile or Norway (Table 1.3).

Attempting to influence the exchange rate would be neither easy nor necessarily desirable in Australia

The best way to use natural resource revenues depends in part on their size relative to the economy. The mining sector (including oil and gas) accounts for approximately 20% of Norwegian GDP, but only 9% of GDP in Australia. Government revenue generated by the sector has totalled around a third of aggregate government revenue in recent years in Norway, versus 6% in Australia in FY 2008/09 (Gruen and Garton, 2012). Spending such

Table 1.3. **Saving and investment: an international perspective**

Per cent of GDP

	National saving			Investment		
	1994-2003	2004-07	2008-11	1994-2003	2004-07	2008-11
Australia	24.0	25.9	28.0	25.0	27.8	27.6
Canada	23.1	25.4	21.4	19.6	22.3	22.3
Norway	31.3	37.8	36.8	21.4	22.6	23.1
Chile	24.0	32.4	28.4	23.4	20.7	22.2
United States	16.9	14.6	12.3	19.4	20.1	16.1
Japan	27.2	24.2	20.8	25.8	22.7	20.6
Germany	22.6	23.8	23.2	21.0	18.1	17.8
France	20.0	19.8	18.0	18.3	20.5	20.3
Italy	22.6	21.4	18.9	20.2	21.5	20.1
United Kingdom	16.2	14.4	13.1	17.3	17.5	15.4
G6	20.9	19.7	17.7	20.3	20.0	18.4
Other mining countries	26.1	31.9	28.9	21.4	21.9	22.5

Source: OECD, OECD Economic Outlook Database.

revenue domestically would be highly destabilising in Norway, but less so in Australia, including in its effect on the exchange rate.

The example of Norway shows that a sovereign fund can be effective in avoiding appreciation of the real exchange rate that can accompany a boom in the terms of trade. However, it would be difficult for the Australian authorities to neutralise the appreciation of their currency as in Norway, if they wished so, because the government collects only a small portion of the mining rent exploited by the private sector. The Australian authorities collect less than one-fifth of the revenue from factors in this industry, a share unlikely to substantially increase despite the recent rise in resource taxation, versus approximately two-thirds in Norway due to a higher effective tax rate on mining resources. Given these differences, the budgetary savings required in Australia to stabilise the exchange rate would be large and should offset the redistribution of supplemental revenue generated by the mining boom carried out locally by private interests (Corden, 2012). According to Gruen and Garton (2012), to save the same proportion of the additional national revenue generated by the rising terms of trade as the Norwegians, a budget surplus averaging 4% of GDP would have been necessary over the past eight years. Without a larger government control on the mining rent, achieving a fiscal objective of this magnitude would impose considerable budgetary constraints, which would potentially be harmful for the economy and difficult to accept in political economy terms.

The terms of trade may also stabilise at a relatively high level in historical perspective, with long lasting effects on the economy given the large reserve of natural resource of the country, which contrasts with the Norwegian situation. Under such a scenario, insofar as exchange-rate appreciation is an equilibrium adjustment mechanism, efforts to resist it would only delay the required structural changes. Slowing the appreciation would protect some sectors from structural adjustment, but this would also mean lower investment because of reduced capital inflows (Corden, 2012). This would entail a cost in Australia, particularly in the realm of infrastructure, where more investments are needed (Chapter 2).

A stabilisation fund could help protect the budget against the volatility in natural resource revenues

An SWF could be used to smooth the distribution of resource revenues to the economy. Saving part of the public resources generated by the boom can help smooth government and private consumption. Combined with a shift in medium-term fiscal strategy, such a SWF would better protect the economy against shocks related to volatility of commodity price movements. As the previous *Economic Survey of Australia 2010* recommended, such risks could be avoided if the authorities were to draw on the experience of the Chilean fiscal management model by creating a budget reserve to accumulate public revenues from mining taxes when they are unusually high. It could be helpful to further de-link government spending decisions from revenue fluctuations caused by changes in those prices, for instance by introducing an expenditure rule. In all, creation of a stabilisation fund combined with a cautious budget rule would be consistent with the thinking behind the current fiscal strategy for a relatively modest cost – that of deferring and smoothing out the use of public mining resource revenues. A stronger fiscal buffer induced by the creation of a stabilisation fund could also be useful in a low inflation environment, where monetary policy might have too little scope for tackling large-scale shocks.

Efforts to enhance transparency of budget discussions and strengthen the fiscal framework should continue

Like many OECD countries, Australia has created an independent budget institution, which reports to Parliament, the Parliamentary Budget Office (PBO). This body has been operational since July 2012, with an annual budget of AUD 6 million and staff of some 30 to 35 persons headed by an independent officer appointed for a renewable four-year term. The PBO's main function is to provide independent and non-partisan analysis of the budget cycle and fiscal policy; evaluate the costs of proposals put forward by political parties during elections, to put price tags on MPs' suggested reforms (on a confidential basis, if requested) outside of electoral periods, and to respond to Parliamentary inquiry committees. The PBO, which has access to information and statistical resources held by Australian Government bodies, can also conduct its own analyses and its research which it will publish. Provisions have also been made to ensure that the Office is accountable for its work: it can be subject to independent review within a nine-months period after each federal election.

The PBO should play a useful role in improving information available about public finances and enhance the transparency of the already solid budget framework that Australia has instituted at the federal level. The features of this new body are consistent with good practices (Hagemann, 2010). Its initial years of operation will be important for establishing its credibility and the non-partisanship of its evaluations, following the lead of other key Australian institutions, such as the Reserve Bank and the Productivity Commission.

Once this step has been completed, the authorities should consider expanding its functions and responsibilities. For example, the PBO could help fill the information gaps regarding the public finances of the states, perhaps under the aegis of the Council of Australian Governments. With regard both to historical data and analysis of short-term fiscal policies or the long-term sustainability of public accounts, information about the states is fragmentary and unavailable on a consistent basis. This feature, which Australia shares with other federal countries, constitutes a handicap which ought to be fixed. A PBO

with extended powers would be useful for conveying an overall picture of the country's fiscal policy, incorporating analysis of the situations of the states. This body could also examine the efficiency of some government programmes in areas where there is overlapping responsibility between federal and state governments, with the risks of duplication and waste, as in the health care and education sectors (BCA, 2011). Another mission could be to supplement the Treasury's regular evaluations of sustainability of federal finances by preparing Intergenerational Reports covering all levels of government.

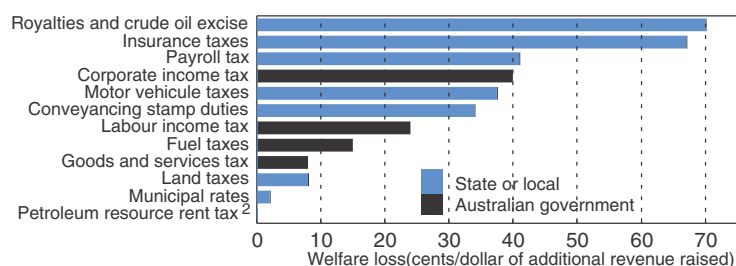
Tax reforms have a useful role to play in facilitating structural adjustment

The Australian Government has adopted substantial tax reforms and launched a number of initiatives aimed at spreading the benefits of the mining boom throughout the economy and helping businesses adapt to the transformations underway. The mineral resource rent tax (MRRT) and widening the base of the petroleum resource rent tax (PRRT) took effect in July 2012. Part of the proceeds from the new tax will serve to enhance tax incentives for SMEs on investment. Tax treatment of business losses has also been improved in line with the proposals of a working group on business taxation. Moreover, the authorities have expressed their support for reducing the corporate tax rate and assessing other options for reform to lower company taxation, such as the introduction of an allowance for corporate equity (ACE). To fund these reforms, which need to be neutral for the public finances given the fiscal situation, offsetting measures are to be identified within the business tax system.

Fine-tuning the reform of natural resource taxation

Rent taxes, such as the MRRT, are more efficient than royalties because they avoid penalising marginal deposits and new projects, relative to older and more profitable operations, which supports output and overall efficiency of the sector (Freebairn, 2012). As emphasised in the Henry Report (AFTS, 2010), royalties constitute the most inefficient levy in the Australian tax system (Figure 1.13). Moreover, the tax take on non-renewable resources is relatively slight in Australia: in FY 2008/09, public revenue generated by the mining sector accounted for roughly 6% of general government revenue, versus a third in

Figure 1.13. **Marginal welfare loss from a 5% increase in selected taxes¹**



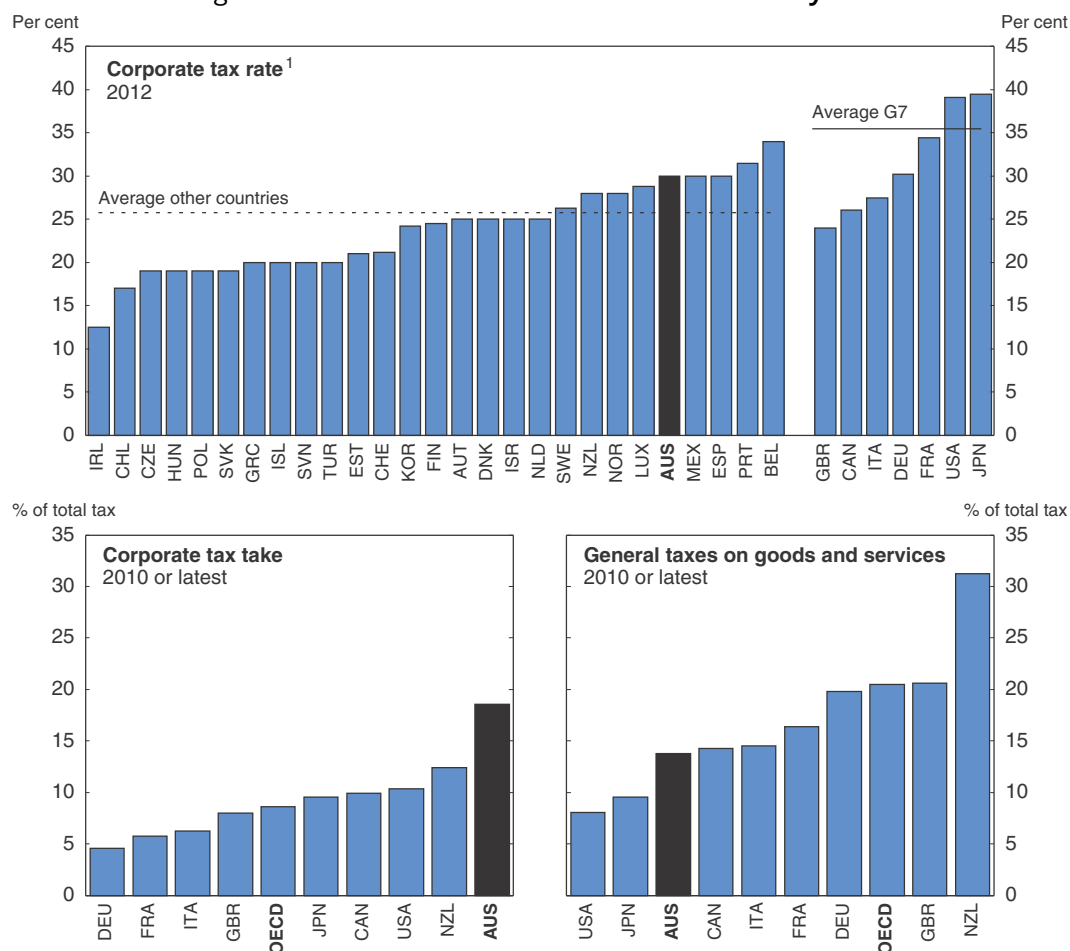
1. Based on the KPMG Econtech MM900 general equilibrium model of the Australian economy, the welfare loss is defined as the loss in consumer welfare per dollar of revenue raised for a small (5%) increase in each tax, simulated individually. It is measured as a satisfaction (utility) at its original level, once the revenue raised by the tax has been returned to the consumer as a lump sum transfer. The extent of such compensation reflects the distorting effect of the tax in the economy.
2. The petroleum resource rent tax is modeled as a pure rent tax giving rise to a zero welfare loss. In practice, a small increase in this tax could be expected to induce some welfare loss because it is not a pure resource rent tax with full loss offset. However, it would be expected to rank as one of the most efficient taxes in the chart.

Source: KPMG (2009), Econtech.

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Norway, 14% in Chile and approximately 40% in Mexico. An increase of taxation of this sector to ease the relatively heavier burden on business income (Figure 1.14) is justified on efficiency grounds for the economy as a whole. Competitive taxation on the most highly mobile production factor, capital, is important for a “small” country like Australia to attract foreign investment, which is likely to facilitate structural adjustment and foster productivity in the non-mining sector (OECD, 2009).

Figure 1.14. **Selected characteristics of the tax system**



1. The use of effective rather than statutory tax rate would provide a more accurate international comparison of corporate tax rates. However, the calculation of homogeneous effective corporate tax rates, taking into account the large diversity of tax deductions in the various tax systems, is not readily available.

Source: OECD (2012), *Tax Database*.

StatLink  <http://dx.doi.org/10.1787/888932737421>

The MRRT raises difficult questions of how to measure rent, which needs to be separated from normal profits, and is complicated by the deep vertical integration of many mining firms (Ergas *et al.*, 2010). Contrary to the recommendations of the Henry Report, the MRRT treats corporate profits and losses asymmetrically, which raises the effective tax rate relative to its theoretical level and discourages the riskiest projects (AFTS, 2010). The MRRT and PRRT also have limited coverage, less than two-thirds of the value of mineral exports (iron ore, coal, oil and natural gas), and exclude small firms, thereby creating distortions in investment choices between projects that are or are not subject to the taxes. Lastly, and

most importantly, output-based royalties remain in place at the state level. Royalties are credited to MRRT taxpayers, but they are neither refundable nor transferable, meaning that they are paid in full on projects whose returns fall short of the threshold for MRRT liability. Consequently, the MRRT does not eliminate the greatest inefficiencies, and the recent decisions by some states such as New South Wales, Western Australia, Queensland and South Australia to increase royalty rates have exacerbated the problem. Because state level taxes can be effectively credited to MRRT payers, increasing them will raise state revenues without imposing an additional burden on highly profitable mining projects paying MRRT, but will exacerbate the distortionary impact they have on low-profit mining projects. The GST distribution review, due to report by the end of 2012, is considering ways to remove incentives for states to increase royalties.

To address these difficulties, one option could be to replace royalties by a tax on mining rents based on the federal approach, while leaving the states free to set their own tax rates. This approach would respect the states' sovereignty in tax matters and improve the coherency and effectiveness of the tax system, although at a cost of potentially increasing the volatility of states' mining revenues. This issue, which may complicate their fiscal management, could nonetheless be addressed in the context of the ongoing revision of the fiscal equalisation system, or by a broader reform of the state tax systems, as suggested in the previous *Survey* (OECD, 2010a). The MRRT could also be extended to all mineral commodities and all mining businesses. The adoption of symmetrical tax treatment of profits and losses could be considered, although caution is necessary in weighing the benefit of shifting a greater share of project risk onto public sector against the impact of such measure on budget revenue. Lastly, once the lessons have been drawn from this new scheme, the authorities should consider further raising mineral tax rates if, as appears likely, they remain low relative to the private rent extracted.

Reforms of business taxation should also help adjustment

The tax breaks for businesses, and SMEs in particular, implemented to date or under consideration, in tandem with the reform of mining taxation, should have a positive impact on investment and productivity. The initial measures, estimated to cost only AUD 1.3 billion per annum (0.1% of GDP), will be funded by additional revenue from the MRRT and the PRRT. They include simplified rules for depreciating investments, such as a sharp increase in the ceiling on capital spending (from AUD 1 000 to AUD 6 500) that SMEs can write off immediately. More importantly, in line with the Australia's Future Tax System Review's recommendation and the Business Tax Working Group's recommendations, the asymmetry of the current tax rules applicable to corporate profits and losses will also be reduced through the introduction of a loss carry-back arrangement.

This latter reform, which came into force in July 2012 and provides the possibility of carrying back corporate losses to offset previously taxed profits, is helpful for entrepreneurs who need to alter their business models to meet new challenges and opportunities created by the structural changes underway. As in some other OECD countries, the Australian tax system imposes a levy on businesses when they make a profit but does not provide for refunds in the event of losses, except under certain restrictive conditions. This increases the effective tax rate to above the standard 30% and tends to skew entrepreneurs' behaviour against risky investments and associated innovation efforts, which are particularly needed in the current circumstances (Australian Government, 2012b). The corporate loss carry-back reform will not only have beneficial

effects on the level and quality of capital investment, but, depending on how firms reallocate their tax burdens over time, it may also bolster the automatic stabilisers in the economy. In Australia, these stabilisers are relatively weak by international standards, since they imply that a 1% dip in GDP increases the budget deficit by less than 0.4% of GDP, versus an average of 0.5% of GDP across OECD countries (André and Girouard, 2005). This reform should make the collection of corporate tax more volatile, with a sharper decline in revenue during recessions, due to increased refunds to loss-making firms. To reduce the risks to government revenue and target SMEs, for which the reform is especially important, the losses that could be carried back have been limited to a maximum of AUD 1 million and current-year losses can only be used to offset taxes paid by in the two previous years. However, the ceiling on refundable losses can be adjusted according to economic conditions, if necessary.

As the Australia's Future Tax System Review and the Business Tax Working Group suggest, the reform of the tax treatment of losses could go further. First, the possibility for loss carry-backs, which are currently restricted to corporate firms, which account for only 28% of SMEs, could be extended to unincorporated entrepreneurs. However, the extension of this measure to individual entrepreneurs, who can already set any losses against income from other activities, is likely to generate lower benefits than in the case of corporate firms. Second, it could be desirable to be less restrictive on the eligibility tests applied to firms claiming loss carry-forwards. Currently, carry-forward of losses to reduce future taxable profits is possible only for firms that have changed neither their ownership nor their line of business. However, the "Ownership Test" could be fine-tuned to ascertain whether a change in ownership was motivated by tax considerations or commercial objectives, although this might be difficult in practice. Moreover, the "Same Business Test" is also problematic because it is defined too narrowly and creates uncertainties that prevent taxpayers from knowing in advance whether they will qualify for the provision. These additional changes would be especially useful for young businesses such as innovative start-ups that take risks in the realm of capital investment.

The government has also expressed a welcome aspiration to cut the corporate tax rate currently at 30%, when prevailing fiscal and economic conditions and other Budget priorities permit. A reduction of this tax rate, which is around 5 percentage points above the OECD average, would enhance Australia's attractiveness for foreign investments and boost productivity. However, the scope for lowering this tax rate and the net efficiency gains of this reform might be limited by the government's current plan to fund this measure by adjustments within the business tax system. In its final report released in November 2012, the Business Tax Working Group indicated that a cut of the company tax rate of 2 to 3 percentage points would be needed to drive a significant investment response, which would also be beneficial to productivity and real wages. However, the Working Group has found that there was a lack of agreement in the business community on how a lower corporate tax rate could be funded by business tax base broadening. Reductions in the company tax rate in the 1980s and 1990s were financed by making the business tax base broader and further broadening would involve a removal of longstanding taxation treatment which were not changed by previous reforms or/and would significantly affect small groups of tax payers (Australian Government, 2012c).

As in most other countries, the tax system in Australia incorporates a bias towards debt-financing of capital investment by allowing firms to deduct interest payments on their borrowings from their taxable income but providing no similar deduction for equity-

financed capital spending. This bias is, however, reduced by an imputation system for the taxation of dividends which applies to domestic and New Zealander investors. Nevertheless, it gives firms, especially foreign ones, an incentive to increase their debt-to-equity ratios, and penalises the development of innovating firms, which rarely pay dividends and generally experience greater difficulties in obtaining credit than established companies (Aghion *et al.*, 2007). Moreover, it is conducive to the development of financial engineering by multinational enterprises, which can cut their taxes by restructuring debt among their subsidiaries.

Various solutions are available and have been used to address this issue in some countries at some times. A recent proposal is an allowance for corporate equity (ACE), which aims at granting a deduction for a share of the equity that is used to finance capital spending on the basis of long-term interest rates (*Mirrlees Review*, 2011). Such a deduction, which might be conceived as an extended imputation system for the taxation of dividends to foreign investors, would give corporate taxation greater neutrality between sources of funding for capital investment. It would also bolster the scheme's efficiency by making it more similar to a system of rent taxation, with beneficial effects in terms of both growth and quality of investment (Heferen, 2011). "Normal" profits of less than the deduction generated by the ACE would in fact not be taxed, favouring a more symmetrical treatment for business losses and "normal" profits, and facilitating the adjustments of firms undertaking restructuring efforts. As the profitability of firms exceeds the ACE deduction and increasingly resembles a rent, the effective tax rate of corporate profits will rise and gradually get closer to the headline tax rate.

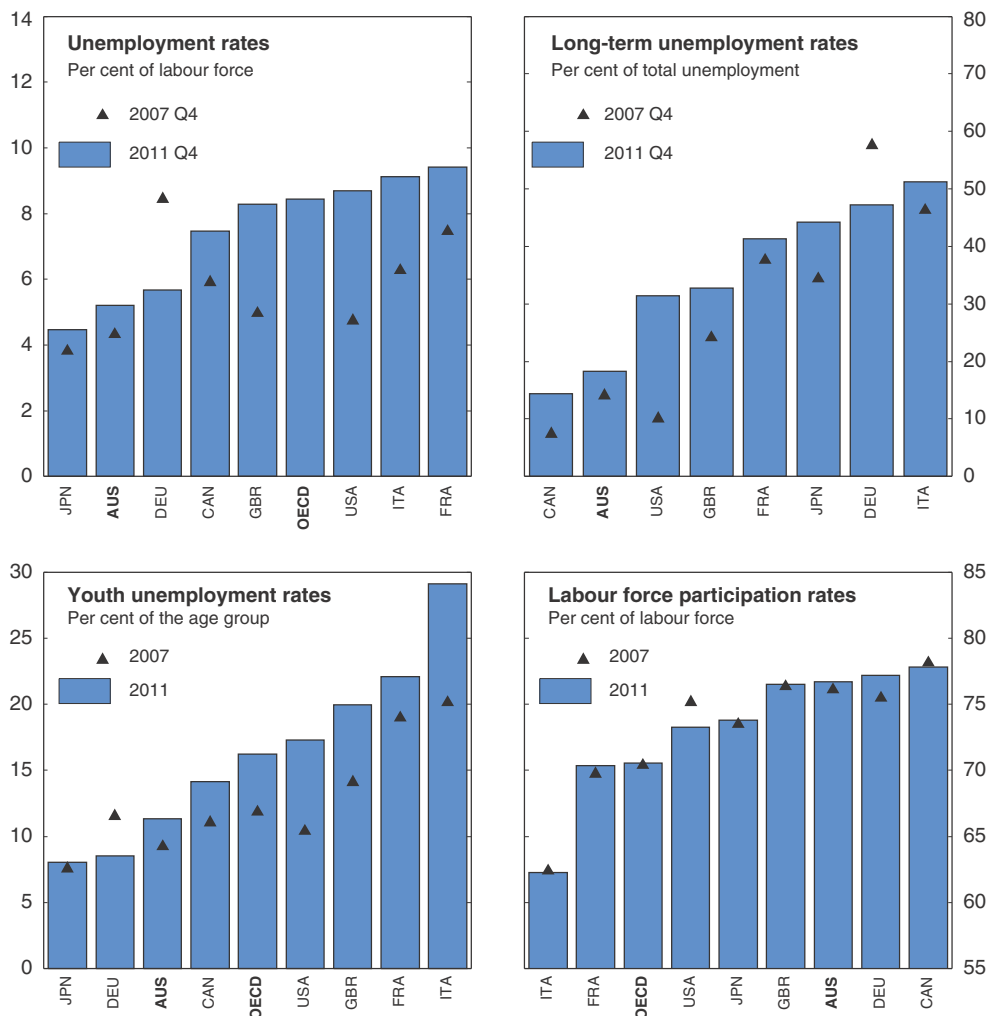
Introduction of an ACE would be a far-reaching reform, the consequences of which should be carefully assessed beforehand. The main difficulty associated with such a reform is its potentially high budgetary cost since it involves a narrowing of the corporate tax base. Such reform option has not been retained at this stage by the Business Tax Working Group, in the short to medium term, since it would be difficult to fund within the business tax system, although some of its features look attractive. According to some estimates, the reduction of the corporate tax base induced by an ACE at 5.6% could reach 20% in Australia and bring about a loss of tax revenue equivalent to approximately 1% of GDP (de Mooij, 2011). Moreover, the introduction of an ACE might encourage businesses, and especially multinationals, to develop tax planning and financial engineering to strengthen the relative share of equity financing and ease their tax burdens (Devereux, 2012).

Until now, a reform of this sort has been implemented by only a few countries, such as Belgium and Brazil, with results that on the whole are in line with theoretical predictions. In Belgium, the reforms seem to have attracted foreign investment from other euro zone countries. Belgium also recorded a dip in its corporate tax revenue in the initial years after implementation (Gérard and Valenduc, 2007). In the short term, these costs could nonetheless be limited if the ACE applied only to new capital investment, although this would make the system more complex. Extending the ACE to the existing capital stock would create a windfall gain for the capital owners without clear economic benefits. In the long term, costs could also be reduced by the reform's positive economic effects on growth, if the reduction in corporate taxation were compensated by a rise in less distortive tax such as consumption taxes (Mooij and Devereux, 2008). However, this would entail wider fiscal reform, which would imply a shift of the tax burden from the corporate to the household sector.


A flexible labour market remains essential to facilitate adjustment to the changes underway

Although Australia enjoys a relatively flexible labour market, with low unemployment and high participation rates compared with many OECD countries (Figure 1.15), employment reallocations are likely to pose a challenge. Two institutions have a particularly important role to play in facilitating the adjustment process: the industrial relations system and the public employment services.

Figure 1.15. **Labour market indicators**



Source: OECD, Short-Term Labour Market Statistics Database and Labour Force Statistics Database.

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The current functioning of the industrial relations system is subject to criticism

The industrial relations system, based on the Fair Work Act (FW Act) that came into force in July 2009, has been the subject of a vigorous debate over the past several months, due in part to the recently completed review of the legislation. The review, required because the FW Act was adopted without a prior regulatory impact assessment, is welcome. In the view of the business community, the FW Act moved too far in favour of employees in recasting the organisation of labour relations, after the Workplace Relations

Amendment (“Work Choices”) Act of 2005 had tilted the system to the benefit of employers (OECD, 2008 and 2010a). The unions, on the other hand, while more satisfied overall with the changes made by the FW Act, sought further reforms to improve equity and fairness in the workplace (Box 1.3).

Box 1.3. Main aspects of the Fair Work Act reform of industrial relations

Historically, the industrial relations system was extremely bureaucratic and centralised, and based essentially on awards. These were issued by administrative tribunals such as the Australian Industrial Relations Commission (AIRC) or similar agencies at the state level, which in this way set specific minimum wage and employment standards for a broad range of trades and sectors and even firms. Beginning in the mid-1980s, a series of reforms led to decentralisation of labour-management bargaining, introducing the “no disadvantage test” which guaranteed that wage and employment conditions negotiated in firms were to be no less generous, in net terms, than the corresponding awards. In 1996, introduction of the Workplace Relations Act simplified the system further: individual employment contracts (Australian Workplace Agreements, AWAs) were introduced; the tribunals saw their role restricted, as they lost their capacity for arbitration beyond the minimum employment conditions set in the awards; the number of these minimum conditions was reduced to 20; finally, the right to strike and the possibilities of industrial action by the unions were fenced in. In all, these reforms led to a sharp increase in the proportion of employees whose terms and conditions of employment were set by agreements, either collectively or individually. While these agreements represented only 32% of employees in 1990 (compared to 68% for the awards), the rate of coverage rose to 80% in 2002 (PC, 2011).

Although the reforms of the 1980s and 1990s were marked by a certain continuity and a consistent logic, the two waves of reforms since 2000 have had essentially opposing objectives, although both have extended the field of federal legislation in industrial relations to cover nearly all of the private sector (except unincorporated enterprises in Western Australia) and simplified the award system. The *Workplace Relations Amendment (Work Choices) Act 2005* took effect in the first quarter of 2006 and sought to reinforce employers’ prerogatives at the expense of employees, while the *Fair Work Act 2009 (FW Act)* had the opposite objective. A summary of the main provisions that these two reforms in turn amended is presented below (Borland, 2012; OECD, 2008).

Regulation of the level at which negotiations take place. *Work Choices* favoured the development of individual labour contracts, and eliminated the “no disadvantage” test. *Work Choices* established a hierarchy such that statutory individual agreements took precedence over the other types of (collective or individual) agreements that had been reached (with or without trade unions), even if these other types of agreement were in force. *The FW Act* does not provide for the making of individual statutory agreements: bargaining must now be conducted collectively at the enterprise level.¹ The no-disadvantage test has been reintroduced in the form of the “better off overall” test. The result of these negotiations has to be approved by the regulator, Fair Work Australia (FWA), which verifies, among other things, that all collective agreements comply with minimum requirements, including the provision that employees are better off overall in comparison with the relevant modern award. Collective agreements and modern awards must also provide for the making of “individual flexibility arrangements” between an employer and an employee. These arrangements do not need to be lodged with FWA and they can be terminated by either the employee or employer with notice of not more than 28 days.

Box 1.3. Main aspects of the Fair Work Act reform of industrial relations (cont.)

Provisions affecting the process and the format of labour-management negotiations. Work Choices made unions subject to restrictions by limiting their right of entry to businesses and requiring them to conduct a secret ballot of employees to authorise industrial action. The process for stopping unprotected industrial action (action taken outside of negotiations for a collective workplace agreement) was also tightened with the regulator being required to make a determination within 48 hours of receipt of an application. Since the introduction of the FW Act, the limitations on the right of entry of unions into company premises have been softened, but the requirement for a secret ballot before launching a strike has been maintained. Employers, employees and their representatives are now required to negotiate for enterprise agreements in “good faith”, which entails compliance with minimum standards of bargaining conduct. The FW Act also reduced the number of regulators overseeing the national workplace relations system from the six agencies under Work Choices to just FWA and the Fair Work Ombudsman.

Minimum terms and conditions of employment. Minimum entitlements defined in awards were a feature of the systems that preceded Work Choices. Work Choices reduced the safety net of minimum terms and conditions of employment previously covered by awards to five statutory conditions provided for in the Australian Fair Pay and Conditions Standard. These five statutory conditions applied to all employers and employees.² The FW Act safety net has been broadened to 10 statutory entitlements or national employment standards³ and 10 additional conditions included in modern awards to reflect the needs of specific industries and/or occupations.

Rules affecting the content of enterprise agreements. Work Choices prescribed a range of prohibited content that workplace agreements could not contain, *e.g.* matters such as the use of contractors or labour hire. The FW Act removed the prohibited content restrictions introduced under Work Choices; however, there are a small number of “unlawful terms” that cannot be contained in agreements.

Unfair dismissal protections. Work Choices removed unfair dismissal protections for employees of firms with fewer than 100 employees. The FW Act restored these protections subject to minimum qualifying periods of one year service for workers in firms with fewer than 15 employees and six months’ service for workers in firms with 15 or more employees. In addition, a number of protections previously available under Work Choices were streamlined and broadened in the FW Act to protect workers against discrimination and adverse actions because they have a workplace right.

The reforms of the last decade led to a further decline in the use of awards to set wages: whereas these covered 20% of employees in 2002, the proportion fell to 16% in 2008 and 15% in 2010. There has also been increased resort to company-specific collective agreements, from 38% in 2002 to 40% in 2008 and 43% in 2010. The use of individual contracts, on the other hand, has retreated slightly since 2008, from 44% of employees (including individual entrepreneurs) to 41% in 2010, a level close to that of 2002.

1. Although AWAs are no longer authorised, individual common-law contracts are possible, as long as the agreement complies with the national employment standards and any award conditions. Workers earning more than 100 000 Australian dollars (AUD) per year are free to negotiate individual common-law contracts with no reference to the 10 conditions set in the awards.
2. These five minimum conditions relate to the minimum wages, ordinary weekly working hours (38 hours) and entitlements to annual leave (four weeks), parental leave and personal leave.
3. These standard conditions cover the maximum workweek; the right to request flexible working arrangements; the right to parental leave or compassionate leave; the right to annual vacation and a minimum number of holidays; seniority leave; and rights concerning prior notice and compensation in case of contract cancellation or layoff; access to information from the FW Act on the detail of workers’ rights and the possibility of requesting assistance.

The key shortcomings of the industrial relations system as seen by business associations relate to what are regarded as excessive constraints on firms:

- The system is too compliance-oriented. The obligation to bargain in “good faith” introduces a procedure that firms find cumbersome to manage (BCA, 2012).
- The unions have too much latitude for bargaining over certain managerial prerogatives. The FW Act, for example, allows employees to seek to include job security provisions in agreements which place constraints around the use of contractors (BCA, 2012).
- Layoff procedures increase costs and uncertainties. This affects SMEs in particular, as they are now exposed to unfair dismissal claims, and they often feel themselves constrained to pay “go-away money” to avoid the high costs of litigation (ACCI, 2012). There seems to be a sharp asymmetry between the cost to employees of lodging an unfair dismissal complaint (AUD 62.4) and the burden on firms when a formal hearing or legal representation of parties is needed if conciliation does not succeed.¹ Another source of criticism concerns the potentially abusive resort to complaints of discrimination (“adverse action claims”), which, in contrast to “normal” recourse against unfair dismissals, can give rise to financial penalties with no ceiling.
- It is difficult to negotiate firm-specific agreements favourable to productivity, including individual flexible arrangements (ACCI, 2012; PC, 2011). Moreover, the provisions requiring employers commencing a genuinely new business to bargain with a relevant union for a greenfield agreement (i.e. when they have not yet engaged any employees) make appropriate and timely agreements more difficult to reach at a time when large new investments projects are planned.

Some sectors, such as retail trade, also seem to have specific difficulties to manage employment conditions (PC, 2011). Excessively high overtime rates and the three-hour minimum work time required to justify temporary employment limit the capacity of retailers to adapt to observed shifts in consumer behaviour. These restrictions prevent many firms from operating a profitable business on holidays, whereas households with increasing concerns for the loss of free time, place great value on this shopping opportunity. If it is not available they will turn to the Internet. Many students seem ready to work for a few hours, especially on weekends, for wages that pose no threat to retailers’ profitability.

Greater effectiveness of employment services would reduce adjustment costs

Australian employment services are organised differently from those in most OECD countries. While the unemployment benefit is centrally managed by a public agency (the Department of Human Services), these services (which were called Job Network from 1998 to 2009 and Job Service Australia, JSA, since 2009) depend on private providers who receive financing from the federal government in proportion to their success in returning the unemployed to work (“pay to outcomes”). Relying on private-sector delivery of employment services can in principle be good for encouraging competition, increasing responsiveness to the needs of jobseekers, and containing costs. Linking service providers’ funding to outcomes rather than to inputs should also encourage innovation on their part. This system has fostered competition and has contained the cost of delivering a standardised service, but the objectives of innovation and responsiveness to user needs have, according to most experts, not been achieved, even if the JSA model is delivering better results than previous arrangements (ACOSS, 2012; DEEWR, 2011a).² In 2011, 60% of

the New Start Allowance (unemployment benefit) recipients had been drawing the payment for over 12 months, and a third of recipients were aged over 44.

Private service providers naturally have an interest in selecting those who are easiest to place (cherry picking) and in “parking” the harder-to-place jobseekers, to achieve quick employment outcomes at low cost. It is also difficult to encourage the most disadvantaged jobseekers to take an active role in retraining, yet this is essential for integrating them into the labour market. Lastly, the authorities need to rein in the “deadweight cost” associated with paying private service providers for assistance to jobseekers who do not need it.

The incentive issues explain the reform efforts of the past, as well as current problems. To avoid cherry picking, the authorities have revised their method of funding. Both the funding model and the “Star Rating” performance assessment, which the Employment Department uses to assess the relative performance of service providers, have been adjusted over time to better incentivise the active and effective servicing of the most disadvantaged, with signs of improvement in their labour market outcomes. In particular, the use of regression analysis within the Star Ratings to control for differences in job seeker characteristics acts to promote the active servicing of all jobseekers. The effect of these changes has been observed in relation to the improvement in labour market outcomes achieved for the most disadvantaged. Services targeted towards job seekers with severe vocational and non-vocational barriers to employment (the Personal Support Programme) achieved a 15% employment rate under the previous arrangements compared with an employment rate at around 30% more recently (DEEWR, 2009 and 2011b). Since 2003, these changes also include payment for services to the unemployed and financing of back-to-work programmes (Employment Pathway Fund, EPF). In FY 2011/12, payments for the placement of jobseekers (“outcome payments”), represented 29% of suppliers’ funding; 42% was in the form of service fees, and the remaining 29% were reimbursements for services purchased or delivered funded through EPFs. Thus there has been a gradual shift toward a system that gives the authorities more control over inputs to ensure a minimum offer of services to disadvantaged jobseekers.

Yet this has increased the need to oversee the activity of the service providers and has made the system more bureaucratic: repeat interviews for problem jobseekers, for example, usually yield little in terms of landing them a job. On the other hand, the financing of private service providers also depends on the ongoing assessment of their performance, which keeps up healthy pressure on them to be efficient. The “Star Rating” performance assessment is published every three months to help jobseekers compare outcomes of service providers; it allows the providers to assess their performance *vis-à-vis* their competitors; and it is used by the Employment Department to inform purchasing decisions of employment services. Nevertheless, efforts seem desirable to further refine this statistical evaluation system and ensure it has no bias against providers handling hard-to-place unemployed or less disadvantage jobseekers (OECD, 2012c).

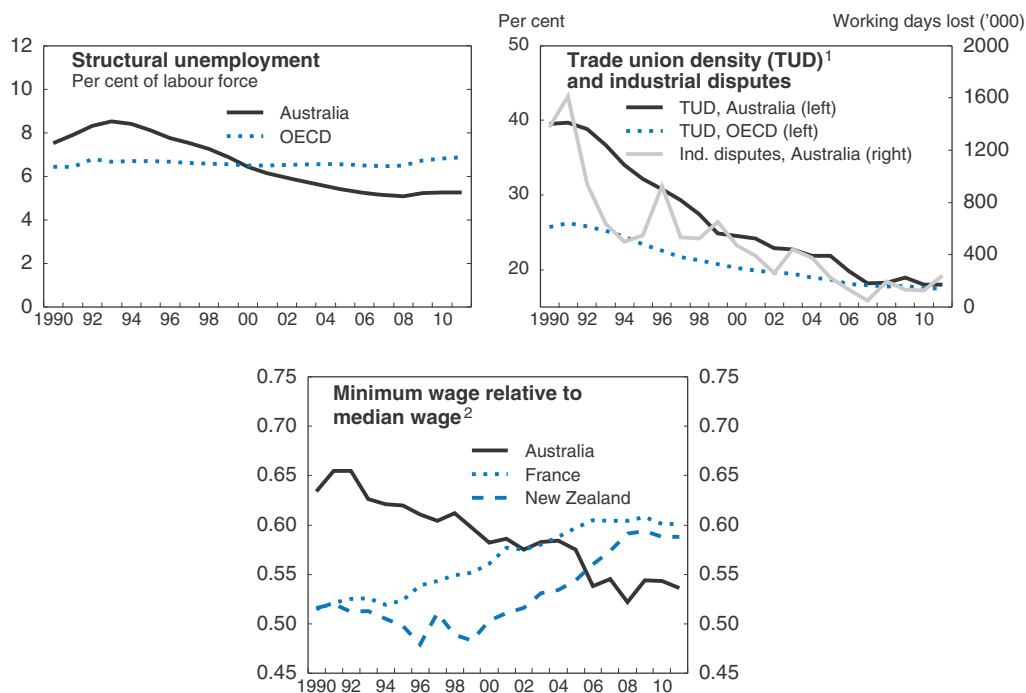
With the creation of the JSA in 2009, the emphasis is now on identifying the needs of jobseekers at the outset and steering them upon their arrival at the Department of Human Services to one of the four levels of assistance (“employment assistance streams”) offered by the employment services. While this is a welcome approach, the specific system in place seems too complicated (ACOSS, 2012; DEEWR, 2011a). Moreover, it could further promote active engagement of jobseekers, who must, for example, choose a service provider within two days after they enrol with the Department of Human Services. JSA has

also retargeted its funding toward the most disadvantaged jobseekers, and it has rationalised its organisation by rolling seven previously separate programmes into a single system (DEEWR, 2011a). JSA resources, however, have been cut in relation to those used in these seven programmes. This has led JSA to restrict services, not only for the less disadvantaged jobseekers, already inadequately served (OECD, 2010a), but also for persons facing serious barriers, for whom the level of assistance seems insufficient and drops off sharply after three years.

Nevertheless, the labour market has been functioning fairly well to date


The industrial relations reforms of the last decade have had an impact on labour market institutions. The unionisation rate has trended down since the early 1990s, but has stabilised at around the OECD average since 2008 (Figure 1.16). This development has coincided with a slight upswing in wage disputes, the number of which remains however historically low. The minimum wage in relation to the median wage, which had fallen by around 15% between 1990 and 2007, has also stabilised. Moreover, according to OECD estimates, the steep decline in the structural unemployment rate since the beginning of the 1990s eased around 2008, although the subsequent rise in that indicator has been slight, and smaller than the OECD average (Guichard and Rusticelli, 2011). The number of unfair dismissal claims lodged in the federal workplace relations system has nearly tripled since the introduction of the FW Act. However, it must be noted that the FW Act restored unfair dismissal protections to employees of firms with less than 100 employees. This increase also reflects the broader coverage of the federal workplace relations system due to

Figure 1.16. **Structural labour market indicators**



1. Number of wage and salary earners that are trade union members, divided by the total number of wage and salary earners.
2. Of full-time workers.

Source: OECD, Trade Union Density Database; Minimum Wages Database; OECD Economic Outlook Database.

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referrals of workplace relation powers from state governments. The success rate for unfair dismissal claims at arbitration in the federal system has risen (Freyens and Oslington, 2012). This rate, which was 33% under the Work Choice system, rose to 51% under the FW Act (or, comparing like with like, 41%, if only firms with over 100 employees are considered). While the increase in unfair dismissal claims may be attributable to the FW Act changes, the period also coincides with the onset of the global financial crisis, which may have increased the volume of dismissals, and unfair dismissal claims.

The loosening of legal protection by the Work Choice Act and its subsequent toughening by the FW Act seem to have had a minimal impact on employment (Freyens and Oslington, 2007 and 2012; Borland, 2012). The average compensation ordered at arbitration to workers unfairly dismissed appears to be similar under the FW Act and the previous regimes, at around three months' salary, compared to a potential maximum of six months as authorised by law. However, the statistics disclosed by FWA are inadequate for a thorough evaluation of the stiffening of employment protection legislation: comprehensive data on the outcomes of claims settled through conciliation is not available, although they account for 80% of all cases. Only partial information was recently provided by FWA on the outcomes of conciliation, indicating that of the matters settled at this stage, 26.7 % were settled without any monetary payment in the FY 2010/11 (Australian Government, 2012d). Moreover, where payments were made at conciliation stage they were usually modest, with 50 per cent under AUD 4000, and they often included settlement of outstanding entitlements. However, the frequent recourse to conciliation may well be related to the entrepreneurs' choice to avoid lengthy and more costly procedures independently of their likelihood to win (Collier, 2012).

Detailed information is also lacking on the success rate of adverse action complaints and the associated financial penalties. However, the annual number of these complaints has remained much lower than the comparable number of applications under the final year of the Work Choices Act and, in FY 2010/11 about two-thirds of these applications were resolved or withdrawn during the conciliation stage (Australian Government, 2012d).

More broadly, the labour market has continued to function well since the introduction of the Work Choice and FW Act reforms. The unemployment rate and the proportion of long-term unemployed have remained low in comparison to other OECD countries, even after the financial crisis (Figure 1.15). Available empirical studies suggest a flattening of the Phillips curve since the year 2000 compared to the previous period (inflation is less responsive to changes in unemployment), but they do not point to any moderation in the inflation/short-term unemployment dilemma over the last decade (Borland, 2012). There has been very little if any movement in the Beveridge curve for Australia over the period since 2000 indicating no significant shift in structural unemployment (OECD, 2012d). Spillovers in wage setting across sectors and from mining to non-mining states have been weaker in the current mining boom than in previous ones. The labour market has also shown strong resilience, with an endogenous reduction in hours worked, during the global financial crisis when demand contracted sharply. Finally, although productivity growth has declined substantially, this phenomenon started before the introduction of FW Act and Work Choice (Chapter 2).

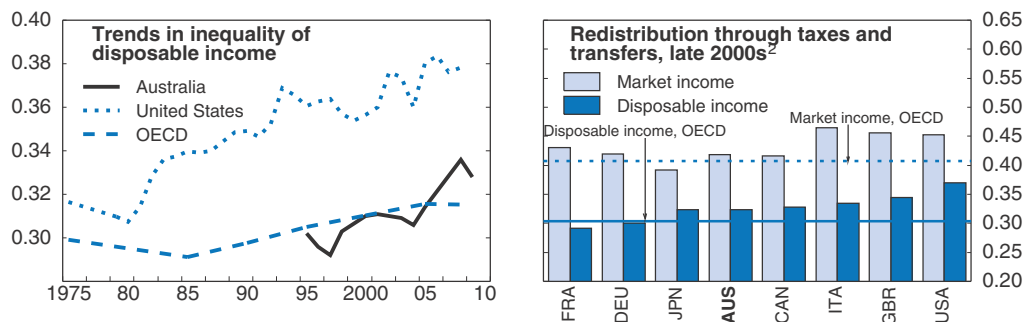
It is thus difficult to establish a clear causality between the industrial relations system and this weaker productivity performance, an assessment broadly consistent with the conclusions of the independent post-implementation review of the functioning of FW Act.

It must be recognised, however, that since the introduction of the Work Choice and FW Act the business climate has not been conducive to the search for efficiency, because of the initial windfalls of the mining boom – something that is now changing and may explain the criticism voiced about the FW Act by firms increasingly preoccupied with the need to boost their efficiency.

On the other hand, the development of labour market institutions since 1990, together with the impact of other factors such as the rising demand for skilled labour associated with technological change, seem to have exacerbated income inequalities among the working-age population (OECD, 2011). The widening of disparities in this area has outpaced the OECD average since 2000, and their absolute level was also higher in 2010 (Figure 1.17). In this context, the successive industrial relations reforms of recent years reflect the search for a balance between the need for labour market flexibility and the concerns for equity and social justice, to which Australian society has traditionally aspired, not only for their intrinsic value but also for political economy reasons. The system of industrial relations is in fact at the core of income redistribution mechanisms in the economy, and a balanced functioning of the system is important in garnering public support for structural reforms.


Figure 1.17. **Income inequality**

Gini coefficient¹



1. The Gini coefficient ranges from 0 (when all people have identical incomes) to 1 (when the richest person has all the income). Market incomes are labour earnings, capital incomes and savings. Disposable income is market income plus social transfers less income taxes. Incomes are adjusted for household size. Data refer to the working-age population.
2. Late 2000s refer to a year between 2006 and 2009.

Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, OECD Publishing, Paris.

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The authorities should adopt a prudent approach to further reforms as labour markets are working fairly well

Although the economic changes underway raise concerns among social partners, the existing framework of decentralised bargaining between employers and employees still seems to be yielding good results, judging from the labour market performance. The structural labour market indicators do not point to significant imbalances in the organisation of labour relations in favour of employees since the introduction of FW Act. This legislation has been in place for a relatively short period and the repeated regulatory changes of these last years, which generated adjustment costs to firms, especially to SMEs, should not be underestimated. It thus seems desirable to avoid further major reforms of its institutions in absence of obvious need. This view seems consistent with the conclusions

of the independent panel on the functioning of FW Act which has not suggested major modification to the industrial relations system.

However, this panel also put forward a number of mainly technical recommendations to alleviate some constraints affecting the flexibility of the bargaining mechanisms or the equity of the system that were not intended by the legislation. These recommendations, on which the authorities should provide an answer in the coming months, are broadly welcome, although they might be somewhat adjusted. They relate to the following main points:

- Promoting more flexible arrangements responding to specific individual needs of employees and employers. Although the reintroduction of statutory individual contracts has not been proposed by the panel, suggestions have been provided to make the individual flexibility arrangements (IFAs) easier to access and more attractive. For instance, it has been suggested that all firm agreements include the model flexibility term allowing at least variations in overtime rates, leave loading and work arrangements, and that the IFAs expressly permit the provision of non-monetary benefits to an employee in exchange for monetary benefits.
- Increasing the role of FWA, giving it arbitration powers in the case of greenfield negotiations. While this proposed extension of regulatory powers might facilitate agreements in a suitable time frame, it runs counter to past trends of reduced arbitration by third parties in favour of direct discussions between employees and employers. To encourage efficient negotiation of initial (greenfield) agreements with reasonable terms and within a reasonable time frame, the authorities might consider allowing for non-union rather than only union greenfield agreements, rather than extending the arbitral role of FWA, as is suggested by the review.
- Reducing the risk of excessive and improper recourse to unfair dismissal procedures. Proposed provisions include some streamlining of the procedure to resolve unfair dismissal claims, as well as stronger powers for FWA to reject unfair dismissal applications in some circumstances. These proposals could be complemented with a re-examination of the structure and distribution of litigation costs relating to unfair dismissal disputes between employees and firms to ensure that they do not encourage abuse of this remedy, without creating a barrier to industrial justice for workers. The current filing fees for employees are quite low, at AUD 62.4, and they can be waived in case of financial hardship. It is also important that FWA should make available all the statistical information needed to assess the impact of labour protection legislation.
- Improving access to flexible working time arrangements.

Efforts are also warranted to reduce the confrontational approach opposing business sector and unions concerning the functioning of the industrial relations system to promote a smoother employment reallocation required by the structural adjustments underway. A more co-operative climate to deal with the efficiency/fairness dilemma opposing social partners would benefit both employers and employees and favour employment-driven innovation with positive effects on firms' productivity and competitiveness (Chapter 2). It is important not to underestimate the capacity for innovation and inventiveness embodied in workers' experience and human capital (Hoyrup, 2010).

To support a more co-operative approach, the Fair Work Act Review panel suggested that FWA and the Fair Work Ombudsman take a more active role to encourage more productive workplaces. This would include identifying and promoting best practices in the

productivity enhancing provisions of agreements, developing model productivity clauses for awards and agreements and sponsoring training workshops for both employees and employers on how to enhance workplace productivity. These suggestions could be usefully complemented by a better identification of the concrete arbitration needs of the efficiency/fairness dilemma taking into account sectoral specificities, as was recently suggested for the retail sector by the Productivity Commission. While the level of overtime rates and the limits on part-time hiring constitute constraints for the employers of this sector, the latter could also better use current workplace relations flexibility to examine with their employees how their workplace practices can be improved to increase productivity and, thus, incomes (PC, 2011). In the same spirit, it could be useful to investigate sector-specific working conditions affecting the flexibility and equity issues negotiated between employers and employees. It is likely that these issues in the manufacturing, mining, finance and tourism sectors will vary according to their characteristics and constraints. Better information on particular flexibility needs and equity issues in the various sectors could help move the debate forward by focusing on concrete questions, which could facilitate negotiations and compromises.

There is also room to make the employment services more effective, although the authorities do not intend to reform JSA in the near future, as it depends on private providers financed by the federal government with the current contracts running until 2015. This is particularly important for mitigating the social costs of adjustment for displaced workers. The JSA in fact performs two distinct tasks, which could usefully be separated because they respond to different concerns: a relatively standardised employment service for jobseekers who are at no particular disadvantage, and more intense and sometimes multidisciplinary, individualized services for the currently or potentially long-term unemployed. Dividing the organisation of services according to this typology could be more efficient if, for example, it led to greater specialisation among private service providers. Consideration should also be given to a mechanism for remunerating service providers that is more closely linked to the “Star Rating” performance evaluation system of the Employment Department. This system should be closely monitored to minimize the risk of statistical bias in evaluations and attention should be paid to provide adequate assistance to all unemployed, both the easiest and the hardest to place (OECD, 2012c). Such a change would entail a reduction in the role of service fees, which now encourage generally inefficient micromanagement of private providers’ services by the federal authorities and increase the volume of red tape. To spur performance, the funding of employment services could be linked to jobseekers, letting them shop among competing providers for services that meet their needs.

Moreover, the authorities could consider putting stronger emphasis on active labour market policy (ALMP). In this perspective, the strengthening of assistance from employment services to the very long-term unemployed, together with tougher participation obligations as from July 2012, is a step in the right direction. Increasing the resources devoted to ALMP could also be worth considering as such spending is likely to be effective and could help compensate the losers from structural adjustment. If they are well targeted, resources put on ALMP may well have a relatively high rate of return as it would help reduce social spending required to support the long-term unemployed and bring in other quantifiable benefits to the community (including in terms of reduced delinquency). Developing quantitative analyses in this domain would be worthwhile to provide a strong basis for further policy improvements.

Box 1.4. Main policy recommendations

Medium-term fiscal policy

- Refrain from increasing or extending government assistance to industries, including the automotive sector.
- Consider creating a stabilisation fund together with a shift in medium-term fiscal strategy to better insulate public spending decisions from revenue changes caused by volatile terms of trade.
- Promote smooth activation of the new Parliamentary Budget Office (PBO). Once its role and credibility are established, consider expanding its functions to fill the information gap on the states' finances. For instance, ask the PBO to extend the Intergenerational report to all government levels and examine government programmes where federal and state responsibilities overlap such as in education and health where there are risks of duplication and waste.

Tax reform

- Pursue business tax reforms including reducing the corporate tax rate and a possible extension of the loss carry-back scheme to unincorporated firms.
- Continue to analyse solutions to the asymmetric taxation of corporate debt and equity, including the introduction of an “allowance for corporate equity”.
- Broaden the mineral resource rent tax (MRRT) coverage to all commodities and businesses. Consider replacing state royalties by a mining rent tax modelled on the federal approach, allowing states to set their own tax rates. In the longer term, ensure that levies on the private rent extracted from mineral resources are adequate.

Labour market reform

- Preserve the existing framework of direct and decentralised bargaining as it has yielded good results so far. Avoid substantive changes to the framework to minimise the costs of adjusting to frequent regulatory changes.
- Consider minor changes to the industrial relations framework including allowing employers commencing a genuinely new business to negotiate collective agreements both directly with potential future employees and/or unions.
- Ensure more complete disclosure of information to evaluate the impact of the recent tightening of employment protection legislation. Rebalance the distribution of litigation costs of unfair dismissal procedures between employees and employers to reduce incentives to abuse them.
- Investigate sector-specific working conditions affecting the flexibility and equity issues negotiated between employers and employees to help move the efficiency/fairness debate forward and focusing it on practical questions that are potentially easier to solve through negotiations and compromises.
- To increase the effectiveness of the employment services, more closely link their funding to jobseekers, possibly by introducing a voucher system. Consider linking the remuneration of service providers more tightly to the “Star Rating” performance evaluation system.
- Envisage separating the offer of standardised services for jobseekers with no particular disadvantage from the individualized services for the currently or potentially long-term unemployed.

Notes

1. Information concerning the total costs to employers and employees of unfair dismissal procedure when conciliation cannot be found is not readily available. According to one estimate, a three-day hearing by FWA may involve legal costs for the firms amounting to up to AUD 10 000-15 000 (Keen and Lawson, 2012). On the other hand, if matters are not resolved at conciliation, employees have not only to bear the filing fees (AUD 62.4), but also the costs of legal representation. In practice however, the vast majority of unfair dismissal claims are settled quickly and flexibly with telephone conciliation and do not require formal hearings or legal representation (Australian Government, 2012d).
2. The Government is aware and supportive of the need to foster innovation in employment service delivery. It has provided funding through the Innovation Fund and the JSA Demonstration Pilots to encourage innovative approaches to servicing job seekers. The results of projects funded by these two measures will be considered in future program development and contract arrangements.

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