Australian Government

The Treasury

THE TREASURY

ECONOMIC ROUNDUP

ISSUE 2, 2014

© Commonwealth of Australia 2014

ISBN 978-0-642-74998-7

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International Economic Cooperation — Is it at Risk?

Dr Martin Parkinson, PSM[1]
Secretary, Australian Treasury

Speech to the Centre for Strategic and International Studies — Thursday 10 April, Washington DC.

1 This article has benefited from comments and suggestions provided by Neil Cribbens, Jyoti Rahman, Sandra Roussel, Christopher Legg and David Pearl. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

It's a privilege for me to address you this evening.

I would like to commend the Centre for its Pacific Partners Initiative. It's a great way to bring Australians and Americans together to speak on issues of mutual interest for our two countries.

I notice in the past six months alone you've hosted the Australian Foreign Minister — Ms Julie Bishop — twice, the Australian Minister of Communications, Mr Malcolm Turnbull, and Australia's G20 Sherpa, Dr Heather Smith. The high profile of these speakers reflects the high regard in which the Centre is held in Australian policy circles.

Ms Bishop has already spoken to you about the importance of US-Australia relations. So I would like to speak about a broader topic — the challenge to international economic cooperation, and its underpinning global architecture, in today's increasingly plurilateral world.

It may be considered unusual for a Treasury Secretary to present on a topic more commonly reserved for foreign affairs officials. In fact as my friend, the Secretary of the Australian Department of Foreign Affairs and Trade, Mr Peter Varghese, recently remarked: 'it's a most dangerous situation — a Treasury Secretary with a worldview — and one not to be encouraged'. But jokes aside, these are not issues that can or should be ignored by domestic economic policymakers.

The global economic backdrop is changing. These changes inevitably have implications for the global environment and architecture in which international economic cooperation occurs and hence on how we consider domestic policy choices.

Changing Global Economic Fundamentals

I would like to begin by briefly identifying four key pillars behind the current global economic reshaping.

The first is the advance of technology.

The Industrial Revolution broke the link between the size of a country's population and its ability to project economic might on the global stage. Advances in technology that occurred in Britain and Europe allowed a relatively small part of the world's population to wield outsized influence.

Today, the much wider dispersion of cutting-edge technology and productivity advancing processes is leading to a return to the pre-Industrial Revolution paradigm, where the size of a country's population is itself a driver of geoeconomic and geopolitical importance.

Technology in the hands of many is restoring the link between population and influence that was broken by technology in the hands of a few.

While the developed world in many ways still has an absolute technological supremacy, the democratisation of technology is helping facilitate the rise of the emerging world.

With this return to the pre-Industrial Revolution paradigm, population and demographics — the second pillar — become increasingly important. This matters a lot to the developed world because we're characterised by an ageing, educated workforce and more or less stable populations.

For developed countries, our ageing populations will detract from future growth, and the ageing of the median voter may inhibit willingness to embrace structural reform. In contrast, the demography of many — but not all, China being a prime example — emerging economies will, by and large, accelerate their development.

In fact, in some instances, population is magnifying the effects of the first pillar as the dynamism and innovation engendered by large and increasingly better educated populations provide emerging economies greater opportunity to take the lead in technological advancements.

The third pillar is sustainability. Partly due to climate change, we're seeing a change in the distribution and relative importance of resource endowments worldwide. With that comes new opportunities for conflict or cooperation, for example over food, water and energy security.

As the implications of climate change become clearer to countries, it will be increasingly important to integrate climate change mitigation strategies and energy security policy into broader foreign and economic policies. Diversification into alternative energy sources will become more attractive and given the importance of energy — and who controls it — this kind of democratisation of energy will change geopolitical and geoeconomic dynamics.

The intersection between the democratisation of technology, changing demographics, and the growing importance of resource sustainability comes together in the fourth pillar — the shift in the global economic centre of power.

The centre of economic gravity, which had been shifting from Asia to the West since the Industrial Revolution, is now returning to the Asia-Pacific. In the case of China, its embrace of market forces has unleashed the economic potential of its large population, and that transformation is far from finished. In the thirty years since reforms began, China's share of world output has increased almost eight-fold, while the size of the world economy has itself increased five-fold.

The economic growth experienced in Asia will also generate sustained growth in average incomes in these countries, reinforcing aggregate growth. It will continue to lift millions out of poverty and millions more into a growing Asian middle class. Based on plausible projections, by 2030 the Asian middle class could expand to around 3.2 billion people — more than the rest of the world's middle classes combined, and up from half a billion in 2009. By 2050, four of the five largest economies in the world are projected to be in Asia — China, India, Indonesia and Japan.

But it's not just a story of a shift in the global economic centre of power from the Atlantic to Asia; it's also one of dispersion. The world where there was a clear single centre has changed. In addition to the Atlantic and Asian centres, lesser but still influential 'hubs' are emerging, such as in Latin America.

In 1950, emerging and developing economies represented three-quarters of the world's population and a third of global GDP. Today, emerging and developing economies account for 85 per cent of the global population and 50 per cent of GDP.

Before I continue, I'd like to note an important caveat to this. The drivers I've outlined here project a convergence of emerging with developed economies — however, this is potential, not preordained, change. For this potential to be converted into outcomes requires good policies, sound institutions, and the conventional facilitators of growth.

The 'demographic dividend' faced in countries like India and Indonesia is a good example. We have seen in North Africa and the Middle East the double-edged sword that a large, young population can present. If a country's economic institutions cannot generate strong and sustainable job growth, the prospective 'dividend' can quickly become, as some put it, a time bomb.

Similarly, if institutional arrangements don't ensure economic growth is reflected in the overall living-standard improvements expected by the lower and middle classes, as their expectations adjust to being global citizens, this can further destabilise growth and derail potential. Emerging economies cannot be complacent.

Implications for International Economic Cooperation

Given these changing global fundamentals, what are the implications for international cooperation and the global architecture?

First and foremost, despite the changing shape of global influence — and even because of it — the need for economic cooperation and collaboration between countries is vital.

Today, the intricate networks of trade, finance, people, and confidence channels that link us all have created a world where a country's economic circumstances and policies don't simply affect itself. It's not necessary to cite examples in support of this as the years since the onset of the global financial crisis have brought this starkly into conventional wisdom, if it wasn't there previously.

In such a world, international cooperation is essential. It's important that countries identify commonality of interests, taking action to mitigate negative spill-overs and recognising the potential benefits of collective action to provide global public goods. Comparing the inter-war period with the post-World War II era, the lesson is that global growth and stability requires this co-ordination, and it's truer now than ever.

However, while the importance of international cooperation remains unquestioned, the changing backdrop is presenting challenges to the global architecture. The global architecture was set up under a Trans-Atlantic hegemony. As the hegemonic status has changed, the system has become strained, and the inability to adjust is resulting in growing fragmentation. The very use of the word 'architecture' — implying a relatively fixed, well-designed, and uniformly accepted set of global institutions and conventions — is, arguably, increasingly misleading.

One factor challenging the architecture is the simple fact that global power is shifting and dispersing. As power spreads across multiple centres and hubs, new institutions naturally spring up to represent them.

Also, what we're seeing is that these centres are themselves more heterogeneous groupings than previously. Asia is a case in point. The Asia-Pacific region represents an area of more divergent interests, values, cultures and histories than, for example, Europe or North America. This diversity can naturally engender multiple forums to reflect it.

A second factor challenging the global architecture is the faltering progress being made to reform the traditional global institutions.

The emergence of multiple centres with stronger and more divergent voices is both a cause of, and a response to, this faltering progress. Common endorsement can no longer be achieved simply through shared interests and values of a small number of countries. Emerging powers are increasingly

unwilling to accept outcomes from processes in which they have not been meaningful participants, and they do not necessarily share the core values and interests of the traditional players.

But this faltering progress is also partly due to hesitancy from the larger players to commit to taking the lead to make global cooperation successful.

Here in the US, the belief that global multilateralism is in America's best interests is arguably being increasingly questioned. Indeed, as Richard Haass has noted, the US has two co-existing but contrary inclinations: 'to try to do too much and too little' in foreign policy.[2]

This is not restricted to foreign policy. Moreover, as Haass also notes: 'American political dysfunction … is getting in the way of the US restoring the foundations of its power and doing what it can and should do to make sure that the economic foundations of all that [it does] … in the world are secure'. The unwillingness of Congress to progress IMF reforms is a striking example of Haass' thesis.

At the other end of the Trans-Atlantic axis, Europe is characterised by introspection as countries struggle to come to grips with the aftermath of the global financial crisis, the failure in many countries to progress structural reforms after the creation of the euro, and the consequences of an ageing population. This introspection, combined with the failure of US leadership, allows those European countries opposed to modernizing the global architecture, to avoid facing today's economic and strategic realities.

Meanwhile the emerging powers are still only taking tentative steps towards a leadership role in providing global public goods. Despite their desire to exercise influence, they've so far been conservative in what they bring to the table, with agendas that are relatively inward-looking, due partly to challenges some face in transitioning from emerging to advanced status. This hesitance is making it easier for others to leave the architecture unchanged at little short-term political cost.

To the extent these actions are generating complacency, about the sustainability of the current architecture, that complacency is seriously misplaced.

The growing number of voices and the absence of meaningful progress at the global level are resulting in a preference for issues to be addressed in sub-global forums. This is taking a number of forms.

As the most obvious form, regional multilateral groupings are common. These groupings, with more formal institutional structures, processes and membership, to some extent replicate the structures at the global level, but with fewer voices around the table and more commonality between members.

What we're also seeing is a range of less formal arrangements, sometimes described as 'softer' governance and coordination.

One approach is the creation of issue- or context-specific plurilateral groupings with constrained membership based on shared interests and a predisposition to work together. Formal and legal requirements may still exist, but the key is that their commitment and shared interests allow faster progress on an issue or initiative, sometimes on the basis that the final agreement is open to others to join at a later date.

2 Haass, R. 'The Post-Cold War World 25 Years On'. Speech to the Council of Councils Regional Conference, 23-25 February 2014

Another trend is towards plurilateral groupings based on voluntary participation and without strong ex ante expectations of outcomes or initiatives. These groupings are designed more to facilitate the exchange of views and dialogue, and create a stronger, more coordinated voice in larger forums. Where necessary, they rely primarily on 'peer pressure' to achieve outcomes.

The result of all this is the emergence of a large, loose and evolving web of overlapping forums, institutions, and arrangements — each with a slightly different emphasis and key players — that sits both below and within the global architecture.

Engagement and Leadership in a Plurilateral World

So, in this world, is economic cooperation at risk? And if so, how do we ensure it continues meaningfully?

Firstly, I want to make clear that I still believe that global multilateralism delivers benefits that cannot be achieved through a network of bilateral, plurilateral, and regional arrangements.

While its ability to address new issues may be facing challenges, the existing architecture of global institutions, forums and agreements provides a stock of rules and standards that still underpin international behaviour, including in the sub-global forums.

Also, given the global interconnectedness I described earlier, it's vital we retain effective global economic dialogue that recognises the spill-overs — both positive and negative — that stretch so prevalently across today's world. This includes the need for global cooperation to address challenges that, in terms of their nature and potential impacts, are truly global.

To paraphrase Richard Haass again, the world faces a number of global challenges — climate change for example — where there is a significant gap between the scale and nature of the challenge and the scale and nature of the global consensus and arrangements in place to manage it. Closing this gap through effective global cooperation is the only way to address these global challenges.

That said, I caution against the temptation to try to insert every major global issue into those forums that work reasonably well. This is almost certainly a recipe to undermine what is actually effective. Instead, if subject specific forums — such as the World Trade Organisation or United Nations Framework Convention on Climate Change — are not delivering, a key focus of effort should be renovating those bodies to make them more useful.

It's also important to note that the current architecture reflects, at its core, a set of values for which the traditional powers stand. While some argue this is part of the issue, these countries ought to see that it's in their interest to retain these institutions that are best able to build on those values — although when I say 'retain', they also need to adapt to the new global backdrop and ensure they are fit for purpose. Without adaption and evolution, retention of those institutions will not equate to retention of their existing capabilities!

A recent model for global cooperation in which Australia sees significant merits is the G20.

The G20 represents around 85 per cent of the world economy, 75 per cent of global trade and two thirds of foreign direct investment, so it's naturally well-placed to be a key global economic policy-making body. However, its strengths are broader. Its representation is designed to be regionally balanced and reflective of the global economy, while its less formal structure allows both flexibility and frankness in discussions.

We have seen the strength of the G20 through the global financial crisis. As bad as it was, the crisis could have been much worse if not for the leadership and actions taken by the G20, which moved quickly to help stabilise financial markets and support the global recovery.

And following the crisis, the G20 remains relevant. It has continued to press for domestic policy shifts from members, such as euro-area structural reform and the easing of austerity measures, and renminbi appreciation. And, as is being seen with the crisis in Ukraine, the G20 recognises that countries will need IMF support at critical junctures. It was the G20 that pushed for a substantial increase in the IMF's resourcing to ensure a strong global safety net exists, and for reforms to IMF governance to ensure ongoing legitimacy and credibility.

In saying this, it's important to acknowledge that the G20 has its own shortcomings.

One criticism levelled at the G20 in recent times is that it has become less effective as its agenda has become broad and unwieldy. Australia is acutely aware of this and in our presidency year we are running a tight agenda focused on promoting private-sector-led growth and building global resilience.

We fully expected, and are seeing, pushback on our attempts to narrow and focus the agenda. We will, however, maintain the discipline we think is necessary for the G20 to function effectively and deliver in those areas where it can best make a real difference. In short, under Australia's presidency, 'forum shopping' and efforts to bring other issues into the G20 will be strongly resisted.

In the same vein, the quality of debate and interaction among ministers has been characterised as less robust than in the past, leading to less effective policy outcomes. To address this, Australia has introduced innovations to the G20 meeting format to facilitate genuine debate on policy issues — in short, to allow Leaders to be Leaders.

Given its depth and reach, the G20 has an important role to play in steering the global economy, and Australia is committed to securing it as the key international economic governance institution.

However, despite the importance of global forums, we also have to accept the world we're living in: one in which the emerging importance of an ever-growing network of sub-global engagement is unlikely to reverse. As such, countries need to be creative and flexible in how they balance their commitments and interests to ensure they engage meaningfully across these sub-global forums.

This engagement is important — countries need to remain involved in cross-border issues and policy initiatives that are increasingly addressed at the sub-global level.

It's also important for the respective forums themselves. The trend towards regional and plurilateral engagement risks undermining international cooperation, potentially engendering regionalism and nationalism that could inhibit global efforts. But at the same time, it can also support international cooperation.

To achieve the latter, we need to ensure that global and sub-global forums coordinate and maintain linkages across the web of interconnections I noted earlier. If countries engage effectively across these forums, overlapping membership is one way to help ensure consistency across frameworks, and thus ensure that sub-global efforts strengthen and complement — rather than undermine — global efforts.

Plurilateralism in the Asia-Pacific

Before finishing, I'd like to briefly focus on the Asia-Pacific. As an area not traditionally heavily involved in the global institutions, and one with disparate interests, values and cultures, the Asia-Pacific is a region where this regional and plurilateral engagement is especially important. As such it provides a good example of the sub-global network I have just described.

The Asia-Pacific's network of forums and arrangements for economic and financial cooperation has grown significantly over recent decades. This has been spurred by the broader global economic fundamentals I outlined earlier, as well as region-specific factors like the financial volatility experienced during the Asian and global financial crises, a growing sense of common opportunity in the 'Asian Century', and a response to the shifting power relativities that are evolving quickly and significantly.

Achieving cooperation in this environment — particularly cooperation that complements global efforts — is challenging, but possible.

Regional forums, such as the Asia-Pacific Economic Cooperation (APEC), the East-Asia Summit (EAS), and the Association of Southeast Asian Nations (ASEAN), provide established vehicles for region-wide cooperation. APEC's institution of voluntary commitments, without binding agreements, has provided a solid basis for collaboration and dialogue, and made progress in areas where difficulties with formal treaty ratification may otherwise, as in the US, have presented hurdles. Meanwhile, ASEAN has strongly encouraged its members to recognise their commonality of interests and strengthen their voice in larger forums.

Plurilateral arrangements have also resulted in cooperation where, arguably, progress wouldn't have occurred through traditional vehicles. For example, voluntary initiatives like the Trans-Pacific Partnership free-trade agreement and the Asia Region Funds Passport — an initiative aimed at facilitating cross-border recognition of mutual funds products — were driven initially by a subgroup of like-minded countries operating separately from, but alongside, broader multilateral efforts, to make progress and gain traction. These have both been opened to broader country participation once progress has been made.

Avenues for linking these forums with larger ones are also in place. For example, the rotating chair of ASEAN has a permanent invitation to the G20, while under Australia's G20 presidency this year symposiums will be held to discuss areas of complementarity between the agendas of both G20 and APEC — being held, in fact, next week in Shanghai — and G20 and ASEAN.

While this is only a brief insight into the web of forums and institutions within the region, it provides a taste of how the growing trend towards sub-global forums doesn't have to present an obstacle for international cooperation.

Conclusion

The global backdrop has changed significantly. This has had major repercussions for the environment and the mechanisms for international economic cooperation. Partly in response to the global institutions' failure to adapt to the change, a growing web of sub-global overlapping forums, institutions and arrangements are emerging that, on the face of it, present a risk to international cooperation — and at the very time when it's needed most.

However, I believe this is not an insurmountable challenge. In fact, it can strengthen the existing global architecture.

If we remain creative and flexible in how we engage with this web, and if we approach it as providing a complement rather than a threat to the existing global architecture, international economic cooperation can be stronger than ever.

If we don't, the costs from reduced international economic cooperation will be large, permanent and felt by all countries.

Thank you.

Capacity development in economic policy agencies

Harry Greenwell and Bede Moore[1]

In the past decade, Treasury deployees have accumulated considerable experience of the theory and practice of capacity development in economic policy agencies in various countries in the Asia Pacific region. In this paper, we address issues that we grappled with in our roles as capacity development advisers in Papua New Guinea and Solomon Islands, such as how to maintain good working relationships with counterparts, whether we were focusing on the right priorities, and how to assess whether we were being effective in our work.[2]

1 The authors are from Markets Group and Macroeconomic Group, respectively, of the Australian Treasury. We were both deployed to the Structural Policy and Investment Division in PNG Treasury between 2009 and 2012, Bede was the manager of the International Relations Unit in the International Policy and Engagement Division between 2012 and 2014, and Harry was previously deployed to the Economic Reform Unit in Solomon Islands MOFT between 2005 and 2007.

2 This article has benefited from comments and suggestions provided by Barry Sterland, Graham Teskey, Rebecca McLaren, Matt Flavel, Paul Flanagan, Colin Johnson, Shaun Anthony, Joanne Evans, Darren Kennedy and Phillip de la Rue. We have also benefited from the exit reports of several former deployees. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

The Australian Treasury first became heavily involved in the provision of 'capacity development services' in the early 2000s, with the deployment of Treasury officials to the (then) Solomon Islands Ministry of Finance (now Ministry of Finance and Treasury, MOFT) in 2003 and to the Papua New Guinean Treasury from 2004.[3] For several years prior to 2003, Treasury also sent a series of short-term deployments to the PNG Treasury through the PNG-Australia Treasury Twinning Scheme (PATTS), an arrangement that endures. Overall, since 1999, Treasury has made at least 104 deployments involving 78 staff to PNG (52 deployments), Solomon Islands (30), Nauru (10), Indonesia (8), Iraq (2), Vanuatu (1) and the Seychelles (1).

In the past decade, Treasury deployees have accumulated considerable insight into and experience of the theory and practice of capacity development in economic policy agencies in various countries in the Asia Pacific region. This article attempts to document this experience.

During our own deployments to PNG Treasury and Solomons MOFT, we frequently wrestled with a range of questions about our role as capacity development advisers, such as:

- From the wide range of possible capacity development activities that we could support, were we focusing on the right ones?
- Where there was a tension between focussing on capacity development and achieving policy outcomes, did we strike the right balance between the two? In particular, did we make the appropriate judgments about the extent to which we directly assisted counterparts with the policy content of their work?
- Of the activities we pursued, were we pursuing them in the most effective fashion, were we achieving sufficient progress to justify our continuing presence, and what data could give us confidence in making this judgement?
- Were the improvements to which we contributed robust enough to outlast our tenure as advisers and, if not, what could we do to have a more sustainable impact?
- What was the best way to build and maintain effective working relationships with a diverse group of counterparts?

In this paper we flesh out our thoughts on these and related issues, ones that, we suspect, most capacity development advisers grapple with during their deployments. Our aim is to set out the conclusions we reached (and the questions that we still have) in the hope that they will be useful to current and future deployees to economic policy agencies, their team leaders, and those involved in the design and review of such programs. We hope that some aspects of our paper will also be relevant to our counterparts in PNG Treasury, Solomons MOFT and other economic policy agencies and to international organisations and academic researchers interested in capacity development.

Before proceeding, we wish to clarify the scope of the paper and acknowledge its limitations. We do not attempt to argue in this paper for the merits of capacity development programs (or for aid generally). Rather, our focus is on the effective delivery of such programs, since it seems likely that Treasury will remain involved in capacity development services for some time.

3 These deployments came under the umbrella of the Regional Assistance Mission to Solomon Islands (RAMSI) and what was then known as the PNG Enhanced Cooperation Program (ECP), subsequently renamed the Strongim Gavman Program (SGP).

Cross-cultural awareness and an understanding of the political economy of counterpart countries are both highly relevant, if not vital, to the design of capacity development programs and, indeed, the potential for such programs to be effective. These topics are covered in some detail in the existing literature and so we only address them where they are directly relevant to the *delivery* of capacity development programs.

Finally, our conclusions are, of course, a product of our perspectives and experiences. We are well aware that there is a lively debate on many of these points amongst deployees, our counterparts and others involved in delivering capacity development programs. This is our contribution to the debate.

The central theme underpinning this paper is that it is important to think strategically about capacity development. The following section provides context by reviewing the objectives and design of the capacity development programs that involve Treasury officials. The subsequent section lists seven key steps involved in adopting a strategic approach to capacity development; this provides the structure for the remainder of the paper.

Capacity development: objectives and design

This section provides the context for subsequent sections by, first, briefly reviewing standard definitions of capacity development and its objectives and, second, outlining the main characteristics of the capacity development programs involving Treasury officials.

Definition and objectives

Standard definitions of 'capacity' and 'capacity development' (or 'capacity building'[4]) can be applied broadly to individuals, to organisations or institutions, and to society as a whole. 'Capacity' refers to the ability of these entities to 'perform functions, solve problems and set and achieve objectives in a sustainable manner'.[5] 'Capacity development' then refers to the process whereby these entities 'unleash, strengthen, create, adapt and maintain capacity over time' or, on a similar definition, the process whereby these entities 'develop competencies and capabilities … which lead to sustained and self-generating performance improvement'.[6]

In our roles as capacity development advisers, we found it was important to think about the different levels at which capacity development can occur — for individuals, organisations and for society as a whole. However, the focus of this paper is on capacity development *in economic policy agencies* (what could also be called *'institution strengthening'*), unless specified otherwise.

The Department of Foreign Affairs and Trade (DFAT) has suggested that capacity development has two objectives:

> First, performance improvement can be sustained once donor support ceases. Second and much more challenging, the partners can then go on to achieve similar performance improvement themselves as circumstances require over time. (AusAID 2009, p 1).

4 AusAID (2009, p 1) states that 'AusAID makes no practical distinction between the terms 'capacity building' and 'capacity development'.' We take the same view in this paper and have generally used the term 'capacity development' throughout, except in direct quotes from other sources. (Note that we cite AusAID as the author of any publications by the then-AusAID that were published prior to its integration with DFAT.)

5 This is a UNDP definition quoted in Matheson (2011). A similar definition is provided in AusAID (2009, p 1): 'Capacity is the ability of people, organisations and society as a whole to perform appropriate functions effectively, efficiently and sustainably.'

6 The first definition, from the OECD DAC, is quoted in Bolger (2008, p 9). The second definition is from AusAID (2009, p 1).

In other words, successful capacity development advisers will, ultimately, do themselves out of a job.

These objectives — sustained performance and the capacity for self-regeneration — have two immediate implications. First, the point at which advisers are no longer needed is when organisations are 'resilient' in the sense that they have the capacity to address any serious lack of capacity themselves. Enhancing the organisation's capacity for self-regeneration — its ability to build capacity itself — may be the most advanced stage of capacity development that can only be actively developed once other, more basic capacities, have already been entrenched.

Second, a long timeframe is required to fully achieve these objectives and should usually be measured in decades rather than years. In our experience, achieving significant, measurable progress against these objectives typically takes at least two to three years and so substantial program reviews should be conducted no more frequently than this.[7] Similarly, decisions to undertake capacity development programs should be based on long-term funding commitments.

The design features of Treasury's capacity development programs

While capacity development programs can take various forms, this paper reflects the programs in which Treasury deployees participate. These programs typically have the following characteristics.

First, most deployments are long-term (two to three years), although they can be supplemented by short-term 'twinning' (less than 12 month) placements.

Second, Treasury capacity development advisers are usually deployed as part of a team, rather than as individuals. Team leaders then take on multiple responsibilities: to support and advise senior management in the counterpart agency, to lead the team of advisers (with responsibilities not only for adviser's capacity development work but also for their safety and wellbeing), and to report to and liaise with Australian government colleagues both in-country and in Australia.

Third, Treasury advisers remain attached to the Australian Treasury for the purpose of performance appraisals, promotions and where they return post-deployment. As such, their performance assessments and incentives may be different to those of contracted or volunteer advisers. Further, deployees may be required to maintain communication with the Australian Government for program and individual evaluation purposes. Current guidance from the Australian Treasury encourages deployees to be open about these communication obligations and to maintain confidentiality regarding host government activities, consistent with local information disclosure laws and policies.

Fourth, in most cases, Treasury deployees have not held 'in-line' positions within counterpart governments but have been strictly 'advisers'. Nonetheless, deployees are assessed against a combination of policy outcomes and capacity development, with inevitable tension between the two objectives. The question of when capacity development advisers ought (or ought not) to intervene to ensure a policy outcome is discussed further below.

Finally, advisers are typically matched with a counterpart in an 'individual-to-individual counterpart model' that serves as the basis for joint reporting and assessments of capacity development. In practice, advisers usually provide capacity development advice to a range of staff, and this is often reflected in reporting on and assessments of capacity development outcomes. This suggests that an alternative counterpart model could simply match advisers with a team or organisation. While we see some merit in this idea, we do not explore it further in this paper.

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7 For example, the key reviews of the ECP/SGP occurred about once every four years: see Dixon et al. (2008) and Callan and Saneto (2012).

Thinking strategically about capacity development

Capacity development is a complex and challenging project and so adopting a systematic, strategic approach is essential. Drawing on Bolger (2008, pp 95-101), we have identified seven issues that can help advisers and counterparts to conceptualise and implement effective capacity development activities in economic policy agencies. These seven points provide the structure for the remainder of the paper:

- Take time to establish priorities
- Understand the importance of management capacity
- Effective relationships are critical to the effectiveness of advisers
- Advisers face difficult judgments about when to intervene and when to 'let things fall over'
- Measuring progress is important but difficult
- Think about the interaction between incentives and capacity development
- Recognise that capacity development requires specialised skills and expertise

Setting priorities for capacity development

In our experience, the potential scope of capacity development activities can be very broad. In the absence of a thorough assessment of options, there is the distinct risk that capacity development priorities will be determined by whatever capacity gap becomes apparent first.

To assist with identifying possible priorities, we have developed a checklist of capacity development activities that advisers and their counterparts can use to assess possible priorities. This checklist reflects Bolger's (2008, pp 95-98) advice to think in terms of different 'capacity levels': individual, organisation/group, sector/network, public sector institutional context and enabling environment. It also recognises the distinction he draws between 'hard capacity' and 'soft capacity', which we discuss further below. The full list is Attachment A and is based on the following four broad categories:

- Staff skills, training and development;
- Divisional and Departmental systems and processes;
- Broader systems and processes in the Department or the public service; and
- 'Soft capacity'.

Soft capacity: leadership, trust, team identity, values and morale

Of the four categories above, the first three principally relate to 'hard capacities', a term that refers to individual or organizational competencies, such as recruitment and promotion procedures, financial and resource management, or expertise in economics, law or related disciplines.

'Soft capacity', by contrast, includes features like leadership, legitimacy, trust, and an ability to motivate or strengthen team identity and values. Arguably, soft capacity also extends to a shared ambition or sense of what is possible, which may be more difficult to develop in organisations where there are few successful teams to point to as models. Bolger (2008, p 98) argues that:

> various reviews and analyses suggest that capacity development efforts often fail, or fall short of expectations, due to a lack of attention to these less tangible, 'soft' capacity issues. Part of the reason is that it is usually easier to address hard capacities, which are more likely to yield objectively measurable results in the short to medium term.

The challenges associated with developing soft capacity are closely related to several ideas that are developed later in this paper. First, Bolger points to one of the difficulties with measuring the effectiveness of capacity development work. Second, senior managers are central to developing (or undermining) team identity, values, mission and trust and so the importance of soft capacity reinforces the centrality of management capacity to successful capacity development. (We discuss management capacity further in the section immediately below.) Finally, in a later section we reflect on the balance advisers must strike between when to intervene and do some of the work and when to step back to avoid creating unhelpful dependency. We found that we intervened most often to support managers in maintaining aspects of soft capacity, often because of concerns we had for team morale if we did not do so.

Understanding the importance of management capacity

A key role of managers is to develop and sustain the capacity of their staff and teams and so there is a close relationship between successful capacity development and satisfactory management capacity. Conversely, gaps in management capacity can act as a key constraint on the effectiveness of capacity development programs.

There are numerous factors that contribute to gaps in management capacity in developing countries including:

- the sheer volume of issues to which managers must respond;
- competing priorities outside of work (family and community obligations, security issues, etc);
- a lack of exposure to good management practices;
- a lack of incentives and feedback to reward good management practices (or the existence of perverse incentives that encourage poor management practices like information hoarding);
- external pressures from, for example, the fluid political environment, including ministerial reshuffles, or inexperience or incompetence in other parts of the bureaucracy;
- difficulties in recruiting and retaining high calibre staff who could progress through the ranks into management roles; and
- a lack of systems to support good management (such as recruitment, appraisal, security and ICT systems).

The centrality of effective management for successful capacity development implies that, where possible, supporting improved management practices should be a priority for advisers. For example,

in cases where one-on-one mentoring or executive coaching are possible and likely to be fruitful, this should be pursued. Another strategy may be to support departments to develop a management and leadership course for mid-level managers with assistance from local and international specialists.

There are significant limits, however, on how much advisers can do to address management weaknesses, not least because several of the constraints on management capacity noted above are beyond the control of advisers. As a result, these capacity gaps need to be accepted as a fundamental part of the working environment that, whilst susceptible to gradual improvement, will remain an obstacle and challenge for a considerable period.

One implication of this is that advisers will frequently need to make careful judgments about how much they fill the 'management capacity gap'. We address the general issue of when to step in and 'do the work' in a later section.

A further implication is that advisers (and external evaluations) need to be realistic about what can be achieved. Without managers who are able to send signals to staff about priorities, expected performance and even basic standards of conduct, there is a limit to how much advisers can achieve (in terms of both capacity development and policy outcomes). This does not imply that capacity development will be ineffective: rather, it means that there are limits to what can be achieved and that many of the most important improvements will only occur over a timeframe of decades, not years.

Relationships and the role of the adviser

The effectiveness of capacity development advisers is critically dependent on the strength of the relationships they have with their counterparts. For team leaders and senior capacity building advisers, relationships depend on maintaining a regular dialogue with the senior management of the host institution. For advisers who are matched with individual counterparts (as is the case for Treasury's capacity development programs), the immediate relationship will be with the counterpart and their team. But relationships are likely to be equally important for other counterpart models (such as those that match advisers with a team or organisation), since advice is only influential if it is delivered to a receptive audience.

At times there can be formidable obstacles to maintaining strong relationships including, for example:

- Relationships may be affected by cultural differences, particularly in relation to communication styles, and also attitudes towards appropriate behaviour in a work context, including fraudulent or corrupt behaviour.

- Advisers and counterparts may have fundamentally different perspectives on their work, including what they hope to achieve, their level of commitment and their conception of what represents a good outcome.

- Possible tensions between the national interests of the counterpart country and the adviser's country that may arise if there is ambiguity in the adviser's role as an Australian government official working inside a foreign government department.

- Establishing new relationships will be affected by the quality of previous relationships and also the perception of some counterparts of the short-term nature of the relationship.

The foundation of an effective working relationship between advisers and counterparts is to develop and ideally document clear expectations, whilst leaving enough flexibility for the relationship to

evolve naturally. If possible, the starting point should be to clarify the counterpart's understanding of their responsibilities and what the adviser's role might be. This role may, in different circumstances, encompass one or more of the following scenarios:

- Advisers do the work and hope that capacity will be developed through exposure to the exhibited professional behaviours.
- Advisers design and control the approach, but try to engage local counterparts through consultation, participation, on-the-job training, and other measures (the 'direct approach').
- Advisers work within developing-country processes, building on local motivations and facilitating change (the 'indirect approach').[8]

A mix of these approaches is likely to be required at any time, depending on the complexity of the task and the aptitude of the staff involved. However, it will usually be appropriate to have an understanding of the adviser's 'default role' such that any variations from that role should be agreed between advisers and counterparts on a case-by-case basis. In particular, a discussion about the adviser's role should also help to establish when an adviser may intervene to assist with the work of the counterpart or their team (see following section for further discussion). Over longer periods (perhaps three to five years), improvements in team capacity should lead to a gradual shift in the emphasis on these different roles away from doing the work and towards the indirect approach. (At times, however, a reverse shift may also be appropriate if, for example, a series of staff vacancies results in a decline in team capacity.)

In addition, there are a number of basic protocols that advisers and counterparts may wish to agree upon in early on in the relationship. We have formulated a series of questions that advisers and their counterparts may find useful. They are set out in full at Attachment B; the key areas they address are as follows:

- Adviser participation in external and internal meetings
- Sharing of and access to information, including files, records and email correspondence
- External engagement by advisers, with or without counterparts present
- Degree of adviser involvement in clearance processes and feedback to staff
- Adviser involvement in team tasks — selective or comprehensive
- Degree of adviser involvement in management or administrative tasks
- Work behaviours — both inappropriate work behaviours that should be avoided and desired work behaviours that advisers should consciously model and reinforce
- Joint planning and reporting on the progress of capacity development activities
- Reporting by the adviser back to the Australian government

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8 These roles are drawn from Bolger (2008, pp100-101), who cites correspondence with Peter Morgan as the original source.

Where possible, any such protocols should retain some flexibility to allow for, amongst other things, a review of initial judgments about how much involvement advisers should have in different tasks. In other words, the protocols should be a means of creating an ongoing, open dialogue about how to find the right balance in the relationship.

There are several other fairly straightforward steps that we also found helpful in developing effective relationships with our colleagues. These included training on cross-cultural sensitivity prior to departure and attending capacity development courses with our counterparts once we had been deployed. Some language training can be extremely helpful to establish a rapport — whilst English is the official language in both PNG and Solomon Islands, much office chatter reverts to Tok Pisin or Solomons Pijin. Similarly, it never hurts to share a little about your background and family, take interest in the country you are in and to participate in the local community (whether that be through art, music, history, travel, sport or religion). For both us, part of what made our deployments so enjoyable was our participation in activities like umpiring AFL games, teaching at the University of PNG, playing local sport, supporting local charities, and preparing a guidebook on treks in Solomon Islands. Finally, it is important not to rely too heavily on one relationship since personnel inevitably change.

When to intervene and when to 'let things fall over'

There are distinct advantages to long-term deployments (twelve months or longer) in terms of establishing relationships, diagnosing organisational weaknesses, reinforcing capacity development achievements and seizing opportunities when they emerge. However, a key risk of long-term deployments is that advisers may crowd out local capacity, diminish local ownership and hence undermine capacity development objectives by creating increased dependency upon advisers.

We were both very conscious that, at times, we took a 'hands on' role as advisers and thus worried about the risks that this involved. One solution that is often mentioned is to 'let things fall over' in order to allow management and staff to learn from failures (unquestionably a valuable process in any organisation). Whilst this idea has superficial appeal, we saw a number of risks and found little guidance, either at the time or subsequently, to help advisers to make judgment about when to get involved (and do part of the task themselves) and when to step back and monitor the consequences. This section is our attempt to spell out some of the issues and provide some suggestions for the scope and limits of constructive non-intervention.

What does 'letting things fall over' or 'non-intervention' mean?

The phrase 'let things fall over' seems unhelpful since it suggests that advisers can identify discrete, one-off tasks that will either succeed or fail. In practice, while there are some process-related functions of economic policy agencies that could fit this characterisation (for example, the production of budget documents, monthly financial reports or a debt issuance process), much of the work does not. Instead, economic policy typically involves ongoing, evolving projects that involve longstanding relationships and where the output at each stage may be produced to a lesser or higher standard.

We think it is more meaningful to talk about advisers 'allowing work to fall below acceptable standards'. Clearly, judgments will always be necessary in determining what is an acceptable standard and, in some cases, counterparts and advisers may have different views. It may help, at least, to diagnose the various ways that work may be below acceptable standards, such as:

- Failure of analysis or presentation: the quality of research, analysis or presentation is substandard;

- Failure of time management: a brief or submission is delivered too late to be influential;
- Coordination failures: different parts of the agency or government deliver conflicting messages, or fail to recognise linkages between related workstreams; or
- Failure of quality assurance: clearance processes fail to identify that a product omits key issues or contains material errors.

'Intervention', in its broadest sense, may refer to situations where advisers identify the risk of one of these potential failures eventuating and then choose to contribute to the substantive work in some way in order to reduce that risk. In the discussion that follows, we assume that the adviser has judged that the risk is very likely to eventuate without intervention, perhaps due to time or resource pressures. In other circumstances, the appropriate course of action will be for advisers to discuss the potential risks with counterparts and then allow them to take whatever steps they judge necessary in response.

Create a constructive environment by clarifying roles and expectations

It will help to create a constructive environment for non-intervention if advisers and counterparts set clear expectations regarding substandard work and quality control. For example, some counterpart managers believe that part of the role of advisers is to, in effect, provide a 'back stop' that prevents acute problems from emerging. At the same time, Treasury's capacity development programs have always asked advisers to strike a balance between the twin objectives of improved capacity and good policy outcomes. Thus, 'back stop' arrangements may well be appropriate as long as it is clear that there are limits to how they will be applied such that, in some circumstances (consistent with the points outlined below), advisers will deliberately refrain from providing quality control or other input.

Wherever possible, expectations about the level of involvement (or 'intervention') by advisers should be based on guidance from the senior management of the host institution. This reinforces the importance, noted elsewhere, of team leaders and senior capacity development advisers maintaining a regular dialogue with senior management.

Once advisers make a decision to intervene to improve the standard of an output, this decision should, where possible, be made in conjunction with counterparts and involve feedback afterwards, ideally in accordance with pre-agreed protocols for how such situations might be handled.

Assess the risks of intervention and non-intervention

Intervention will be less appropriate when it will greatly increase the risk of dependency on advisers or when it will result in other ongoing problems, such as damaging relationships with counterparts. Equally, intervention will be less appropriate when the risks of poor policy outcomes are low. These risks probably have to be assessed on a case-by-case basis.

Assess the potential for counterparts to learn from mistakes

Non-intervention will be more attractive if there is clear potential for management and staff to recognise and learn from the consequences of the substandard work (or at least there is potential to receive negative feedback from outside the organisation, such as from ministers, parliament, the media or other stakeholders). The potential to learn from failure depends, in part, on management capacity. In some cases, management weaknesses (especially lack of appropriate accountability from supervisors) may be so great that there a few signals to staff that their work is substandard, let alone

any incentives to redress this. If it is also the case that there is limited negative feedback from external stakeholders (or limited impact of such feedback), there may be little benefit in allowing work to remain below acceptable standards.

Contain any negative side-effects of non-intervention

Non-intervention by advisers may have negative side-effects for aspects of team capacity, especially 'soft capacities' such as team morale, credibility and motivations. Sometimes this impact can be easily measured in terms of a decline in the standard of subsequent output, or even work attendance. Similarly, substandard work may damage a team's credibility to a point where stakeholders stop engaging with the team, thereby undermining officers' ability to develop and sustain effective stakeholder relationships.[9]

As a result, it is important to recognise that in pursuing one capacity development objective (reducing dependency by not intervening), there is likely to be a trade-off with other capacity development objectives. In particular, if the team's 'soft capacity' in areas such as morale or credibility is very weak, we believe that building these facets of capacity should be given priority over concerns regarding dependency and learning from failure.

Ensure that advisers have incentives not to intervene

Deliberately allowing work to remain below acceptable standards will usually cut across the natural instincts of advisers (and, as noted above, it may also conflict with counterparts' expectations). In addition, advisers may face strong incentives to intervene in cases where capacity development programs are assessed largely on the basis of the organisation's outputs. Deciding not to intervene must be a deliberate decision that, where appropriate, should be rewarded. Typically, advisers are rewarded for high quality outcomes (both policy and capacity) in their initial role selection and via in-country assessments. Thus, team leaders and performance evaluators should try to establish a mechanism for formally acknowledging such decisions, evaluating the consequences and lessons learnt and then, where appropriate, reward advisers through their performance appraisals and otherwise.

The challenge of measuring progress

A persistent challenge that we wrestled with was how to measure our progress, and that of our counterparts. Our main vehicle for regular assessments was an annual work plan that we prepared jointly with our counterparts and that we jointly reviewed semi-annually. Most of the details of the work plans and how we reported on progress were left to our discretion. This gave us valuable flexibility but little guidance on whether our measures were robust and informative or merely self-serving. While we were principally focused on regular, ongoing monitoring during our tenure as advisers, many of the issues that we faced are also pertinent for the independent, in-depth reviews that were conducted every three to five years.

The first difficulty is that some aspects of capacity development do not readily lend themselves to objective, quantitative measurement. We suspect that this is true of capacity development generally, not least because of the challenges of measuring improvements in 'soft capacities' such as team mission, values, trust and morale. The difficulty of measuring progress may be especially great in the case of economic policy agencies where their own outputs and performance are also not readily

9 On the other hand, if relationships are only sustained due to the intervention of advisers and this is apparent to all then the relationship may only exist in substance between the adviser and the stakeholder. Thus, as always in questions of when to intervene, careful judgment is necessary.

susceptible to objective, quantitative assessments. (This is as true for the Australian Treasury as it is for any of our counterparts in the Asia Pacific.)

Departments whose function is primarily focused on implementation and administration may be in a better position to develop quantitative measures of performance that could also underpin measures of capacity improvement. By contrast, evaluating the quality of policy advice is often highly subjective and so assessing the contribution of capacity development efforts to any improvements in policy advice will typically also be subjective and qualitative.

The fact that evaluations must depend on subjective, qualitative assessments does not mean that it is pointless to attempt to measure the performance of economic policy agencies or the progress of capacity development within them. On the contrary, the very difficulty and subjectivity of measuring progress means that it is particularly hard for advisers and their counterparts to know if capacity development efforts are well-directed and, if so, effectively implemented. Consequently, it may be even more important to develop robust monitoring frameworks for capacity development in economic policy agencies than for other aid programs.

A second difficulty is that it is hard to assess the *sustainability* of capacity improvements because capacity, especially for teams and organisations, does not steadily increase, plateau or decrease. Instead, capacity will naturally ebb and flow in response to internal changes (such as turnover of staff or management) or external pressures (such as changes in the business environment or a ministerial reshuffle). Even highly effective capacity development activities may not prove resilient to significant internal or external changes. This has implications for measuring the performance of capacity development advisers: a decrease in capacity does not necessarily represent failure and mere maintenance of capacity may constitute success. Of course, it also follows that improvements in capacity may occur independently of or even despite the efforts of advisers.

A third issue is that the ultimate 'success' of a capacity development program depends on both actual capacity and the required or expected level of capacity, where changes in one often lead to changes in the other.[10] As a team's capacity increases, the demands imposed on it tend to increase also. In other words, the goalposts will shift over time such that even if the capacity improves over time (albeit with ebbs and flows), the gap between desired and actual capacity may only decline gradually. For example, for many years, the main responsibility of the Solomon Islands Budget Unit was to produce an accurate record of planned and actual expenditure. In the late 2000s, a new team was established to review and provide advice on expenditure proposals — a standard budget review function but one that had not, until that time, been possible due to existing capacity constraints.

Measuring the capacity gap is important for determining whether a capacity development program was 'successful' (and the possibility of exit). But it is also important at earlier stages. A program that achieves good progress should be able to adjust the role of advisers from direct, hands-on methods to more indirect, mentoring approaches. However, such a change should be made once there is a narrowing in the 'capacity gap', which depends as much on the expectations for counterpart teams as it does on improvements in capacity that they have already made.

10 The expected level of capacity and the 'capacity gap' are important for 'forward-looking evaluations' that seek to determine, for example, the potential for exit or a significant change in the design of a capacity development program. They are less inappropriate for 'backward-looking evaluations' that assess the effectiveness of capacity development efforts to date. In that case, the starting point and subsequent obstacles or opportunities should be the main yardstick.

Political economy: the interaction between capacity development and incentives[11]

Incentives matter for both the development and utilisation of capacity. In addition, economic policy agencies (and, by extension, capacity development programs that support them) have a role in shaping society-wide incentives that impact on development outcomes generally. For both these reasons, incentives are highly relevant to capacity development.

Incentives can come in many forms including, for example, financial (wages, etc), professional (promotion, career advancement, other recognition), social (expectations of family and community), bureaucratic (work norms and hierarchies) and political. Within an economic policy agency, many of the 'internal incentives' for staff also relate directly to aspects of that agency's capacity. These incentives include: performance appraisal systems, processes for recruitment and promotion, pay structures, non-remuneration rewards and recognition, and a sense of purpose and camaraderie in the workplace. Capacity development advisers will typically interact with and attempt to shape these incentive systems as part of their work.

The development of organisational capacity is also heavily dependent on 'external incentives' determined by politicians, stakeholders, family and communities, and the public generally.[12] Unlike the internal incentives mentioned above, there is only limited scope for economic policy agencies or their capacity development advisers to influence or adjust these incentives. (An important exception is the occasional opportunity available to senior management to shape the agency's relationship with a new minister.) Thus, in general, the prevailing incentives acting on economic policy agencies and their ministers, staff and stakeholders, should be recognised as a central constraint on what capacity development advisers and programs can realistically achieve.

External incentives impose a further constraint on the effectiveness of capacity development efforts: not only do incentives stimulate or retard the *acquisition* of greater capacity, they also have the same effects on its *utilisation*. This is critical to the ultimate objective of capacity development programs: that government institutions, through advice to their ministers and the administration of government programs, are more effective in contributing to poverty reduction and improved public wellbeing. Organisational capacity is necessary for improved performance but it is clearly insufficient if such capacity is either under-utilised or misdirected due to inappropriate incentives.

In summary, in countries that do not have a strongly alignment of interests between the public, political leaders and the bureaucracy, capacity development will be particularly challenging (and may, in some cases, be inappropriate) due to the disincentives for developing and utilising capacity to the benefit of the public.

A countervailing consideration for economic policy agencies, however, is that they also have an important role in shaping society-wide incentives. They do this, for example, through macroeconomic, budget, taxation and debt management policies that aim to improve transparency of key data, strengthen accountability for government decisions, or limit the scope (or establish a sound structure) for discretionary decisions on expenditure or tax concessions. Similarly, microeconomic and structural reforms will often involve large shifts in economic power from protected interests,

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11 We acknowledge Graham Teskey and Rebecca McLaren, who prompted us to think more about the importance of incentives for capacity development.

12 The distinction between 'internal' and 'external' incentives is not intended to be precise. Incentives within an organisation will inevitably be influenced by broader factors and vice versa.

with resulting changes in future political incentives. By extension, capacity development in economic policy agencies has a role in shaping these broader, society-wide incentives.

Given the importance of incentives for development outcomes generally and for the development and utilisation of organisational capacity, it may be appropriate for advisers to reflect on the incentives that impinge on their work. From this base, advisers can explicitly record the aspects of their activities that seek to realign the 'internal incentives' or 'external incentives' that impinge on capacity development itself or on development outcomes more generally.

Capacity development skills and techniques

Treasury officers bring important skills and experience to the role of capacity development in economic policy agencies however capacity development also involves specialist skills that are less likely to be developed in a Treasury context. As such, this section proposes that, where appropriate, Treasury advisers undertake training in capacity development skills early in their deployments.

This section also provides some examples of capacity development techniques that we adopted or that were used by other deployees from the Australian Treasury. Our aim is to record some thoughts and approaches that others may find useful, and perhaps prompt further efforts to record and refine the techniques that deployees use to strengthen capacity. Whereas most of this paper has focused on organisational capacity and institutional strengthening, a couple of these examples relate to the development of individual capacity. This is, in part, because these examples are more readily applicable to other situations whereas improvements to organisational structures, appraisals systems, or recruitment processes, are more dependent on the organisational context.

Training for capacity development advisers

At one level, capacity development is 'not unique to aid programs and can be similar to how any organisation might invest in organisational change and renewal' (AusAID 2009, p 1). Such organisational change and renewal is usually the responsibility of management and so the role of capacity development advisers is, to a large extent, to support good management practices. By implication, while it may be sufficient for some advisers to have demonstrated policy and technical skills, at least some advisers should also have a depth of managerial experience.

It is equally true, however, that:

> what differentiates capacity development in a foreign aid context is the way it is supported through resources provided from outside the country being assisted; *and the fact that many of the building blocks (skills, systems, resources, etc) are either absent or weak in developing countries*. (AusAID 2009, p 1, emphasis added)

It follows that some of the expertise required to be a successful capacity development adviser in a developing country context goes beyond the management and policy experience gained in the Treasury or other agencies in the Australian Public Service. Consequently, we think that new capacity development advisers would often benefit from additional training, particularly in the first year of their deployment. (While this training could also be conducted prior to deployment, it may be more useful once advisers have had some exposure to the relevant work environment.)

A training program designed to broaden and extend adviser's capacity development skills could include:

- Formal training on adult learning styles such as 'train-the-trainer' courses;

- Possible participation in a 'Community of Practice' for economic governance advisers; and/or

- Possible participation in courses like DFAT's Making a Difference course.

An alternative approach could be to recruit consultants with management and capacity development expertise (especially if that includes experience in developing countries) and then provide them with training on the relevant areas of public policy as needed. While this approach may have merits, it is possible that the risks associated with a relative lack of policy expertise would be at least as great as the risks stemming from a relative lack of capacity development expertise (and would not facilitate ongoing institution-to-institution linkages). In short, our guess is that there is a limited supply of advisers who have substantial economic policy and managerial experience *and* who have dedicated expertise in capacity development techniques. Consequently, as with many organisations that provide ongoing training for staff, it will often be necessary to select advisers with some skills and experience and then provide them training to address any remaining gaps.

Collecting data and monitoring capacity development performance

Once capacity development priorities have been agreed, it can be challenging for both advisers and counterparts to pursue them conscientiously and consistently in the face of competing pressures. Simple tracking tools can provide a useful discipline to collect data and monitor performance in achieving capacity development objectives.

For example, where we worked in PNG Treasury, the managers expressed a desire for staff to participate more actively in external meetings. We agreed with our management counterparts that this required ongoing monitoring of:

- whether an adviser needed to attend a meeting;

- how much preparation counterparts did before meetings;

- how much advisers participated during meetings; and

- whether advisers provided feedback after meetings to help counterparts improve their participation in future.

We developed a simple spreadsheet tool to track these four issues and used the data to provide reports (initially quarterly, then six-monthly) to our counterpart managers. The tracking tool was an important constraint on the extent of our subsequent participation in meetings and it was also a regular reminder to us to devote extra time before meetings to promote participation by counterparts.

Using formal workshops or seminars to complement on-the-job training

Formal training workshops or seminars can seem an attractive capacity development activity — there is both strong demand (counterparts often find them interesting and, perhaps, a welcome break from their other work) and strong supply (since seminars often reside within the 'comfort zone' for advisers). In our experience, however, formal training conducted in isolation had only limited impact on future performance. The impact of such training may be much greater if it is used to complement on-the-job training.

For example, a colleague of ours encountered resistance to feedback on policy analysis but found that counterparts were more receptive to discussing policy issues in a workshop. The principles identified in workshops could be used as the basis for future feedback.

Similarly, we noticed common themes that emerged in the feedback we provided on written work. We subsequently incorporated these themes into a series of workshops on writing skills that were tailored to the written work produced in our area. We frequently referred back to the principles and checklists developed in the workshops in future feedback that we provided on written work.

Feedback on written work — iterative approach

Written advice and reports are, along with quantitative and economic analysis, the bread-and-butter of economic policy agencies. In supporting their counterparts in this work, advisers may adopt an 'iterative approach' to providing feedback on written work:

- work with the relevant manager, if possible, to provide guidance on the purpose of the task, its intended length and audience, and the key issues to be addressed;
- the initial iterations focus on general comments on the structure, objective, key issues, and main points of analysis;
- the further iterations seek to improve substantive details; and
- the final iterations adjust the tone and use of language in the document.

In formulating feedback, advisers must be mindful of what is an appropriate (and sustainable) standard of work in that environment rather than seeking to replicate the standard expected in the adviser's home institution.

This iterative approach should be complemented by careful consideration of how the feedback is provided. For example, it is often important to provide feedback both verbally (to check understanding and allow for discussion) and in writing (to keep a record for future reference by both counterparts and advisers). Of course, as with any feedback, this should include a discussion of what was done well.

Following these steps requires considerable discipline and patience on the part of the adviser (and patience and perseverance on the part of the counterpart!). This iterative approach also requires time and, inevitably, must sometimes be truncated due to time constraints. As is often the case, there is a trade-off between capacity development and achieving results.

Summary of key conclusions

This paper is our attempt to address issues that we grappled with in our roles as capacity development advisers, such as how to maintain good working relationships with counterparts, whether we were focusing on the right priorities and how to assess whether we were being effective in our work. Our key conclusions are summarised below.

The objectives of capacity development — sustained independent performance and the capacity for self-regeneration — can only be achieved over a long timeframe, in most cases decades rather than years. Incentives are also highly relevant, both for the development and utilisation of capacity (and, in addition, the role that economic policy agencies play in shaping society-wide incentives that impact on development outcomes generally). In this context, achieving capacity development objectives is likely to be complex and challenging. This is certainly true in economic policy agencies.

To best address this challenge, a systematic, strategic approach is essential. We recommend seven steps for adopting such an approach.

- **Take time to establish priorities**: the potential scope of capacity development activities can be very broad so assess the options thoroughly. As part of this assessment, remember to include 'soft capacities' (leadership, trust, team identity, values, mission, etc) as well as 'hard capacities'.

- **Understand the importance of management capacity**: management capacity is a key constraint on, or a key enabler for, capacity development. This means that improving management capacity should be a priority for advisers, where possible. However, there are significant limits on how much can be done to address management weaknesses and so advisers (and external evaluations) need to be realistic about what can be achieved.

- **Effective relationships are critical to the effectiveness of advisers**: For team leaders and senior capacity building advisers, relationships depend on maintaining a regular dialogue with the senior management of the host institution. More generally, the foundation of an effective working relationship between advisers and counterparts is to develop clear expectations, starting with the counterpart's understanding of their responsibilities and the adviser's role. In addition, there are a number of basic protocols that advisers and counterparts may wish to agree upon in early on in the relationship.

- **Advisers face difficult judgments about when to intervene and when to 'let things fall over'**: several considerations may help capacity development advisers with the difficult judgments about when to intervene and do part of the task themselves, and when to step back and monitor the consequences:

  – create a constructive environment for non-intervention by setting clear expectations regarding when advisers may intervene, with the agreement of counterpart management, to address substandard work;

  – non-intervention will be more appropriate when the risks from intervention (in terms of dependency or damage to relationships) are relatively high and when the risks of non-intervention (for important policy outcomes) are relatively low;

  – non-intervention will be more attractive if there is clear potential for management and staff to recognise and learn from the consequences of the substandard work;

  – be mindful of the trade-off between one capacity development objective (reducing dependency by not intervening) and other capacity development objectives; and

  – ensure that advisers have incentives not to intervene, or at least no disincentives.

- **Measuring progress is important but difficult**: there are several reasons why measuring the effectiveness of capacity development is particularly difficult:

  – Some aspects of capacity development do not readily lend themselves to objective, quantitative measurement, especially for improvements in 'soft capacities' such as team mission, values and morale.

  – It is hard to assess the *sustainability* of capacity improvements because capacity does not steadily increase or decrease; rather, it will naturally ebb and flow.

  - 'Progress' depends on both actual capacity and the required level of capacity: increases in the former often lead to increases in the latter such that the 'capacity gap' between the two may only decline gradually.

- **Think about the interaction between incentives and capacity development**: incentives matter for both the development and utilisation of capacity. In addition, economic policy agencies have a role in shaping society-wide incentives that impact on development outcomes generally.

- **Recognise that capacity development requires specialised skills and expertise**: some of the expertise required to be a successful capacity development adviser in a developing country context goes beyond the experience gained in the Treasury. Consequently, new advisers may benefit from specific training in capacity development skills.

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ATTACHMENT A: SCOPE OF POSSIBLE CAPACITY DEVELOPMENT PRIORITIES

Staff skills, training and development

- General public service skills: written communication, oral communication, teamwork, meetings and stakeholder relationships, time management, ICT and email, research
- Policy analysis skills: general problem solving skills; broad economic, financial, accounting, or legal skills; and technical skills on specific policy areas
- Basic management skills: staff supervision and development, workflow management, prioritisation and planning, clearance and quality control, internal budget management

Divisional and Departmental systems and processes

- Staffing: recruitment and induction processes, performance appraisals and management
- Knowledge management: paper and electronic filing, use of file notes, archiving old documents, induction and handover arrangements, use of Departmental correspondence registers
- Planning and prioritisation: Corporate Plan, annual work plan, planning days, performance reporting
- Internal communications: branch, divisional and/or management meetings, SOP notes
- Training and career development: training needs analysis, internal training programs, links to performance appraisals
- Media and Parliamentary monitoring: procedures to ensure management and staff are aware of emerging issues and relevant research or commentary
- Security procedures: procedures to protect physical security, property and confidential information
- Consultation processes: processes for consultations on both on specific proposals and to get general feedback from key stakeholders

'Soft capacity'

- Team identity and a shared sense of mission
- Team values and commitment to basic standards of professional conduct (eg, work attendance, respect for colleagues and supervisors, sobriety at work, respect for property of team or colleagues, conforming to basic dress codes)
- Team morale, ambition and a sense of what is possible
- Leadership
- Legitimacy, credibility and reputation

- Capacity to adapt to changing circumstances
- Capacity to strengthen partnerships through collaboration, networking or otherwise

Broader public service systems and processes

- Cabinet processes
- Legislative processes
- Medium- and long-term development plans
- Budget processes
- Medium-term fiscal and debt strategies
- Public Service General Orders

Attachment B: Building relationships — possible protocols for advisers and counterparts to consider

- *External meetings*: May advisers ever attend external meetings without a counterpart present? Which external meetings should advisers attend? And if they attend, how much should they participate (for example, only if invited to do so by counterpart)?

- *Internal meetings*: Should all advisers attend all internal team meetings (branch, divisional or management meetings)?

  – Protocol A: yes (attend all). Advisers and counterparts agree that adviser input is important for team meetings to be successful.

  – Protocol B: sometimes (attend some). Adviser and counterparts agree that advisers will attend team meetings occasionally to discuss specific issues. In other cases, management will share the agenda beforehand and brief advisers afterwards on the outcomes.

  – Protocol C: no (attend none). Advisers and counterparts agree that adviser input is not required for team meetings. Management may share the agenda beforehand and brief advisers afterwards on the outcomes.

- *Access to and sharing of information*: Will advisers have access to all of the team's files and records or, if not, how will access to relevant records be managed? Should advisers expect to be copied on all relevant correspondence and should they expect to have access to all relevant documents produced by counterparts? May advisers ever send emails or respond to emails with colleagues outside of the team (or the Department)?

- *External engagement by advisers*: How much (if at all) will advisers discuss work issues with other advisers (or just other officials) without counterparts present? What protocols should be followed an adviser receives a phone call or email from: another adviser, officers in other government departments, donor partners, etc? Should the query always be referred to the relevant counterpart? What if key counterparts are absent? What if an adviser meets other advisers or officials in a social context?

- *Feedback (and potential clearance) to staff*: For advisers whose counterparts are managers, when (if ever) may advisers provide feedback or clearance directly to staff, rather than through the counterpart manager?

- *Adviser coverage of team tasks*: Should advisers try to be involved or aware of all tasks in the Division (that is, shadowing the role of management) or just selected areas (as agreed with management)?

- *Adviser involvement in management tasks*: How much (if at all) should advisers assist with management tasks such as recruitment, work plans, planning days, the Divisional budget, asset management, internal training guidelines, induction pack, performance appraisals, etc?

- *Adviser involvement in administrative tasks*: How much (if at all) should advisers assist with administrative tasks?

- *Cultural sensitivity*: Are there any work behaviours that may be inappropriate in a different context (for example, use of offensive language, speaking loudly, interrupting others)?

- *Modelling good work behaviours*: Are there any work behaviours that advisers should consciously model and reinforce (for example, work attendance and punctuality, informing colleagues of leave or absences, sharing information, supporting meritocratic processes over 'regionalism', 'ageism', sexism or other forms of discrimination, reinforcing the role of the public service to provide sound advice to the Government of the day)?

- *Joint reporting on capacity development*: What planning and reporting is expected of advisers and how will counterparts be involved? How does this balance a capacity development outcomes and substantive policy outcomes? How will such planning and reporting be integrated into similar internal requirements within the counterpart agency? Will reports require joint sign-off?

- *Reporting to the Australian government*: What reporting obligations do advisers have back to the Australian Treasury or other Government Agencies? If counterparts are working on issues that are sensitive to relations with Australia, how will advisers ensure that they respect the privacy of counterparts and the sensitivity of government information?

Capital gains tax: historical trends and forecasting frameworks

John Clark[1]

Capital gains tax, introduced in 1985, is a relatively small but important source of government revenue. This article explores historical trends in capital gains tax, focussing on the behaviours of different entities, and describes Treasury's modelling framework for forecasting the tax.

1 The author is from Tax Analysis Division, the Australian Treasury. This article has benefited from comments and suggestions from Angela Baum, Hayden Dimes, Steve French, Rob Heferen, Amy Leaver, Cathryn Lee, Matthew Maloney, Krispin McAndrew, Tim McGuire, Joshua Pooley and Allan Poon. The views in this article are that of the author and not necessarily those of the Australian Treasury.

This article is split into two parts. After some introductory observations on relevant concepts and the nature of capital gains tax (CGT), the first part of the article will describe historical trends in CGT, providing a context for the second part, which will describe Treasury's methodology for forecasting CGT.

Introduction to understanding capital gains tax

CGT is more complicated than most other items on the income tax return and requires an understanding of several related concepts. First, capital gains income may be *realised* or *unrealised*, referring to whether the asset has been actually sold or not. Tax is paid only on realised gains. Second, capital gains income may be a positive capital *gain* or a negative capital *loss*. Tax is only paid on capital *gains*. Capital losses may be used to reduce capital gains, but not below zero. Third, these capital losses may be from the *current year* or a *prior year*. Both of these losses may be subtracted from current year gains for the purpose of determining taxable capital gains income. Importantly, a *current year* capital gain or loss refers to gains or losses realised in that particular year, even if the gains or losses had accrued over many years.

From a tax perspective, capital gains income is unusual for a number of reasons — five are discussed here.

First, 'capital gains tax' tends to be discussed as a separate tax. In fact, income from capital gains is simply a component of general taxable income, and 'capital gains tax' does not exist any more than, for example, 'interest tax' or 'depreciation tax', two other items reported on income tax returns. In this sense, 'capital gains tax' is a misnomer. In order to satisfy public interest in the amount of tax generated from capital gains, CGT is estimated[2] by applying each taxpayer's tax rate to their amount of taxable capital gains income.[3]

Second, capital losses are treated separately from other taxable income losses. A realised capital loss cannot be deducted from other income to reduce tax. Instead, the capital loss must either be deducted from another current year capital gain or carried forward to a later year to be deducted from a future capital gain. Understanding the generation and use of these losses is important for understanding CGT.

Third, capital gains income is recorded for tax purposes only on the sale, or 'realisation' of the asset. From an economic perspective, this treatment is the same as if an employee had full discretion as to when to receive his or her wages — be it after one week, one month, one year or ten years — and only pay tax on the income at that point. Reporting gains only on realisation effectively enables the taxpayer to defer the payment of tax such that the real tax liability is lower than at the time when the gains were accrued. This tax advantage is only possible, however, if the taxpayer does not need to realise the income, so the effect is usually expressed in terms of savings,[4] where the tax deferral advantage benefits financial investment in capital growth assets ahead of assets which provide an income flow, such as bonds.

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2 CGT amounts presented in this article and elsewhere, including in budget papers, are estimates from available data which are subject to revision as tax returns are processed. The amounts tend to stabilise around 18 months after the end of the relevant income year.

3 While this is straight-forward in the case of income taxes with flat rates (companies and superannuation funds), it is more complex in this case of individuals' income tax with a progressive rate. In this case, the taxpayer's average tax rate is applied to the capital gains income to estimate the CGT (see below for more detail).

4 See *Australia's Future Tax System Part Two: Detailed Analysis* (2009) page 62 (taxreview.treasury.gov.au).

The tax deferral effect is asymmetric: the taxpayer has an incentive to realise a loss quickly in order to take advantage of its full value.

The downside of deferring the realisation of the capital gain is that a large gain realised in a single year might be subject to a higher marginal tax rate than if the gain were realised as it accrued, assuming that the taxpayer's other income is not such that the top marginal rate applied regardless of the capital gain.

Fourth, unlike other income, capital gains income has been adjusted for the effects of inflation. Until 21 September 1999, capital gains income was explicitly deflated by the consumer price index (CPI). Since then, the CGT discount has performed a broadly equivalent role (see below).[5] These adjustments have made capital gains income more attractive than other forms of income.

Fifth, capital gains income is unusually volatile compared to other tax bases, given its dependence on a number of volatile aspects, such as changes to asset prices and the rate of realisation of the accrued gains. Net capital gains income is the second most important driver of volatility in individuals' taxable income, behind wages, which is around forty times larger in value.

CGT has been a major contributor to revenue forecasting errors over the past 10 years,[6] partly due to its volatility. Since 2000-01, CGT has been around 3 per cent of total tax receipts, but errors on the CGT forecasts have been responsible for over 20 per cent of the forecasting error for tax receipts in the budget year.

Part 1: Historical trends in capital gains tax[7]

Capital gains income became subject to tax on 19 September 1985, with only realised gains from assets acquired after the start date[8] being assessable. Not all assets have been subject to CGT, most notably the main place of residence.

Because gains on assets purchased only after the start date are subject to tax,[9] taxable capital gains income increased slowly over many years as assets gradually entered the CGT system (Chart 1). In order to generate taxable capital gains, an asset purchased before CGT needed to be sold twice — the first sale, after 1985, did not result in any assessable gains but only brought the asset into the CGT system. The second sale, which realised the post-1985 gains, resulted in taxable income.

Taxable capital gains income has risen over time, notwithstanding several violent movements, as pre-1985 assets have entered the system. The remaining value of unrealised pre-1985 assets is unknown, although it can reasonably be expected to be small and the CGT system is now likely to be approaching maturity.

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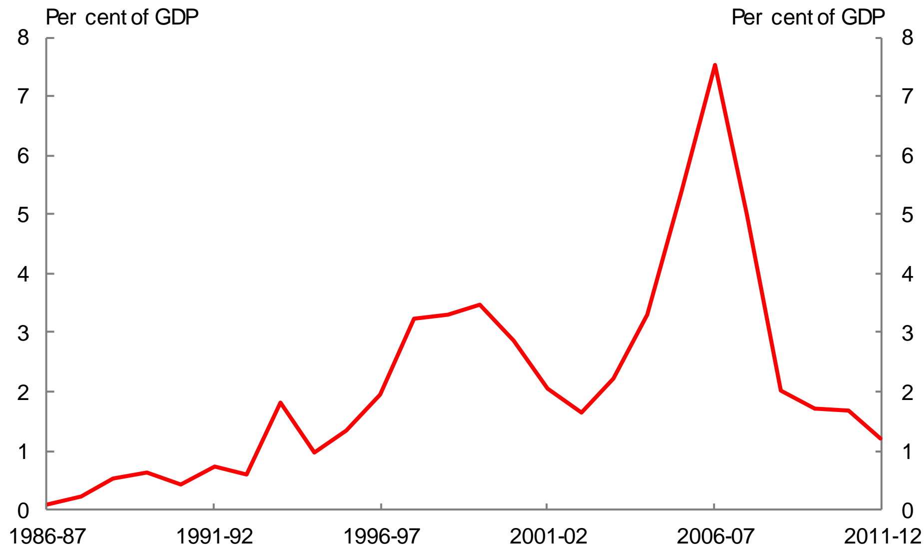
5 From 8 May 2012 the CGT discount is generally not available for capital gains income received by non-residents. Since 12 December 2006 such gains are generally subject to tax only where they relate to direct or indirect interests in Australian real property and the business assets of the Australian 'branch'.

6 2014-15 Budget Paper 1, page 5-22.

7 Analysis of CGT relies on data reported on tax returns and associated documentation. Since 2000-01, all of the relevant data items are reported on the CGT schedule, with some also reported on the main income tax returns. Before 2000-01, however, the detailed items were largely unreported on the main income tax returns. In some years only the final amount of 'net capital gains' was reported. Analysis of CGT before 2000-01 therefore relies on some assumptions and reconstructions of data, making results from this period less reliable.

8 This article will refer to '1985' as the beginning of CGT as shorthand for the full date.

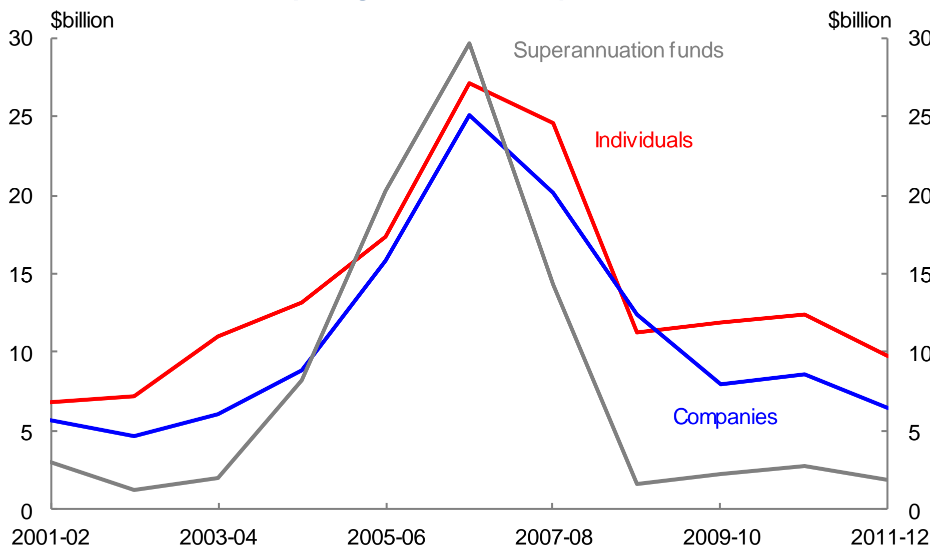
9 For superannuation funds, all of their assets were deemed to have been sold and re-purchased at the introduction of CGT, instantly bringing all of the assets into the system. At this time, however, superannuation fund income tax was relatively small.



Over the past decade, the largest movements in net capital gains income have been related to the share market, particularly the decline in the early 2000s associated with the dot-com crash, followed by the rapid increase in the ASX 200 to the record index of 6800 in October 2007 and the subsequent decline during the global financial crisis (GFC). Net capital gains income is still to recover from this last decline.

In the future, after the effects of the GFC have fully resolved, capital gains income is projected to average around 3½ per cent of GDP, with CGT averaging around 1 per cent of GDP.

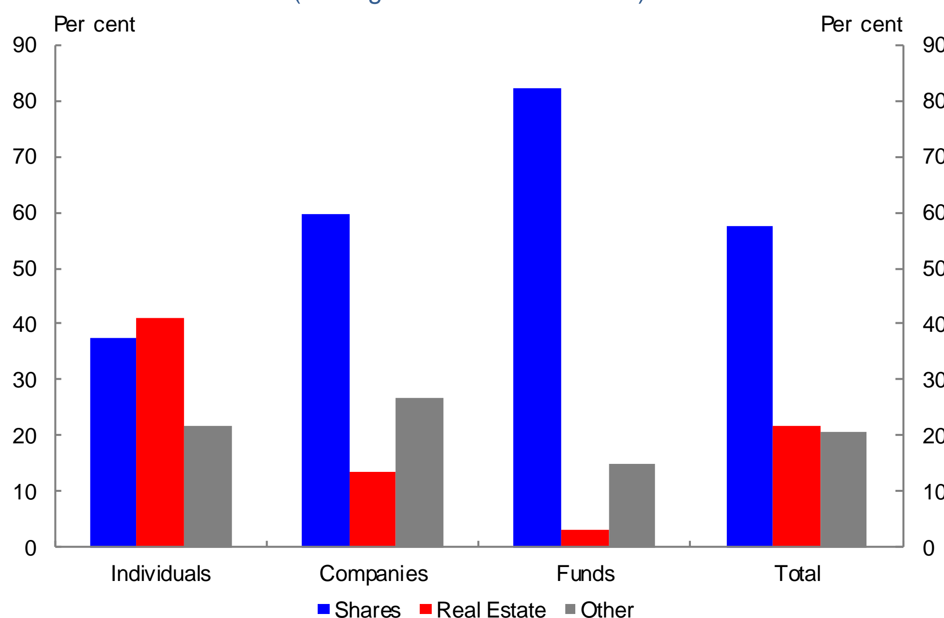
In general, individuals, companies and superannuation funds report similar amounts of net capital gains on their tax returns, and the evolution of the three amounts over the last 10 years is also broadly similar (Chart 2).



Although capital gains income is similar for each entity, it is very different as a share of the taxable income of each entity. Over the past 10 years, taxable net capital gains income has been 2.7 per cent of total taxable income for individuals, compared to 5.4 per cent for companies and 11.1 per cent for superannuation funds.

Income from net capital gains is generally more volatile for superannuation funds than for companies or individuals, which are the least volatile. This is due to the different asset mix for each type of entity. Individuals have a relatively large share of their capital gains in real estate, which is less volatile, while companies and superannuation funds tend to have a relatively large share of their capital gains in shares, which is more volatile (Chart 3).

Chart 3: Current year capital gains income proportions by asset type
(average 2002-03 to 2011-12)



The 'other' category is difficult to interpret because of how trust distributions of capital gains are reported. The 'other' category is likely to be a mix of a wide range of different capital gains, from assets such as collectables, financial instruments (for example bonds sold before maturity), fixed assets and goodwill, but some capital gains distributed from trusts — which will be a mix of shares and real estate as well as the other asset types — will also be included within this category.

Capital gains tax policy before and after 2000-01

CGT changed significantly from the 2000-01 income year. Previously, income from capital gains had been adjusted for changes to the CPI, the intention being to tax only the real gain in the value of assets. The adjustment applied to capital gains realised by all entities. From the 2000-01 income year, the indexation method did not apply to gains realised on assets purchased after 11.45 am (ACT time) on 21 September 1999. Instead, the 'discount method' could apply if the asset was held for at least twelve months. The discount method allows individuals and trusts to report only half of the net capital gain for tax purposes and superannuation funds to report two-thirds of the net capital gain.

The indexation method and the 50 per cent discount method result in broadly similar amounts for net capital gains, assuming CPI increases yearly by 2½ per cent (the middle of the RBA target band) and asset prices increase yearly by 5¼ per cent.[10] For superannuation funds, eligible for a one third discount on their gains, the discount method is not as generous as the indexation method.

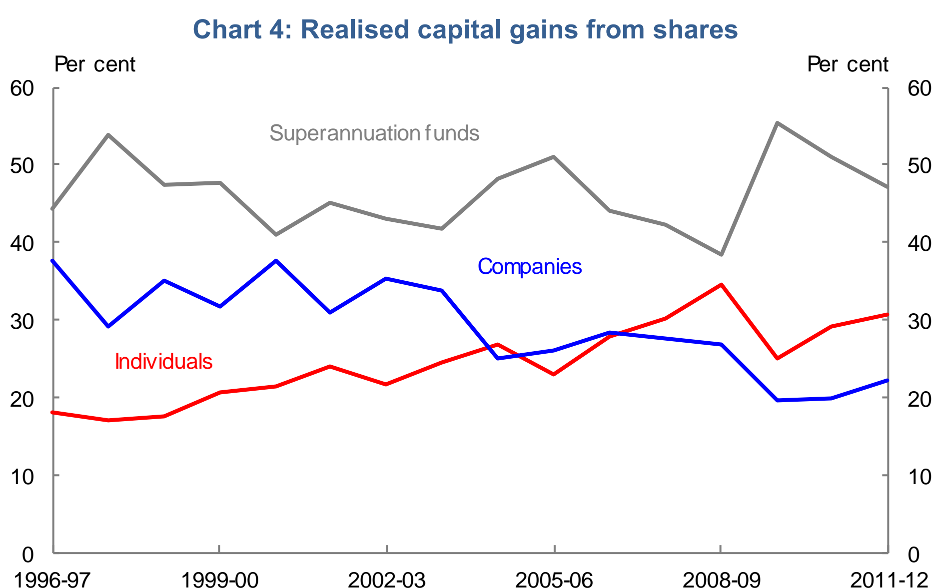
Generally, the discount method does not apply to companies, whereas before 2000-01 all entities could adjust their capital gains income for inflation. This means that, following the 2000-01 changes to

10 5¼ per cent is the projected growth rate for nominal GDP in the *Intergenerational Report 2010*.

CGT, there is a reduced incentive for domestic companies to realise capital gains. Chart 4 shows the percentages of total capital gains from shares reported by individuals, companies and superannuation funds. The percentage of gains reported by companies had fallen from around 35 per cent in the early 2000s to around 20 per cent a decade later. While the amounts are volatile, this decline is consistent with the asymmetric incentives introduced in 2000-01.

Combined with the advantages from the income being taxable only on realisation, previously discussed, the total effective concessions on capital gains income are significant. Both the indexation and discount methods have provided a strong incentive towards financial investment in products which provide significant capital growth, such as shares or property, rather than in products which primarily provide income streams, such as bonds. The concessionary treatment of capital gains income is arguably the primary motivation for financial investment in negatively geared real estate, which aims to shift all of the investment return into the capital gain on the eventual sale of the asset.[11]

Chart 4: Realised capital gains from shares



Realisation rates

Realisation rates are one of the three key determinants for the generation of most taxable net capital gains income, the others being asset prices and the utilisation of losses.

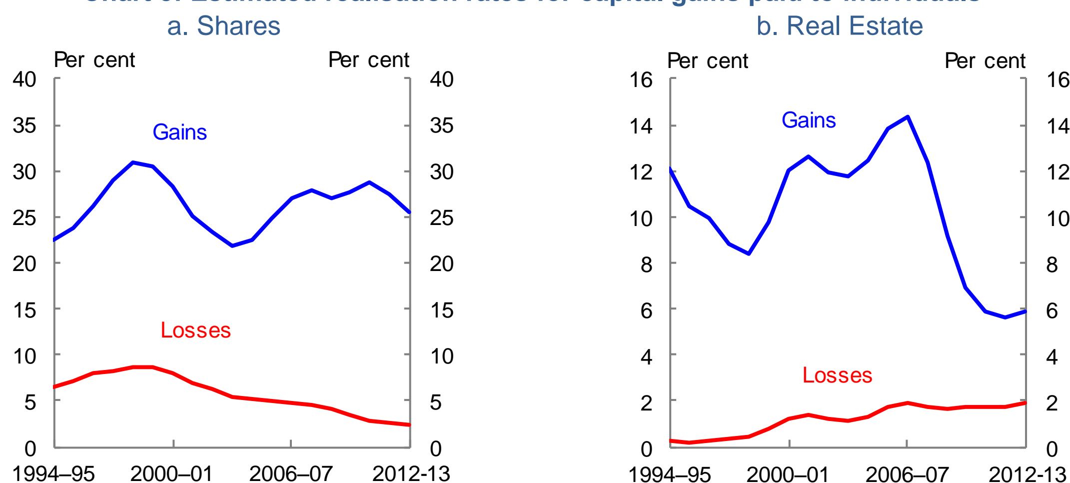
The realisation rate is defined as the percentage of the stock of estimated available gains or losses (both new gains from the current year which will be subject to tax and unrealised gains from previous years) which are realised in the current year. Information on realised gains is available for shares and real estate, from CGT schedule data since 2000-01. Before that, back to the mid-1990s, *Taxation Statistics* provides asset data on gains which can be transformed into the required amounts via some broad assumptions. Realisation rates can then be calculated for gains and losses through history.

Estimated historical realisation rates for individuals' shares and real estate gains and losses are shown in Charts 5a and 5b. These realisation rates are estimated from a combination of actual and modelled data, and are thus experimental and subject to both: (a) significant margin of error, particularly in the

11 Assuming historical trends in key variables such as house prices, interest rates and rental income and depreciation, the largest tax benefit from investment in negatively geared property is the CGT discount, which is around twice as large as either the CGT tax deferral advantage or the ability to offsetting operating losses against other forms of income.

years before the introduction of the CGT schedule in 2000-01; and (b) future revisions, with further analysis and as more data becomes available.

Chart 5: Estimated realisation rates for capital gains paid to individuals



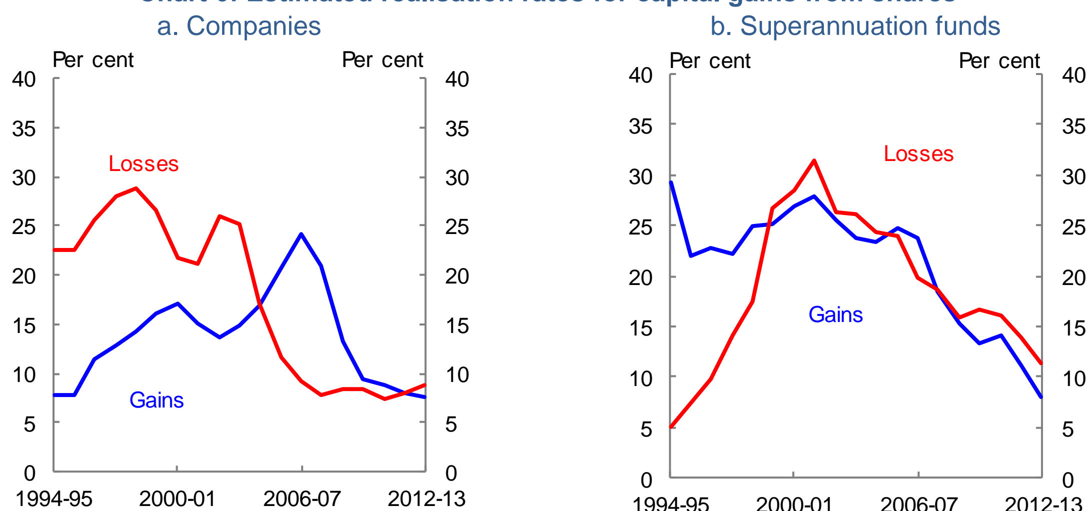
The average estimated realisation rate for gains from shares is around 25 per cent, meaning that individuals hold their shares for around four years on average. In contrast, the average realisation rate for real estate is around 10 per cent, equivalent to holding the asset for around 10 years on average.

Individuals appear to be highly reluctant to realise losses, however, for both shares and real estate, where the realisation rates are around 4 and 2 per cent respectively. This is in marked contrast to companies and superannuation funds (see below). Individuals tend to wait until an asset is in a gain situation before selling.

Interestingly, realisation rates for gains from shares fell during the dot-com crash, but did not change markedly through the GFC. By contrast, real estate realisation rates increased during the dot-com crash and fell during the GFC. This may reflect the differing size and nature of the events. For the GFC, the decreased realisation rates may reflect a desire to hold on to ‘safer’ assets, such as real estate, while the share market plummeted. In addition, the share market falls followed very large rises and many investors would have still sold their shares making substantial gains. The earlier behaviour during the early 2000s may reflect both smaller increases in the share market in the lead-up to the falls and less dramatic falls.

Estimated realisation rates for capital gains earned from shares by companies and superannuation funds are shown in Chart 6, which show a different behaviour to individuals, particularly with regard to capital losses. As will be discussed later, companies realised an enormous amount of capital losses during the first decade of CGT. This is reflected in the high estimated realisation rates for share losses, which continued through to the early 2000s. Realisation rates for gains gradually increased over the first twenty years of CGT, only becoming higher than for losses in the share market boom before the GFC. In the last few years, in the wake of the GFC, estimated realisation rates have been comparatively low for both gains and losses.

Chart 6: Estimated realisation rates for capital gains from shares



In contrast, superannuation funds realised few losses in the first decade of CGT, but realised substantial gains over this period. Estimated realisation rates for capital losses accelerated markedly in the late 1990s, and have largely moved with realisation rates for gains in recent years. Estimated realisation rates for capital gains have been relatively constant at around 25 per cent — similar to the estimated realisation rate for individuals — until 2006-07, before falling steadily to around 10 per cent, for both gains and losses, by 2012-13. In 2012-13, superannuation funds realised very few gains, despite earning a record $189 billion of investment income in 2012-13, including over $90 billion of capital gains from APRA regulated funds alone.[12]

The very low capital gains income from superannuation funds in recent years is therefore not primarily driven by the utilisation of capital losses realised during the GFC (as has been previously thought), although this is still an important factor, but by reluctance by funds to realise gains.

Two possible reasons for the marked decline in realisation rates since 2006-07 are considered here. First, the large and continually increasing amount of superannuation contributions flowing to funds mean that funds do not need to realise capital gains in order to either meet their benefit payment commitments or rebalance their portfolios following asset price movements. It should be noted, however, that contributions have not increased dramatically over the last seven years, except for a one-off spike in contributions following the announcement of changes to superannuation in May 2006. Second, the Cooper review into the Superannuation System,[13] released in 2010, recommended that superannuation funds report their investment returns on a post-tax basis, which may have led to lower realisation of gains.

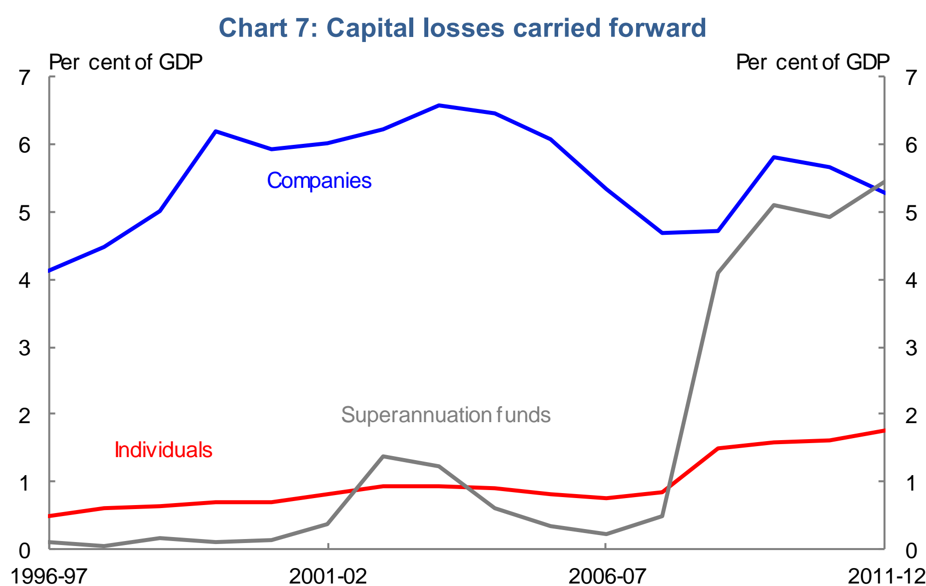
Capital losses

A net capital loss in one year cannot be deducted against other taxable income. Instead, the loss can be deducted against capital gains made in later years. This requires taxpayers to maintain a running stock of realised losses carried forward which are available for use in a later year. The stock of carried forward losses tends to increase when asset prices fall and tends to decrease, albeit slowly, as asset prices rise.

12 *Superannuation Fund-level Profiles and Financial Performance* (8 January 2014) see www.apra.gov.au.
13 *Super System Review Final Report* see www.supersystemreview.gov.au.

The share market falls associated with the GFC generated substantial losses, particularly for superannuation funds, rapidly increasing the stock of capital losses being carried forward (Chart 7).

Chart 7: Capital losses carried forward



There are two striking features of this chart. The first is the enormous stock of capital losses accrued by companies over the first decade of CGT, reaching over 4 per cent of GDP by June 1997. Capital losses held by companies at the end of the 1995-96 income year, the first year this data was reported, was around $22 billion, considerably more than the $13 billion of taxable net capital gains reported until then. The large stock of losses accrued by 1997 may indicate that, in the years immediately following the advent of CGT, companies that chose to realise some assets preferred to realise those in a loss position rather than those in a gain position (and therefore defer paying tax on the gain). Under this scenario, with a capital loss already realised, the companies would then be able to make a later capital gain and offset it with the earlier loss. There was little incentive to realise assets in a gain position before those in a loss position, and given the timing of the 1987 share market crash there was ample opportunity for companies to have loss making assets available.[14]

Even with reliable data for the stock of losses for companies, it is not clear to what extent these losses are available to be used to offset future capital gains. In the case of a company with carried forward losses being acquired by (or merged with) another company, that company may not be able to access those losses, depending on the details of the companies and the transaction.[15] The losses, called 'trapped losses', continue to be reported despite the fact that they cannot be used.

The second striking feature of Chart 7 is the rapid increase in the stock of capital losses by superannuation funds in 2008-09, from around $6 billion at the end of 2007-08 to over $50 billion a year later. These realised losses are still only a quarter of the total accrued capital losses (both realised and unrealised) of more than $200 billion[16] in 2007-08 and 2008-09. The size of these losses is considerably larger than the losses realised during the share market falls around 2002-03, even abstracting from the size of the superannuation asset base.

14 The ASX 200 index did not permanently exceed the level reached in 1987 until 1996.

15 The two main criteria are administered via the 'same business test' and the 'continuity of ownership test'.

16 *Annual Superannuation Bulletin* (June 2013) www.apra.gov.au. Net investment income to funds is reported as a loss of $190 billion in 2007-08 and 2008-09, which includes positive income such as interest and dividends. The capital loss component is therefore expected to be in excess of $200 billion.

More importantly for future prospects, there is no sign of this stock of capital losses decreasing. This is in contrast to the steady decrease in carried forward losses following 2002-03. Two possible reasons for the different behaviour are that: the share market grew more quickly after 2003 than after 2009; and realisation rates for gains and losses are much lower in recent years than around 2003. The rate at which these losses are utilised is a key question for forecasting CGT from superannuation funds. With the superannuation system still to reach full maturity, capital gains behaviour may continue to vary significantly for several years.

Capital gains income and companies

Analysis of company capital gains is complicated by the nature of their income. Many companies conduct their capital gains activities on their operating account rather than as a capital gain — for example, companies whose main business activity is share trading. The amount of capital gains realised in this way may have increased since the changes to 2000-01 when the CGT discount was not accessible to companies. There are over 30,000 companies classified as 'financial asset investors' in *Taxation Statistics*,[17] making it the second largest grouping of companies after 'property operators'. In these cases there is no detailed information on capital gains since the income is only recorded as general revenue. Most of these companies are, however, relatively small.

Another complication for company capital gains is that a large share of capital gains events are unrelated to commonly used investment products, such as shares and property, but instead relate to acquisitions and disposals of other businesses, trading stock and other assets. Sometimes the amounts involved are very large. For example, the coal seam gas joint venture Australia Pacific LNG was created via the 2008 purchase of a part of Origin Energy by ConocoPhillips, resulting in a one-off capital return of $2.8 billion.[18] This kind of one-off capital gain occurs infrequently, but the amounts are large enough to be a regular important explanation for the aggregate amounts. This makes corporate CGT amounts 'lumpy', and often unrelated to standard asset price indicators such as the ASX 200 index.

Chart 8 shows net capital gains reported by non-financial corporations, illustrating the impact of one-off lumpy capital gains.[19] In some years the capital gains from lumpy items are worth half of the total.

Abstracting from the lumpy amounts, the remaining net capital gains reported by non-financial corporations (the blue line in Chart 8) is approximately in line with typical gains from financial investments such as shares, peaking around 2006 and falling with the onset of the GFC.

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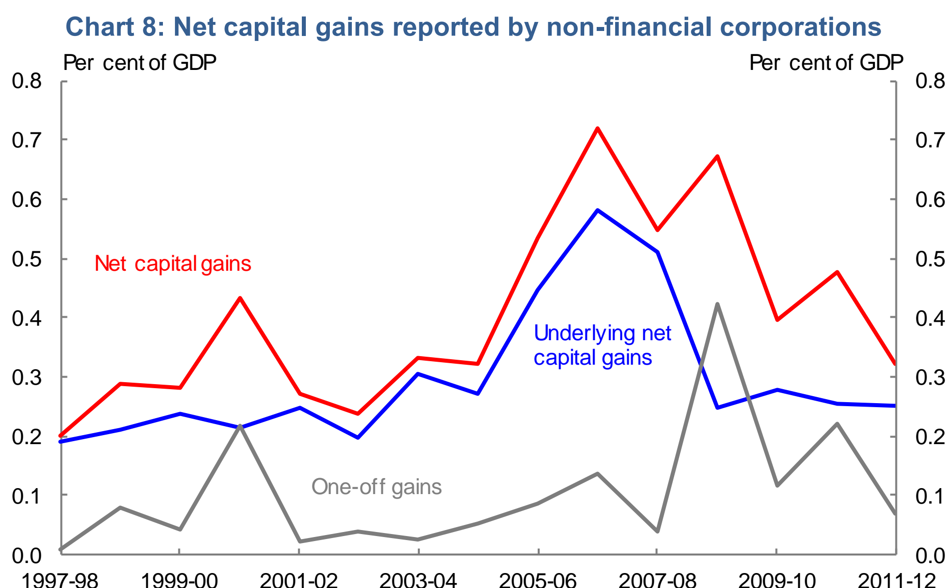
17 *Taxation Statistics 2011-12* (www.ato.gov.au).
18 Origin Energy *Annual Report 2009*, page 5.
19 This data was constructed by identifying very large amounts of net capital gains income for businesses which reported negligible amounts for the surrounding years. The broad amounts are readily estimated from data published at a fine industry level in each year of *Taxation Statistics*.

Chart 8: Net capital gains reported by non-financial corporations



Part 2: Forecasting capital gains tax

Forecasting CGT can be divided into six steps, which are described in some detail here.[20]

Step 1: Asset bases

First, the appropriate asset bases are determined, of which the most important is the total value of shares and investment property held by individuals, companies and superannuation funds. For domestic shares, these amounts can be found in the ABS Financial Accounts.[21] Property asset bases can be found in the Annual National Accounts sectoral balance sheets.[22] APRA provides information on assets held by superannuation funds, which tend to hold the majority of international shares. An allowance is made for assets held by companies which are in the business of financial investing, as described above, which will not be reported as capital gains.

Step 2: Price assumptions

The second step is to determine appropriate price assumptions for the future. No attempt is made to explicitly forecast asset prices.[23] Rather, capital gains forecasts are based on technical assumptions, in a similar manner to those used for interest rates and exchange rates. All asset prices are forecast to grow with nominal GDP [24]. The choice of nominal GDP rather than the consumer price index, or some other price amount, may seem surprising. In should be noted, however, that quantities such as the ASX 200 index are not strictly 'prices' and they contain a volume and a price component. That is, the share 'price' of a particular company will increase proportionally with the value of the company, remembering that the ASX 200 index abstracts from the issuance of new shares.

The value of property is also not linked strongly to other prices such as the CPI, because the value of property is driven by the value of land, which is largely a fixed quantity.

Charts 9a and 9b show the relationships between the ASX 200 and house prices with nominal GDP and the CPI, together with long-run trends. While neither nominal GDP nor CPI is a strong indicator

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20 The *Review of Treasury Macroeconomic and Revenue Forecasting* (2012) recommended that Treasury publish the basis of models used economic and revenue forecasting (www.treasury.gov.au).

21 ABS Cat. No. 5232.0.

22 ABS Cat. No. 5204.0.

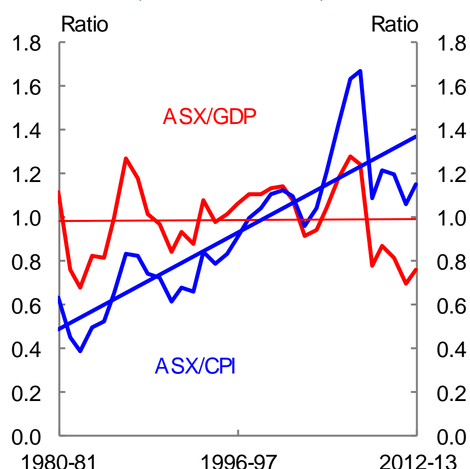
23 A common quip is that if the tax forecasters could forecast asset prices then they would have already retired.

24 2012-13 Budget Paper 1, page 5-7.

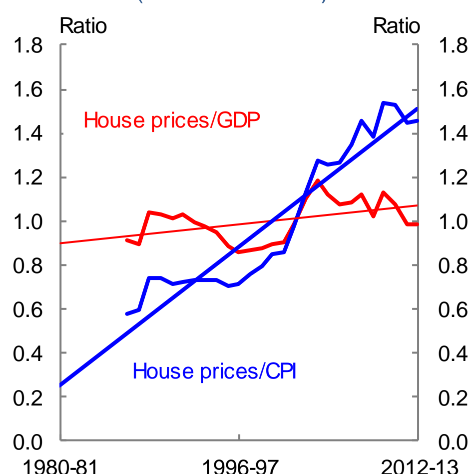
of short-term movements in asset prices, nominal GDP is a much less biased indicator in the longer term — the nearly flat trend lines in the ratios to GDP indicate that the values grow with GDP in the long term — and forms a reasonable technical assumption for the purpose of forecasting.

Chart 9: Key asset values compared to nominal GDP and the CPI (average = 1)

a. ASX 200 compared to GDP and CPI (with trend lines)



b. House prices compared to GDP and CPI (with trend lines)



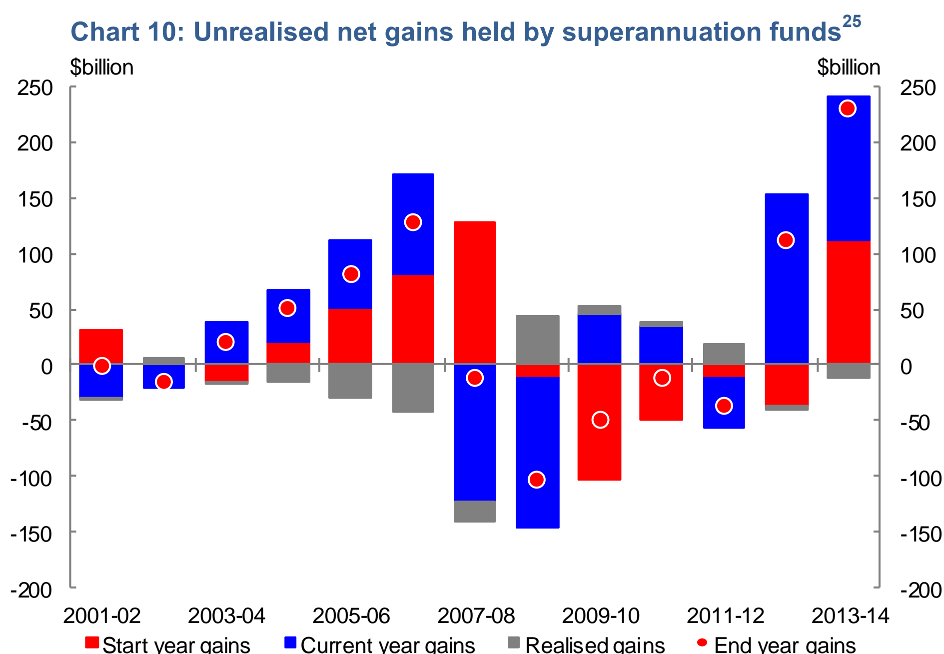
Step 3: An accounting framework for accrued gains and losses

The third step in CGT forecasting is to apply the growth rates in the relevant 'prices' to the asset bases to calculate an estimate of accrued gains or losses for that year. Importantly, there will still be a mix of gains and losses: some shares will increase by more than growth in the ASX 200 index and some by less, with some even moving in the opposite direction. For example, if the total value of the Australian share market was $1.5 trillion, and the relevant index (for example the ASX 200 index) increased by 5 per cent, then the total gains will be $75 billion, which may consist of $100 billion of gains and $25 billion of losses, or some other combination. Because only the realised gains and losses are observed, this mix of gains and losses is modelled, as described below.

The accrued gains and losses are added to the stock of unrealised gains and losses as at the start of the year. The resultant amounts are the stock of unrealised gains and losses available for realisation in the current year. By the end of that year, some of these gains and losses will be realised, reducing the stock of unrealised gains. The accounting framework for the stock of unrealised capital gains is illustrated in Chart 10, using superannuation fund gains as an example, where the end-year amounts of unrealised gains (shown by the circles) equals the start-year amounts of unrealised gains for the next year (the blue bars).

Chart 10 shows that, for example, at the start of the 2007-08 year superannuation funds are estimated to have held around $130 billion of unrealised capital gains (the red bar). During that year the share market fell markedly, resulting in an estimated $120 billion of capital losses (the blue bar). In addition, superannuation funds realised around $16 billion of net gains (the grey bar), which *decreases* the total amount of unrealised gains. At the end of the 2007-08 year, superannuation funds therefore held an estimated -$12 billion of net unrealised gains (the red circle), which becomes the starting amount of unrealised gains for the 2008-09 year (the next red bar).

Chart 10: Unrealised net gains held by superannuation funds[25]



The advantage of this 'rolling stock' framework is that individual assets do not need to be tracked through from purchase to sale, and the year in which the asset was purchased is not required. In addition, the starting point for the stock of gains is zero in 1985 and the stock of unrealised gains is built up from that point. There is a significant degree of approximation involved in the calculation, but it should be noted that uncertainty in the exact size of the past stock of unrealised net gains tends to become less relevant over time because recent gains and losses will almost always be significantly larger than gains and losses from the distant past, if only through inflation.

Estimating the stock of unrealised gains is likely to be most accurate for superannuation funds, given the availability of high-quality financial asset data collected by APRA, and least accurate for companies.

For companies and superannuation funds, it is assumed that there are negligible assets remaining from before 1985 and almost all of the relevant assets are now part of the CGT base. This is less likely to be true for individuals, where it is expected that some people are still holding property and 'blue chip' shares purchased before the introduction of CGT. Given that these assets have been held for an extended period, however, it is assumed that they will continue to be held into the near future.

For real estate assets, held mostly by individuals, an allowance is made for the costs of purchasing the asset, which is included in the asset base for the purposes of calculating capital gains. The ownership transfer costs are sourced from the Annual National Accounts,[26] adjusted for the fraction of dwelling assets which are rented (around a quarter).

Step 4: Realisation rates

The fourth step in CGT forecasting is to apply realisation rates to the available stock of accrued gains and losses available for realisation, in order to produce amounts of realised capital gains and losses relevant for tax.

25 The amount of realised gains for 2013-14 is calculated assuming realisation rates are unchanged from 2012-13.
26 ABS Cat. No. 5204.0 table 49.

Realisation rates have been previously discussed. In the forecast period, realisation rates are generally assumed to be consistent with recent trends, with the additional constraint that they must be sustainable. For example, if the very low realisation rates currently observed in individuals' real estate were to continue, this would result in an ever-increasing stock of unrealised gains. Similarly, superannuation funds will realise their large amount of accrued capital gains at some point in the future, and the realisation rates are expected to trend back to their long-run averages. The evolution of these realisation rates presents a significant risk to the CGT forecasts.

Step 5: Use of losses

Once forecasts of amounts of realised capital gains and losses have been determined, the fifth step in CGT forecasting is to determine expectations for the amounts of losses (from both the current year and prior years) utilised in order to offset capital gains. The stock of capital losses is the subject of another accounting identity, where the stock of losses at the end of the year is equal to the stock at the beginning of the year, plus any new losses realised, less any losses utilised.

As at the end of the 2011-12 income year, individuals reported around $26 billion of carried forward capital losses (1.8 per cent of GDP), a large increase from about $8 billion (0.9 per cent of GDP) on average in the five years leading up to the GFC. The losses held by individuals are small, however, compared to those held by companies ($75 billion at the end of the 2011-12 income year) and funds ($80 billion). The different capital loss behaviours for different entities relate to observations made above. First, individuals are generally reluctant to realise losses. Second, many of the corporate capital losses have been carried forward for over a decade and are likely to be 'trapped' such that they will be utilised at a very slow rate over many years or not at all. Third, declining realisation rates for superannuation funds mean that there is a lack of capital gains available to enable the utilisation of the large amount of losses realised during the GFC (around $50 billion in 2008-09 alone), despite strong gains in share markets over the past few years.

The aggregate amount of capital losses utilised in any year is constrained by the amount of capital losses available to be used and the amount of capital gains available to be offset. For aggregate individuals, being a large number of small taxpayers, capital losses are utilised relatively slowly. Companies utilise their aggregate capital losses more quickly, but are restricted by the 'trapped' losses. Aggregate amounts for superannuation funds are dominated by some very large taxpayers who, by virtue of the size and number of capital transactions, utilise their capital losses more quickly, provided they choose to realise enough gains to do so. For example, the capital losses realised during the share market falls of the early 2000s were almost entirely utilised three years later.

The utilisation of capital losses in the future is assumed to follow historical trends. Similar to the assumptions for realisation rates, these assumptions introduce a risk to the forecasts in terms of the timing of the resultant CGT. For example, the losses may be used quickly, resulting in less CGT over the next three years but more CGT in the three years after, or the losses may be used slowly, resulting in more CGT over the next three years but less CGT in the three years after, all else being equal.

Step 6: Calculation of taxable net capital gains

After applying losses, any CGT concessions or discounts are applied to produce taxable net capital gains. Almost all capital gains income reported by individuals and superannuation funds is subject to the full discount — taxpayers ensure that they hold their assets for a year before realising — so this calculation is trivial. Other available CGT concessions are relatively small and stable. For forecasting purposes these can be assumed to remain as a constant share of pre-concession net capital gains (around 2 per cent).

Calculation of capital gains tax

The forecasting process ends with the calculation of net capital gains income, which is then added to forecasts of the other items on the income tax return to calculate a forecast for taxable income. As discussed earlier, CGT is an allocation of total income tax to that particular item. While this is straight-forward in the case of income taxes with flat rates — companies and superannuation funds — it is more complex in this case of individuals' income tax with a 'progressive' rate. For individuals, assigning an amount of tax to net capital gains income requires information on the income distribution.

Taxable net capital gains income tends to be received by individuals at the higher end of the income distribution. Around half of total taxable net capital gains income reported for 2011-12 was received by taxpayers whose other taxable income was above $180,000 (the top tax rate threshold). For the 2011-12 year the average statutory rate of tax on taxable net capital gains income was 30.9 per cent, compared to the overall average rate of around 22.2 per cent.[27] Since 2000-01, the average rate of tax on taxable net capital gains income has varied between around 29.3 per cent in 2008-09 (the year most affected by the GFC) and 32.6 per cent in 2003-04. The general decline in average tax rates in CGT is partly because of weaker capital gains income over the last five years and partly because of increases to the top tax rate threshold, particularly since 2004-05.

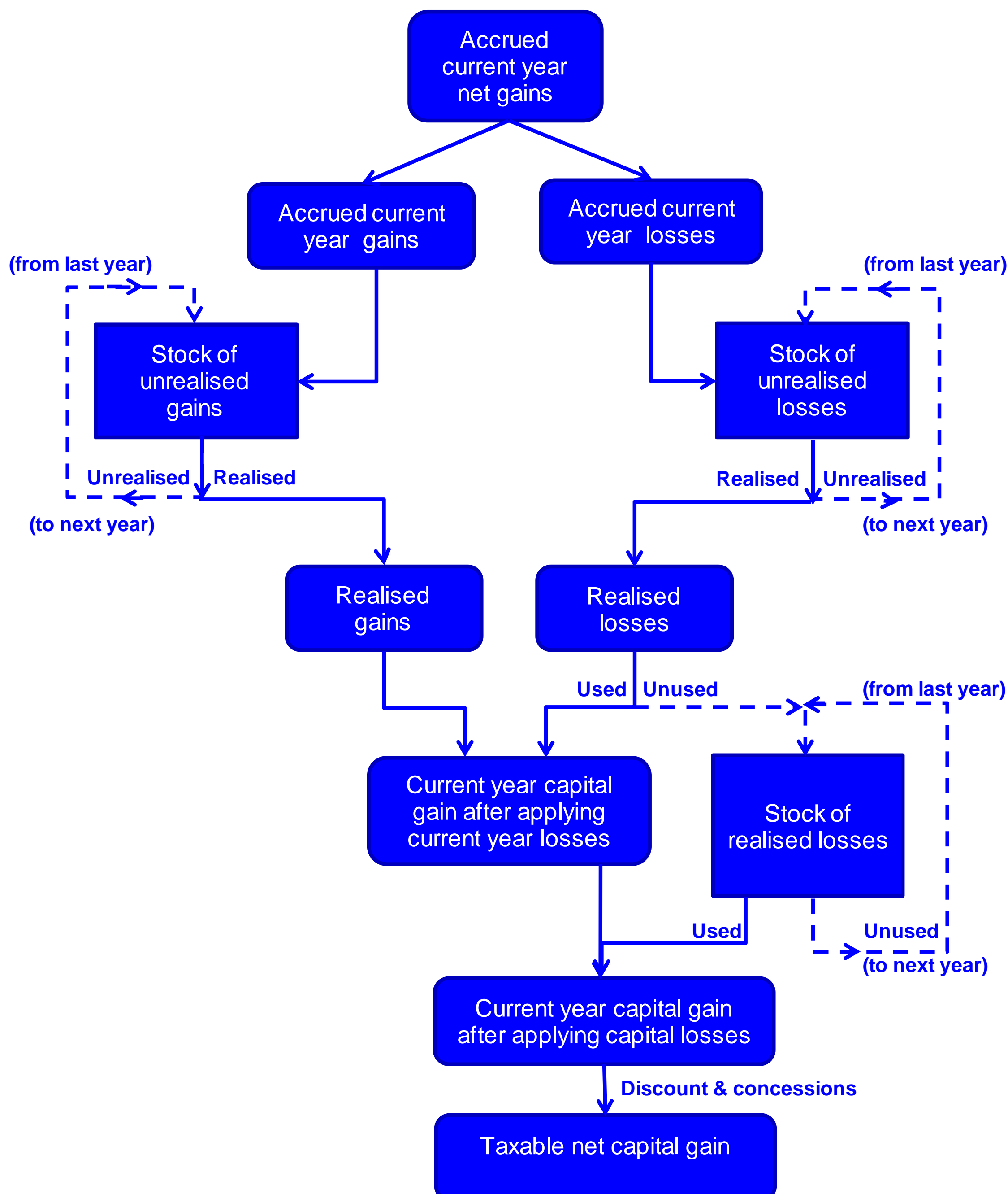
Forecasts of CGT for individuals are constructed by assuming that the relative income distributions for net capital gains income continue into the future.

Summary of forecasting steps as equations

The steps described above can be summarised as both a conceptual flow chart and as a set of equations, of which several are accounting identities. Both are shown below. These effectively form the CGT forecasting model.

27 *Taxation Statistics 2011-12* (www.ato.gov.au) and Treasury calculations.

Chart 11: Net capital gains flow chart



Capital gains forecasting equations

Calculating unrealised capital gains:

- price assumption: prices (for example ASX 200 index and real estate prices) grow with nominal GDP
- new accrued net gains = asset base (start year) x yearly price growth

Realised gains and losses:[28]

- stock of accrued gains available for realisation =
  stock of accrued gains (start year) + new accrued gains;

- realised gains =
  stock of accrued gains available for realisation x realisation rate; and

- stock of accrued gains (end year) =
  stock of accrued gains available for realisation — realised gains.

Use of losses:

- losses available for use = stock of losses (start year) + realised losses

- losses used = losses available for use x loss use rate[29]

- stock of losses carried forward (end year) = losses available for use — losses used

Net taxable capital gains:

- taxable capital gains = realised gains — losses used — discount and concessions.[30]

Key risks to CGT forecasts

The risks to the CGT forecasts are related to the assumptions used. If asset prices move significantly differently to nominal GDP growth then CGT will also be significantly different from the forecast amounts. Major variations in realisation rates from the assumptions will also result in forecasting error. Unexpected loss utilisation behaviour will also drive forecasting error, although, as noted above, this will mostly be an error on the timing of payments of CGT rather than of the overall quantity of CGT.

Summary

Over the thirty years since its inception, CGT has become a significant stream of Australian Government revenue. Volatility in CGT is a major driver of aggregate revenue volatility and revenue forecasting error. CGT forecasts depend on assumptions regarding asset prices, realisation rates and the utilisation of losses. Capital gains behaviour varies across asset types and entities, and their characteristics need to be taken into account.

28 There are two sets of equations, one set for gains (shown here) and a mirror set for losses.
29 As discussed above, the rate at which losses are used is dependent on the amount of losses available and the amount of gains available to be offset.
30 If applicable.

Deregulation in Australia

Justin Douglas[1]

Australian governments have been pursuing deregulation agendas for four decades, with varying success. Where deregulation has been successful, it has increased economic freedom, opened up new markets, increased competition and enhanced the flexibility and dynamism of the Australian economy.

Nevertheless, opportunities to enhance productivity through deregulation remain. Competition and economic efficiency are still constrained by regulation in some parts of the economy. More generally, regulatory compliance costs have continued to grow, despite efforts to constrain them.

In this paper, the various areas where deregulation has, or may, deliver productivity benefits are examined. The direct compliance cost impact of regulation across the Australian economy could be equivalent to more than 5 per cent of GDP each year. Indirect and efficiency costs mean that the total economic cost of regulation is likely to be even greater. To ensure that inappropriate, excessive or unnecessary regulatory costs are not imposed, the author outlines the importance of ensuring that the cost of regulatory cures (compliance costs) are not worse than the disease (the problem that policy makers are trying to solve using regulation). A number of recent policy changes have been designed to support this outcome. Finally, some potential policy areas where deregulatory efforts could be prioritised to deliver productivity and living standards benefits are identified and discussed.

1 The author is from Markets Group, the Australian Treasury. This article has benefited from comments and suggestions provided by Paul McCullough, Amy Land-Pejoska, Graeme Cuxson, Harry Greenwell, Ian Douglas and Andrew Wirth (Australian Taxation Office). It has also benefited from internal workshops with staff of Treasury's Deregulation Division. The assistance of Martin O'Connor with data analysis, staff of the Treasury Library with research and Chris Berg (Institute of Public Affairs) for sharing data is also gratefully acknowledged. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

Australian Governments have sought to reduce the burden of regulation since the early 1970s. Where these efforts have been successful, they have reduced regulatory constraints on economic freedom and removed barriers to competition. However, competition and economic efficiency are still constrained by regulation in some parts of the economy and, more generally, regulatory compliance costs have continued to grow, despite efforts to constrain them. Part 1 of this paper considers the economic context for modern deregulation efforts in Australia. Part 2 describes some deregulation success stories and some future opportunities to improve Australia's living standards through continuing the deregulation story. Part 3 discusses issues relating to the regulatory compliance costs (or 'paper burden') aspect of deregulation. Australia, like most other developed countries, has found this aspect particularly challenging.

While well-designed regulation can assist productivity and enhance the well-being of Australians, regulation that is poorly designed or administered inefficiently can impose unnecessary costs. In extreme cases, if regulation is ineffective or misguided, these costs could even outweigh the benefits that the regulation is intended to achieve. In Part 4 of the paper, issues relating to measuring the direct cost of regulatory compliance are considered. This analysis finds that, on an economy wide basis, regulatory compliance costs may be equivalent to more than 5 per cent of annual GDP. Avoidable compliance costs may represent about 20 per cent of this.

The economic benefits of deregulation are examined in Part 5, which finds that reducing unnecessary or excessive compliance costs has the potential to lift Australia's productivity performance, helping to offset the negative effects of Australia's ageing population and a declining terms of trade on per capita living standards. Some key aspects of the Government's deregulation policies to reinvigorate deregulation efforts and drive success where past policies have failed are discussed in Part 6. Part 7 identifies a range of policy areas where significant deregulation and productivity gains are likely to be found. Finally, in Part 8, key conclusions are summarised.

1. Context for the modern deregulation push

During the post-World War II era, much of the Australian economy was tightly regulated. Some of this regulation, such as high tariffs and import controls, represented the remnants of attempts to protect Australian industries during the Great Depression in the 1930s. Other regulation, such as price regulations and the various agricultural boards, reflected wartime controls of the economy that had not been removed.[2] Consequently, many industries faced regulatory and institutional restrictions on competition in the domestic market.

High levels of regulation created inefficiencies across the economy and constrained Australia's productivity potential. Not only did this regulation impose costs on domestic users and consumers, feeding into inflation, it also reduced the international competitiveness of the traded goods sector and created economic rigidities that limited Australia's ability to adapt to changing international economic circumstances.

As a result, notwithstanding the popular impression that the post-WWII period was a 'golden era' for the Australian economy, output growth slowed, inflation and unemployment rose, and living

2 Crawford, Donald, Dowsett and Williams (1954) list controls over the production and/or marketing of wine, wheat, wool, barley, eggs, hides, leather goods, rabbit skins, apples pears, tobacco and meat as just some of the commodities subject to wartime regulation. They also note that the Pricing Commissioner was given 'virtually unlimited powers' to set prices.

standards declined relative to many other developed countries (Productivity Commission (PC), 2005, p. 1).

Two areas where the negative impact of excessive regulation was most obvious were the financial system and international trade. In the financial sector, lending and borrowing activities by Australian banks were strictly regulated. This constrained the ability of the banking sector to provide consumers with savings products that could maintain the real value of their deposits and made monetary policy largely ineffective (Wallis, Beerworth, Carmichael, Harper and Nicholls 1997, Chapter 14).

Like the financial sector, international trade was also highly regulated by the early 1970s. Effective tariff rates for some manufactures were as high as 120 per cent and local content regulations forced Australian producers to use expensive local components rather than imports. In 1973, the economy was operating at close to capacity, and retailers were reporting shortages of a wide range of goods. With regulation (including tariffs) constraining the ability of consumers and secondary industries to meet their needs via imports, the risk of an inflation outbreak was heightened. These risks were amplified during the mid- and late-1970s, which saw increases in local content regulation for the automotive sector and complex arrangements for tariffs, bounties and import quotas for textiles, clothing and footwear (Emmery, 1999).

2. Deregulation successes

As the economic impact of excessive regulation became clear, successive Australian governments have pursued deregulatory objectives. The earliest deregulation efforts related to the financial sector and international trade, with reform in both areas commencing in the early 1970s.

Financial deregulation commenced in 1973 when regulatory controls over the interest rates that trading banks could pay on wholesale deposits were removed. Battellino (2007) notes that this 'modest, cautious step to allow banks a degree of freedom to compete' had far-reaching consequences with a 'sequence of changes, each one begetting the next, until 13 years later virtually all controls on banks had been removed, foreign banks had been allowed to enter the market and the exchange rate had been floated'. In 1973, the Government appreciated the Australian dollar and reduced regulation by cutting tariffs across the board by 25 per cent (Lloyd, 2007). While the 1973 tariff cuts kick-started the process of deregulating Australia's international trade, the process over subsequent decades was more erratic than for financial deregulation. However, the overall trend over the decades that followed has still clearly been towards reducing the impact of trade regulation.

Following the floating of the Australian dollar and removal of controls on foreign capital flows in the early 1980s, deregulation gained momentum and was extended to many other parts of the economy. For example, controls on airfares were removed in 1987 and restrictions on entry to the domestic aviation market were lifted in 1990. Also, a range of sectors that had previously been dominated by government entities were deregulated by removing prohibitions on new entry (such as telecommunications) or by contracting out to private providers (such as legal services and training for job seekers). In other instances, government-owned enterprises[3] were freed from quasi-regulation through corporatisation or privatisation (Borland 2001).

Deregulation of Australia's rigid and highly centralised labour market arrangements also began during this period. For example, award restructuring and simplification, and the shift from

3 Borland (2001) lists Commonwealth Bank, Qantas, Commonwealth Serum Laboratories and Australia Post as examples of Commonwealth entities that were privatised or corporatised.

centralised wage fixing to enterprise bargaining that began in the late 1980s were deregulatory. This trend was continued following the change of government in 1996, with further award simplification and introduction of individual employment contracts (PC 2005, p. 37). In 2005, Access Economics estimated that these reforms are likely to have added at least 1.7 per cent to GDP (PC 2006, p. 155).

The National Competition Policy[4] (NCP) established a framework for extending the benefits of deregulation to a range of other industries. It built on earlier product market deregulation and sought to remove regulatory barriers to competition, reflecting that competitive forces in markets can generally provide stronger and more effective incentives for suppliers to operate efficiently, be price competitive and pursue innovation. Under the overarching NCP banner, sector specific reforms were pursued in electricity, gas, road transport and water. One of the most far reaching elements of NCP was the Legislation Review Program, which aimed to assess whether regulatory restrictions on competition were in the public interest. The legislation covered by the program spanned a wide range of areas, including: the professions and occupational licencing; statutory marketing of agricultural products; fishing and forestry; retail trading; transport; communications; insurance and superannuation; child care; gambling; and planning and development services (PC 2005, p. XV).

The deregulatory efforts listed above are widely considered to have been successful. Australia's GDP per capita had fallen from 5th highest in 1950 (of the group of pre-1994 OECD countries for which comparable data is available), to 9th in 1973 and 15th in 1990. However, by 2001, following several decades of sustained deregulation, Australia's ranking had recovered to 7th. Parham (2002) notes that it is widely accepted that the microeconomic reform aspects of deregulation played a major role in this turnaround. In 2005, the Productivity Commission concluded that a subset of the NCP reforms had increased Australia's GDP by 2.5 per cent even before the 'dynamic' efficiency gains of more competitive markets are taken into account (PC 2005, p. XVIII).

Despite the effectiveness of deregulation efforts such as NCP, not all deregulation efforts have been successful. For example, a number of NCP and related reforms remain incomplete (Banks 2012 and Harris 2014). In 2008, COAG sought to revitalise the NCP agenda by merging outstanding NCP reforms with other COAG productivity related reforms to create the National Reform Agenda (NRA). Harris (2014) notes, however, that unlike deregulatory reform efforts over the preceding three decades, the NRA 'did not really take off'.

Another area where deregulation efforts have been less successful relates to regulatory compliance costs. These costs are often referred to as the 'paper burden' of regulation or, more disparagingly, as 'red tape'.

3. The paper burden of regulation

In the same way that the deregulation efforts discussed in Part 2 date back to the 1970s, efforts to reduce the paper burden of regulation in Australia also date back to the 1970s. However, whereas the deregulation efforts discussed in Part 2 relate to the removal of barriers to competition or restrictions on innovation, paper burden costs relate to the cost of complying with regulation. As suggested by the name, 'paper burden' costs include the time and money spent completing government paperwork and associated record keeping. It also includes other compliance costs such as the time that people spend learning about (changes in) regulations and substantive costs such as installing new fire extinguishers to meet changed building standards.

4 See Committee of Review of the Application of the *Trade Practices Act 1974* (1993).

Some compliance costs are an unavoidable consequence of regulations that have a clear social benefit.[5] For example, most Australians accept the need for road rules aimed at improving road safety, even if giving way or not speeding might delay their current journey. However, regulatory costs can also be higher than necessary to achieve a particular outcome if the regulation is poorly designed or misguided. In the most extreme cases, regulation can impose significant compliance costs and be ineffective or counter-productive. For example, the Productivity Commission has found that blanket prohibitions on the removal of native vegetation can prevent farmers from adopting modern farming practices that would enhance both farm output and long-term environmental sustainability (PC 2004).

The growth of compliance costs

Like concerns about the impact of regulation on competition and economic efficiency, concerns about compliance costs also date back to the 1970s. In 1978, the then-Minister for Industry and Commerce commissioned an interdepartmental working group 'to conduct an inquiry into the extent of unnecessary paperwork imposed by government in Australia on small business' (Lynch 1978). As part of this inquiry, the Australian Bureau of Statistics (ABS) conducted one of the first significant attempts to estimate paperwork costs in Australia (ABS 1979). Many of the proposals that came out of the 1978 working group[6] remain relevant today:

- The use of sample based surveys rather than full enumeration in censuses for statistical purposes.
- Pre-printing of tax forms (group and sales tax returns).
- Sharing of data between government agencies.[7]

The effort to reduce regulatory compliance costs has been continued by all governments since then. Box 1 contains a timeline setting out many of the significant attempts to reinvigorate the compliance costs element of the deregulation agenda. In 1985 the then government established a Business Regulation Review Unit to examine 'all forms of regulation whether in the form of laws, … subordinate legislation and executive orders which impact on business' (Moran 1986). At the same time, regulation impact statements (RISs) were mandated for all proposals with significant business regulatory implications. These statements were intended to contain an analysis of the benefits and costs of regulatory proposals to ensure that the medicine wasn't worse than the disease that the regulation sought to cure. Commonwealth departments were also instructed to review eleven priority areas of existing regulation to reduce costs on business.

Australia was an early adopter of formal mandatory regulation impact assessment and other mechanisms to improve the quality of regulation making and minimise compliance burden of regulation on the economy (OECD 2010a). However, despite these efforts, the amount of regulation and the rate of regulatory change have continued to grow.

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5 For example, regulations regarding the roadworthiness of motor vehicles mean that owners of trucks and passenger vehicles must keep their vehicles properly maintained and undergo periodic inspections. However, it is generally accepted that these costs are outweighed by the community benefit in terms of safer roads.

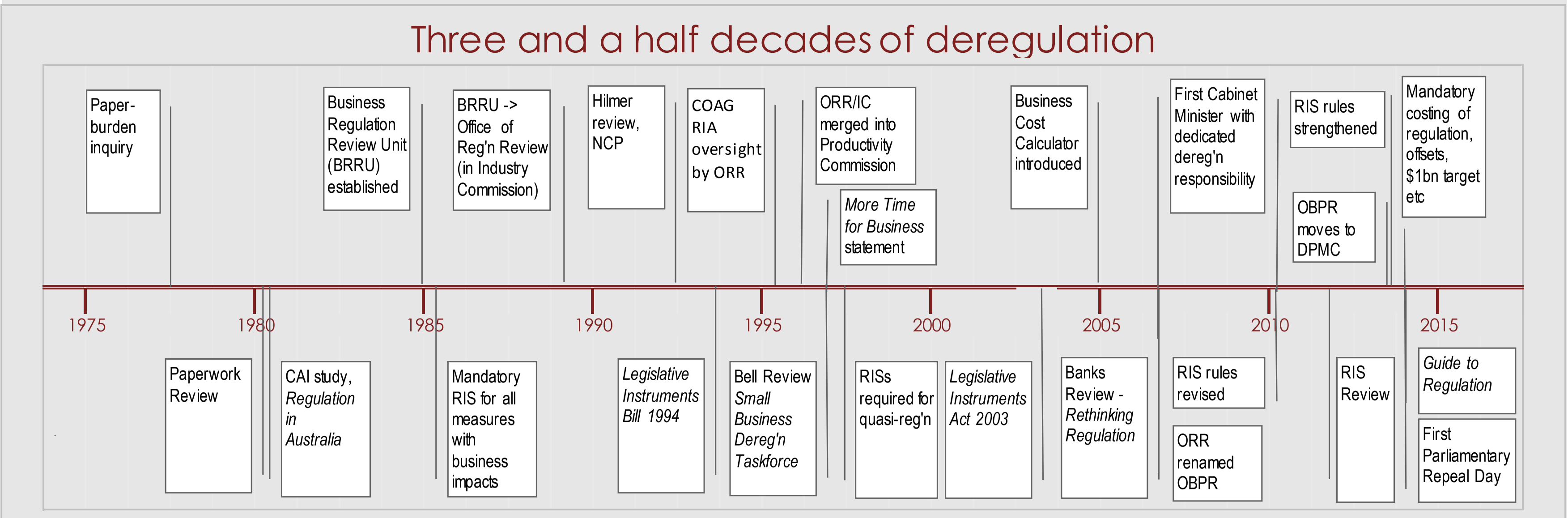
6 See Department of Industry and Commerce, 1980.

7 Sharing of tax data with the ABS to reduce the reporting on business had previously been recommended by the Parliamentary Committee on Integration of Data Systems in 1974. This recommendation was reiterated in Joint Committee of Public Accounts (1981).

Part of the reason for the failure of past efforts to stem the increase in regulation may be that Australia, like other developed countries, has experienced changing societal expectations. In relation to the United Kingdom, Blair (2005) noted that 'In my view, we are in danger of having a wholly disproportionate attitude to the risks we should expect to run as a normal part of life. This is putting pressure on policymaking, not just in government but in regulatory bodies, on local government, public services, in Europe and across parts of the private sector — to act to eliminate risk in a way that is out of all proportion to the potential damage. The result is a plethora of rules, guidelines, responses to 'scandals' of one nature or another that ends up having utterly perverse consequences'.

The OECD has suggested that another reason why governments across many countries have struggled to reverse the trend towards increased regulation and rising compliance costs is that 'bad regulation … will generally face less political resistance, especially where certain groups can benefit at the cost of the wider community [and] is often rewarded with public acclaim, as tangible evidence that government is "doing something"' (OECD 2010b, p. 4).

Box 1: Commonwealth Government deregulation milestones



- 1978 — Inquiry into Unnecessary Paperwork (Lynch, 1978)
- 1980 — Comprehensive Review of Paperwork by all Commonwealth Departments and authorities (Department of Industry and Commerce, 1980)
- 1985 — Business Regulation Review Unit established and Regulation Impact Statements (RISs) first mandated
- 1994 — Legislative Instruments Bill 1994 introduced — would have mandated RISs and automatic sunsetting of legislative instruments after five years
- 1996 — Time for Business (Small Business Deregulation Task Force 1996) recommended that regulatory gate keeping be strengthened
- 1997 — More time for business (Howard 1996) mandated RISs and sunsetting of subordinate legislation
- 2003 — Legislative Instruments Act 2003 — mandated registration and sunsetting of Commonwealth delegated legislation, typically after 10 years
- 2006 — Rethinking Regulation report (Regulation Taskforce 2006) — 178 specific recommendations, including stronger RIS requirements, regulator performance measurement and sunsetting of subordinate legislation after five years
- 2010 — Regulatory Impact Assessment framework strengthened and new Best Practice Regulation Handbook published
- 2012 — Independent Review of the Australian Government's Regulatory Impact Analysis Process (Borthwick and Milliner, 2012)
- 2103 — Mandatory RISs for all Cabinet submissions, regulatory costings and offsets, $1 billion annual deregulation target
- 2014 — Semi-annual Parliamentary Repeal Days, regulatory audit, updated regulator performance measurement and reporting (Abbott 2014)

4. Measuring regulation (and deregulation)

Measuring the amount of regulation is fraught with challenges. One common measure is the aggregate quantity of legislation and statutory rules. As a measure of compliance costs imposed on individuals and businesses, such measures are imperfect as they include legislation that is entirely internal to government, such as the *Public Service Act 1999*, which provides a statutory basis for the employment of government employees.[8] In addition, obsolete and unused rules are also captured, even though they impose no direct regulatory burden apart from making the law more voluminous than it needs to be.[9] However, pages of legislation can still serve as a useful proxy for measuring overall trends in regulation (Berg 2008).

Page counts

The Productivity Commission found that in June 2007 there were 100,000 pages of Commonwealth legislation and 90,000 pages of statutory rules (regulations, determinations etc.) (PC 2008, p. 32). This does not include regulation by state and local governments or the many pages of guidance, rulings and other quasi-regulation that individuals and businesses are expected to understand and comply with. The *Rethinking Regulation* report found that 'there are also literally millions of pages of rulings, explanatory memoranda, advisory notes and so on, plus a number of self-regulatory regimes, sometimes introduced to ward off the "threat" of government regulation'. Over the last 10 years, the number of different licences for businesses and occupations appears to have grown from around 24,000 to almost 32,000 (Regulation Taskforce 2006 and Australian Business Licence and Information Service 2014).

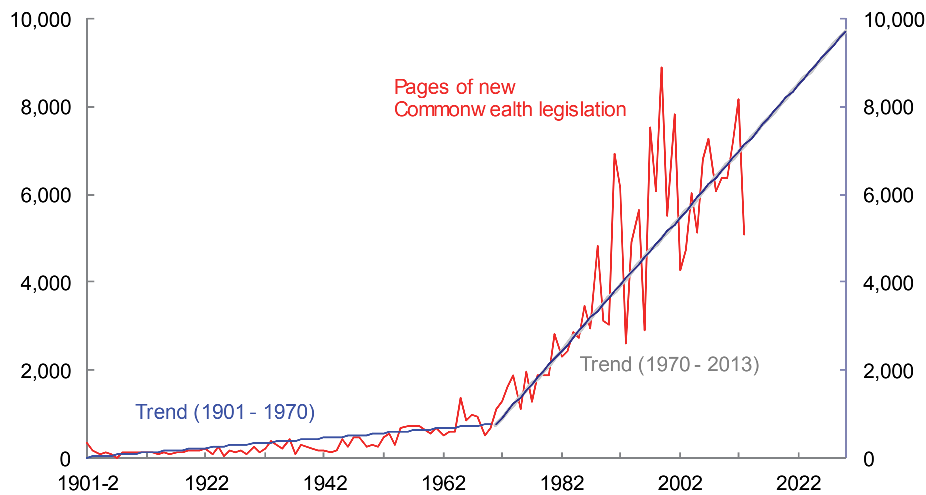
As well as the amount of regulation, it is also important to consider the rate at which it is changing. The rate of change is important because individuals and businesses must not only educate themselves about regulations that may apply to them, but must also monitor for any changes. As the amount of regulation that people are expected to comply with has grown, so has the amount of new regulation each year. Chart 1 shows the number of pages of Commonwealth legislation passed by Parliament each year since Federation. Between 1901 and 1970, the amount of legislation passed each year rose only slowly, from an average of about 130 pages per year in the first decade, to an average of around 750 pages per year during the 1960s. However, the rate of legislative change has accelerated since 1970. So far during the 2010s, there have been more 6,500 pages of legislation on average each year. The dip in 2013 most likely reflects the reduced number of sitting days in 2013 caused by the timing of the election.

While page counts are one way of measuring the amount of regulation, they are only a proxy for the cost of regulatory compliance. What ultimately matters is the number of regulatory burdens and the cost associated with satisfying each of these relative to the benefits stemming from these regulations.

8 Although internal to government regulation does not impose a direct compliance cost on the private sector, it may still impose a cost on the economy if they require the employment of public officials to administer and verify compliance with the regulation. These costs are indirectly passed on to the private sector to the extent that these costs necessitate higher taxes or less provision of public services than would otherwise be the case.

9 Obsolete legislation and statutory rules can still impose an indirect compliance burden if individuals and businesses must examine them to determine that they are not relevant.

Chart 1: Pages of Commonwealth legislation passed per year



Source: Institute of Public Affairs, trends calculated by Treasury.

Part of the growth in the number of regulations and number of pages of regulation over the last four decades reflects the competition-increasing deregulation process that has been underway since the early 1970s. An example of where deregulation led to an increase in the number of pages of regulation is telecommunications. Prior to deregulation, there was a prohibition on the supply of telecommunications services by anyone apart from Telecom Australia. When this prohibition was removed, it was necessary to introduce a range of new regulations to ensure effective competition in the new market. Some of these new regulations included were to ensure that Optus and other new entrants could access Telecom's monopoly infrastructure, to ensure that customers with different providers could call each other, to ensure the orderly and efficient allocation of telephone numbers and to ensure that basic telecommunications services are available across Australia. Overall, these reforms increased economic freedom by allowing competitors to enter the market, gave consumers choice and drove productivity improvements and lower prices through increased competition. Therefore it is clear that the overall effect was deregulatory notwithstanding the increase in the volume of regulations required to give effect to it.

More generally, trends in page counts need to be interpreted with some caution, for several reasons. First, as noted above, it is difficult to know what fraction of all legislation is regulatory in nature (as opposed to being internal to government, for example) or whether this fraction has remained constant over time. Second, the volume of regulations may not provide an accurate guide to the burden associated with those regulations. Third, it is possible that there is substitution between different types of regulations where, for example, legislation replaces subordinate regulatory instruments, or vice versa. Fourth, it is possible that the apparent volume of legislation may have been influenced by the progressive introduction of new drafting or formatting protocols. Finally, the level of litigation and subsequent court decisions may be relevant because governments may introduce new legislation to clarify the implications of court decisions (for example, legislation responding to the Mabo and Wik decisions). In some cases, such legislation may effectively reverse a court decision that had an unintended effect, so that there is no net regulatory change. In other cases it may build on a court decision.

Compliance costs

Another approach to estimating the cost of regulation is to measure how much time and money businesses and individuals spend on complying with regulations. Some early attempts to do this in Australia on an economy-wide basis include Eric White Associates (1978), ABS (1979) and Confederation of Australian Industry (CAI) (1980). These estimates were based on surveys of how much it costs businesses to comply with regulatory obligations. They include the time spent by business owners and their employees to complete paperwork and other regulatory obligations. More recently, the Commonwealth and some state governments have adopted similar approaches for estimating the compliance costs associated with individual regulatory proposals. One example of a tool to do this is the Commonwealth's 'Business Cost Calculator' (see Department of the Prime Minister and Cabinet (PM&C), 2013).

In 2006, the Productivity Commission reviewed a wide range of academic and other studies and concluded that the compliance costs of business regulation are significant and could be as high as 4 per cent of GDP per annum. Business organisations report that compliance costs have continued to grow since then and recent studies of compliance costs associated with the tax system are consistent with this conclusion. Table 1 summarises the outcomes of the major studies of regulatory compliance costs for Australia over recent years.

One challenge when attempting to estimate economy-wide compliance costs is that previous studies have generally focussed on costs for business. In 2006, the Productivity Commission concluded that compliance costs faced by business 'could be as high as 4 per cent of GDP per annum' (PC 2006, p. 133). However, businesses are not the only ones affected by regulation. Individuals and the not-for-profit or community sector must also deal with regulation. Therefore, to derive a true, economy-wide estimate of regulatory compliance costs, it is necessary to combine estimates of business compliance costs with an estimate of compliance costs incurred by individuals and not-for-profit organisations.

One study that examined compliance costs for individuals is Tran-Nam, Evans and Lignier (2014). They estimated that tax compliance costs for individuals are equivalent to about 0.6 per cent of GDP. This is significantly higher than Evans, Ritchie, Tran-Nam and Walpole (1997), who estimated that it was equivalent to just 0.3 per cent of GDP in 1995-95. In addition to taxes, individuals must also comply with a variety of licencing requirements (for example, driving licences) or obtain permits (such as permits for domestic renovations). Individuals must also contend with quasi-regulation when interacting with government, including such things as time spent learning about requirements for government programs, time spent completing application forms to access welfare programs, or time spent queuing for Medicare refunds. While there have not been any formal studies that have quantified these non-tax related compliance costs for individuals, if tax related compliance costs are equivalent to 0.6 per cent of GDP, then it seems reasonable to assume that total compliance costs for individuals could be equivalent to 1 per cent or more of GDP.

Table 1: Summary of recent compliance cost studies and estimates

Study	Cost (%GDP)	Sector					Coverage			Ref. year
		SME	Large b'ness	Indiv'l	Super funds	NFPs (g)	Tax	Non-tax	Delay	
OECD(a)	3.4	✓	✓	✗	✗	✗	✓	✓(h)	✗	1998
ATO/ATAX(b)	2.3	✓	✓	✓	✓	✗	✓	✗	✗	1994-95
PC(c)	4	✓	✓	✗	✗	✗	✓	✓	✗	2006
ATAX(d)	2	✓(i)	✗	✓	✗	✗	✓	✗	✗	2011-12
ATO(e)(f)	3.3	✓	✗	✓	✓	✓	✓	✗	✗	2010-11
Treasury	5+?	✓	✓	✓	✓	✓	✓	✓	✓	2014

(a) Productivity Commission estimate based on OECD (2001).
(b) Evans, Ritchie, Tran-Nam and Walpole (1997, p. ix).
(c) Productivity Commission (2006).
(d) Tran-Nam, Evans and Lignier (2014), Lignier, Evans and Tran-Nam (2014) and Treasury calculations.
(e) Unpublished ATO internal estimates and Treasury calculations.
(f) Includes some ATO related non-tax superannuation compliance costs.
(g) Not for Profit organisations.
(h) Employment and environmental regulation only.
(i) Partial coverage of micro-businesses.

Combining the Productivity Commission's estimate of business compliance costs in 2006 of 4 per cent of GDP with an assumed compliance costs for individuals of 1 per cent of GDP suggests that total economy-wide compliance costs are equivalent to around 5 per cent of GDP. Further, compliance costs could be even higher if business compliance costs have risen since 2006[10] or if costs incurred by not-for-profit organisations or delay costs[11] are taken into account.

Regulatory change

In terms of compliance costs, it is not only the amount of regulation that matters, but also the rate of change. From Chart 1, it can be seen that the number of pages of new legislation has increased dramatically over the last few decades. Therefore, regulatory compliance costs include not only the obligations contained in the stock of existing regulation, but also the costs associated with monitoring changes in regulation. These changes are being made by all three levels of government.

When assessing compliance costs associated with regulatory change, it is important to recognise that change costs do not only occur when legislation or a statutory instrument is formally changed. Costs can also occur if a regulator changes how they administer a regulation, if they change a form (so that businesses or individuals must familiarise themselves with the new paperwork), or if they seek to 'clarify' a regulatory requirement that many people have interpreted differently, particularly if they have operated on the basis of the alternative interpretation for some time.

Treasury's discussions with businesses have also uncovered situations where frequent changes in regulation have undermined the underlying intent of some regulation. For example, one manufacturer identified 22 different changes to regulations relating to product specifications and the energy performance of their products between 2007 and 2013. The aim of these regulatory changes was to improve environmental outcomes by improving the energy efficiency of the products. The manufacturer also revealed that they have identified innovative ways of substantially changing their products to make them significantly more energy efficient but that this would require substantial changes to their production processes that could take up to six months to implement. However, frequent regulatory change and a steady stream of regulatory reviews have meant that they have not

10 International data on the burden of government regulation points to an increase in regulatory burden between 2009-10 and 2013-14 (Hockey 2014, p. 4-17).

11 Delay costs arise when a business or individual incurs costs due to delays while waiting for a permit, approval or other regulatory requirement. The Commonwealth's Regulatory Burden Methodology (previously known as the Business Cost Calculator) was extended to include delay costs in November 2013.

had certainty about what regulations would apply more than a few months in advance. Therefore, rather than taking the risk that by the time they changed their production systems their new product might need further modifications before it is compliant with unexpected regulation changes, they have been limited to making only make minor, incremental changes to their designs. As a result, the benefits to consumers of more efficient appliances and to the environment from step changes in technology remain unrealised.

The potential for reducing compliance costs

As noted in Part 3, some regulatory compliance costs are unavoidable or clearly outweighed by the benefits that the regulation brings. Therefore, it is appropriate that deregulation is directed at removing unnecessary costs and reforming regulations where the costs outweigh the benefits.

Without assessing the benefits and costs of regulations individually, it is difficult to assess the extent to which compliance costs are avoidable, or relate to regulations that do not deliver a net social benefit, is difficult to determine.[12] As an alternative to directly estimating what proportion of compliance costs might be unnecessary or avoidable, the Productivity Commission considered the deregulation targets being pursued in a number of other countries and by some States and found that these targets have generally ranged between 15 and 25 per cent (PC 2006, p. 151). If Australia were to achieve the mid-point of this range by reducing compliance costs by 20 per cent, this would translate into direct compliance cost savings for businesses, individuals and community organisations equivalent to around 1 per cent of GDP.

Only a portion of the regulatory burden is under the direct control of the Australian Government as state, territory and local governments are also responsible for significant amounts of regulation. In the absence of better information, suppose the Australian Government regulation accounts for around half of the avoidable economy-wide compliance burden. If this assumption is approximately correct, then the Australian Government might be able to reduce compliance costs by around ½ per cent of GDP per year or approximately $8 billion. In this context, the Government's target of at least $1 billion per year (Abbott 2014) will allow a significant proportion of this potential to be realised in just a few years, while recognising that if regulations are changed too quickly, then that, in itself, can impose a compliance burden on the economy.

5. Economic benefits of deregulation

The economy-wide benefits of deregulation are potentially much greater than the savings from reducing compliance costs, as regulation can impose a range of other costs in addition to the direct compliance burden. '[R]egulations not only create paperwork, they can distort decisions about inputs, stifle entrepreneurship and innovation, divert managers from their core business, prolong decision-making and reduce flexibility' (Banks 2003b). While these costs are not explicit, as they are not "paid for" directly, they reduce the efficiency of the economy and are therefore known as "efficiency costs" (PC 2006, p. 154). Berg (2008, p. 19) argues that "for much of the economy, the paperburden cost is dwarfed by [efficiency costs]"'.

As noted above, a great deal of reform to reduce efficiency costs has already been implemented. However other opportunities for regulatory reform aimed at reducing efficiency costs remain. The Productivity Commission has conservatively estimated that the direct economic benefit of deregulation in the areas such as retail trading hours, coastal shipping, rail freight, foreign investment

12 Attempts to measure 'excessive' costs via business surveys are known to have an upward bias due to businesses sending a protest message (PC 2006, p. 153).

and water trading could be worth around $6 billion per annum (Harris 2014). The total potential benefit from deregulation in these areas is likely to be much more if innovation and dynamic efficiency gains are taken into account.

Banks (2012) set out a broader list of areas where deregulatory reform might deliver substantial reductions in efficiency costs and deliver improvements in GDP. This list included deregulation opportunities in sectors such as pharmacy ownership, taxi licences, coastal shipping, book imports, professional services, electricity, water, native vegetation and heritage, development and planning, and chemicals regulation. Many of these areas are covered by the Terms of Reference for the Competition Policy Review announced by the Minister for Small Business on 27 March 2014. A key focus of this review will be to 'identify regulations and other impediments across the economy that restrict competition and reduce productivity, which are not in the broader public interest' (Billson 2014).

Estimating the productivity and GDP effects of deregulatory measures that reduce efficiency costs is not straightforward. Such reforms may have only a small direct compliance cost impact, but deliver substantial indirect benefits to the economy. For example, prior to the deregulation of the telecommunications sector, competitors to Telecom Australia did not exist and hence did not incur any paper burden. However, the benefits of deregulation to the economy and society from lower telecommunications prices, a wider variety of services and increased innovation have been substantial. Estimating the benefits, and any offsetting costs, of such reforms typically requires complex economic modelling and requires careful analysis on a case by case basis.

Estimating the economic benefits of reducing compliance costs is also more complex than simply measuring the direct compliance cost impact using a standard costing model. In many instances, the economic benefit of a deregulatory reform will be greater than the measured compliance cost saving because standard costing tools typically only measure the direct impact. However, in other cases, offsetting influences may mean that the economic impact is less than the direct compliance cost impact.

One type of costs that is sometimes excluded from standard compliance cost models is government administration costs. These costs could relate to educating people about a regulation, verifying compliance, receiving and processing applications, licences or forms and potentially costs associated with prosecuting people that don't comply. Often, these administration costs are passed back to the regulated population in the form of cost recovery fees and levies and may be viewed by business as 'adding insult to injury by imposing a regulatory burden on them and then charging for the privilege' (Banks 2003a, p. 12). The Productivity Commission has previously recommended that regulators' administration costs should be included in compliance cost calculations (PC 2011, p. XVIII). While this is particularly the case when administration costs are passed on in the form of fees and charges, it can also be argued that government administration costs should be captured regardless of how they are funded as they are still a cost to the community and ultimately borne by taxpayers (PC 2011, p. 12).

Another reason why standard estimates of the paper burden may differ from the economic impact is that reducing paper burden can free up staff and resources within a business that may be reallocated to other, more productive uses. However, in other cases, the time and resources freed up could be allocated to leisure or uses that are not captured by measured GDP (but still improve societal well-being).

How standard costing tools are used can also affect whether the measured reduction in compliance costs is more or less than the overall economic benefit from a deregulatory reform. For example, the

Productivity Commission has previously cautioned that estimates based on these calculators are often overstated if they are 'based on proposed changes in regulatory requirements, and reflect "gross" rather than "net" savings' (PC 2011). This may be one reason why, in countries where governments have claimed to have reduced compliance costs substantially, surveys show that businesses perceive little impact (op cit, p. XVI).

6. Australia's policy framework for reducing the regulatory paper burden

As noted above, successive Governments have been attempting to reduce regulatory compliance costs since the 1970s, but these attempts have generally been unsuccessful in counteracting rapid growth in the amount of regulation in the economy and the associated paper burden. By themselves, efforts to reduce costs associated with existing regulation are unlikely to be effective in reducing the overall regulatory burden unless the flow of new regulation is also stemmed. It is in this context that the Government has committed to measures aimed at addressing both the stock and flows aspects of the deregulation challenge.

Addressing the flow of regulation

It is preferable that unnecessary, poorly designed or excessively burdensome regulation is identified and either prevented or redesigned before it is implemented. If regulation is revised after it has already been implemented, then this will cause businesses and individuals to incur unnecessary compliance and additional adjustment costs. It has also been claimed that 'it is "five times harder" to remove poor regulation than to introduce it' (Banks 2010).

To improve the quality of regulation going forward, in March 2014, the Government launched the *Australian Government Guide to Regulation* (PM&C 2014). The Guide sets out processes that policy makers (and their advisers) must follow when considering regulatory proposals. These processes are based around a set of ten principles, which are reproduced in Box 2.

An important aspect of the new principles is that now Regulation Impact Statements (RISs) must always recommend the option with the greatest net benefit (Principle 1). Further, Principle 2 requires that regulation only be imposed if there is an overall net benefit. This is intended to address the problem that sometimes in the past regulation may have been imposed because it is the most effective way to resolve a policy problem, but there was not sufficient consideration as to whether the 'medicine' might be worse than the 'disease'.

Box 2: Principles for Australian Government policy makers

1. Regulation should not be the default option for policy makers: the policy option offering the greatest net benefit should always be the recommended option.
2. Regulation should be imposed only when it can be shown to offer an overall net benefit.
3. The cost burden of new regulation must be fully offset by reductions in existing regulatory burden.
4. Every substantive regulatory policy change must be the subject of a Regulation Impact Statement.
5. Policy makers should consult in a genuine and timely way with affected businesses, community organisations and individuals.
6. Policy makers must consult with each other to avoid creating cumulative or overlapping regulatory burdens.
7. The information upon which policy makers base their decisions must be published at the earliest opportunity.
8. Regulators must implement regulation with common sense, empathy and respect.
9. All regulation must be periodically reviewed to test its continuing relevance.
10. Policy makers must work closely with their portfolio Deregulation Units throughout the policy making process.

Source: PM&C (2014).

Other aspects of the Guide are designed to improve the quality of analysis that is used to inform regulatory decisions. Borthwick and Milliner (2012) found that many agencies claimed to lack the skills and resources to undertake regulatory analysis, while the Productivity Commission found three quarters of the time that consultants are engaged to complete a RIS it is because of a lack of skills in cost-benefit analysis within the agency (PC 2012, p. 318). The Guide seeks to address these capability problems by stepping policy makers through the key stages of cost-benefit analysis. Some specific elements of the Guide that should improve the quality and transparency of regulatory decision making include requirements to quantitatively estimate the compliance cost impact of changes in regulation, the need to consider how regulators will implement and enforce a regulation and the need to consider whether regulations should be tailored to different groups.

Explicit consideration of compliance costs

The Regulation Taskforce found that in the past, policy makers have often paid too little attention to compliance costs, and consequently recommended the use of compliance cost quantification tools as a mechanism to address this failing. Despite the availability of tools to facilitate these costings, prior to the introduction of the new policy, very few RISs contained even rough quantitative analysis of compliance impacts (PC 2012). The new Guide overcomes this problem by mandating quantification and, if a proposal increases regulation, requiring that offsetting reductions in compliance cost are identified (PM&C 2014, pp. 34, 37).

Implementation and regulatory approach

In relation to regulatory compliance costs, the way that regulations are implemented is often as important as the content of the formal written regulations themselves (PC 2013). A regulator can administer well designed regulation in ways that 'discourage compliance, squander government

resources or add to business costs and delays. Alternatively, a regulator might take an unwieldy accumulation of regulation and, by choosing what, when and how to enforce, deliver the desired regulatory outcomes in an efficient manner'.

To ensure that regulators implement regulations in a manner that minimises unnecessary compliance costs, a framework to measure how regulators engage and interact with those being regulated is being developed (Frydenberg 2014 and PC 2014). This framework will focus on measuring those aspects of regulator behaviour that contribute to the Productivity Commission's finding that 'businesses continue to report that a high share of what they perceive as unnecessary compliance costs are the result of the way regulators interpret and enforce the regulation' (PC 2011, p. 56).

While regulator behaviour is clearly important, the scope for regulators to reduce compliance costs may be constrained by their legislative framework or other governance arrangements (PC 2011, p. 56). Therefore, it is critical that implementation issues are fully considered when regulation is being developed.

Regulations may, in the past, have been developed and given effect without sufficient consideration of how it would be administered, interpreted or enforced. For example, a 40-page RIS that was published in recent years allocated less than four lines to 'Implementation'. It simply noted that 'This reform will be implemented through legislation to be passed during [year], as part of [a related set of legislative reforms]. This reform will be effected through amendments to the [relevant] Act which will mean that [the relevant regulatory body] will be responsible for administering and monitoring compliance'.[13]

It is difficult to see how it might be possible to establish that the potential benefits of a regulation outweigh the societal costs without taking into account how it will be administered and enforced, whether the relevant regulator has the skills and resources to implement it efficiently and fairly and the impact that different implementation approaches have on compliance costs.

Consultation can provide a valuable mechanism for gathering information about the impact that different implementation approaches can have compliance costs. If the policy makers that design a regulation are different from the regulator that will administer and enforce it, consultation should include with the regulator, as well as those that will be directly or indirectly subject to the regulation. Consultation with those who be subject to a regulation and those will administer it can identify practical implementation issues that might prevent the regulation from having the desired effect or require the regulator to enforce aspects of the regulation that are unrelated to any community benefit. To address these issues, the Guide requires stakeholder consultation (PM&C 2014, p. 39) and consideration of implementation issues (op cit, p. 49) prior to regulatory decisions.

Quasi-regulation

In a related policy change, the new Guide expands the previous definition of 'regulation' so that regulatory impact analysis will also be required for 'quasi-regulation'. This recognises that 'quasi-regulation can affect the behaviour of businesses and impose a burden similar to explicit government regulation' but may be subject to less rigorous analysis and facilitate 'regulatory creep', (Commonwealth Interdepartmental Committee on Quasi-regulation 1997). By expanding the definition of 'regulation' to include 'any rule endorsed by government where there is an expectation

13 This example is not unique — a number of recent RISs in recent years have contained implementation sections equivalent to less than 5 per cent of the RIS.

of compliance', policy makers and regulators will now need to consider compliance costs for a broader range of activities than in the past. For example, the new definition would capture the time that people might take to complete a government form, how many people or businesses will need to call a telephone inquiry line and how long they can expect to wait before they get through. While the compliance costs associated with individual transactions of this type are often small, even minor improvements can deliver substantial savings across the economy when multiplied by the large number of businesses or individuals affected.

Customising regulation

A third aspect of the new Guide is that it requires policy makers to consider whether or not regulations should be tailored for different groups to reflect differences in compliance costs and risk, such as small businesses (PM&C 2014, p. 27).

Tackling the stock of regulation

To address the stock of regulation the Government has sought to change the underlying incentives that may be contributing to its growth. For example, the Government has set itself a target of reducing regulatory burden by at least $1 billion each year and created incentive mechanisms for Ministers and officials to reduce regulations over time.

In the past, if deregulation opportunities have required amendments to legislation, a challenge has been in getting sufficient priority for the proposal in the legislative program to allow for amendments to be drafted or, once they are drafted, introduced. To address this issue, the Government has announced that it will dedicate at least two parliamentary sitting days each year to deal with unnecessary, counter-productive or redundant legislation and regulations.

7. Prioritising deregulation opportunities

Taking advantage of the potential productivity benefits offered by deregulation will be important if growth in average living standards is to be sustained over the next decade. Hockey (2014, p. 4-16) states 'for annual incomes to grow at their historical average of 2.3 per cent over the period to 2025, annual labour productivity would need to increase to around 3 per cent per year … this is well in excess of what has been achieved in the past 50 years, and more than double what was achieved in the past decade'.

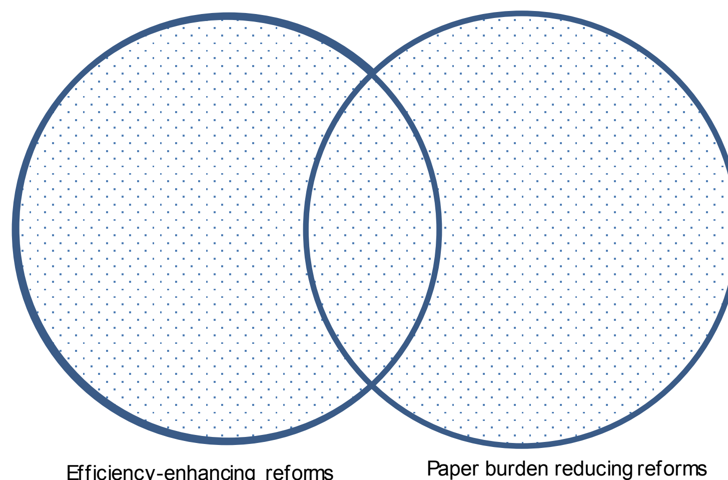
The scope for productivity enhancing deregulation, whether directed at reducing efficiency costs by removing regulatory constraints on economic activity or at reducing compliance costs, is substantial. However, it is not feasible, or desirable, that all of these deregulation opportunities are tackled at once. As discussed in Parts 3 and 4, regulatory reform can, if implemented too quickly or in an ad hoc manner, impose additional costs on businesses and individuals. To ensure that deregulatory benefits are maximised while mitigating possible risks of reform fatigue, it will be important that deregulation opportunities are prioritised and sequenced.

In general, the largest productivity gains from deregulation will come from reforms aimed at realising efficiency benefits — the Productivity Commission found that these are large and possibly 'many times greater than the benefits from reduced compliance costs' (PC 2006, p. 154). However, this does not mean that all competition related deregulation is preferable to all deregulation aimed at reducing compliance costs. The analysis presented in Part 4 of this paper shows that the potential benefits from reducing compliance costs are still significant and that, over time, it may be possible to reduce compliance costs imposed by Commonwealth regulation by an amount equivalent to around

½ per cent of GDP. A similar saving might be realised if compliance costs associated with state and local government regulations are also reduced.

A comprehensive deregulation agenda, such as that currently being pursued, recognises that the two types of deregulation are not mutually exclusive and that the best opportunities of each type can be progressed at the same time. Therefore, a list of priority deregulation opportunities will include both reforms that primarily improve economic efficiency and reforms that primarily target compliance costs (see Diagram 1).

Diagram 1: Total Deregulation potential



The Competition Policy Review will provide a mechanism to identify and prioritise deregulation opportunities that can most effectively promote competition and address efficiency costs. The complex relationship between economic benefits and compliance cost savings means that reforms directed at reducing compliance cost need to be considered on a case by case basis. However, to the extent that compliance cost savings and economic benefits are correlated, it is useful to consider which types of deregulatory reform are likely to provide the largest scope for compliance cost savings. Three areas where large compliance cost savings are likely to exist are:

- deregulation aimed at large populations;
- deregulation affecting small business; and
- tax-related deregulation.

Deregulation directed at large populations

In terms of identifying areas where deregulation can provide the most significant compliance cost savings, it may be noted that, in general, it may be easier to achieve large savings by identifying reforms that benefit a large regulated population. For example, a change to income tax arrangements that saves 10 million taxpayers an average of $50 each, either in time or tax agents' fees, would save $500 million in total compliance costs. In contrast, a deregulatory proposal that only affects the ten largest companies in Australia would need to save each of them $50 million each to have the same total impact.

Some areas of regulation that currently affect a large proportion of the population are:

- *taxation;*
  - *individuals* — in 2011-12 there was 12.7 million individual taxpayers (Australian Taxation Office 2014);
  - *businesses and not-for-profit organisations* — as at 30 June 2013, 7.5 million entities held an Australian Business Number (Australian Business Register 2013);
- *social welfare* — approximately 5 million Australians receive income support (Department of Social Security 2014) and Medicare processes around 350 million claims each year (Department of Human Services 2013);
- *workplace regulation* — approximately 11½ million Australians were employed in early 2014 (ABS 2014);
- *company regulation* — more than 200,000 new companies were registered during 2013 and there was more than 2 million companies registered as at the end of 2013 (Australian Securities and Investments Commission 2014); and
- *small business* — over 95 per cent of Australia's businesses are small (PC 2013).

Deregulation affecting small business

The large number of small businesses is not the only reason why deregulatory measures aimed at reduced compliance costs for small business can be significant. Small businesses face greater challenges in understanding and fulfilling their compliance obligations than larger businesses (PC 2013). Previous studies have found that 'SMEs … bear roughly 85 per cent of the aggregate paperwork compliance burden, although their share of economic activity is about one third' (Lattimore, Madge, Martin and Mills 1998, p. XXIV).

One reason that small businesses may face relatively higher compliance costs than larger businesses is that it is often easier for larger businesses to achieve scale efficiencies. Larger businesses allow for greater specialisation within the business and many large companies have specialist regulatory compliance departments that can specialise in monitoring regulatory change. For example, Lignier et al (2014) found that micro businesses (with turnover below $75,000 per year) incur gross tax compliance costs that are 40 times greater relative to their turnover than mid-sized businesses (turnover of between $2 million and $100 million per year). Various other studies have confirmed that small businesses bear disproportionate compliance costs in other areas of regulation (PC 2013, p. 72-76).

By itself, the fact that small businesses face proportionately larger compliance costs suggests that it is more likely that the costs of a regulation applied to a small business will outweigh the benefits of the regulation than is the case for larger businesses. This is even more likely if small businesses represent a proportionately smaller risk in relation to the harm that regulation is seeking to minimise.

This analysis suggests that significant deregulatory savings may be possible from 'tiering' regulations to better reflect both the relative costs of compliance and the risk posed by small business. Two examples of tiering are the use of lighter touch regulatory regimes or outright exemptions (Bickerdyke and Lattimore 1997). Another benefit of a more tailored approach to regulation for small businesses is that regulators can also incur disproportionate costs to procure a small firm's

compliance (PC 2013, p. 77). As argued in Part 5, these administration costs should also be taken into account when assessing the net benefit of regulation.

Tax deregulation

A majority of Australian individuals and businesses must comply with at least some part of the tax system. Some of the major taxes are: income tax and goods and services tax at the Commonwealth level; payroll tax for the States; rates and related changes for local government. The Australia's Future Tax System Review Panel (2009) identified some 125 different taxes that apply to businesses and individuals and concluded that 'Australia has too many taxes and too many complicated ways of delivering multiple policy objectives through the tax system. The capacity of the legislative and operating platforms of these systems, and their human users, to deal with the resulting complexity has been overreached'. The review also concluded that 'Improving the structure of the tax system, by replacing inefficient taxes with a rationalised suite of taxes and streamlining administration, has the potential to increase government accountability, reduce system complexity and business compliance costs, and make the Australian economy more productive'.

It is likely that tax-related compliance costs represent around 40-50 per cent of total economy-wide regulatory compliance costs. Oliver and Bartley (2005) cite various studies suggesting that tax compliance costs are equivalent to around 2 per cent of GDP. The more recent ATAX studies referred to in Part 4 suggest that this may have increased slightly over the last decade, despite the Australian Tax Office's attempts to reduce compliance costs by encouraging online preparation and lodgement, as well as pre-filling.

Two possible explanations for this increase in tax compliance costs could be an increase in the complexity of the tax system, or an increase in the complexity of the economy such that more people and businesses are now interacting with more complex aspects of the tax system. To some extent, growth in the number of individuals and businesses interacting with more complex parts of the tax system reflects voluntary choices. For example, as the proportion of adult Australians that directly own shares has increased, it is likely that more Australians have needed to interact with the capital gains tax system. In other cases, an increase in compliance costs may have been consciously traded off against perceived tax and other benefits when choosing to use a particular business structure.

While tax-related compliance appears to account for a large share of the regulatory burden in Australia, historical studies suggest that it is not the fastest growing area of regulation and has therefore been falling as a share of the total regulatory burden over time. An Australian Bureau of Statistics survey found that in 1978, Commonwealth and State Government taxation accounted for around three-quarters of the total regulatory burden (ABS, 1979). Therefore, if measures to reduce tax related compliance costs are to be effective in reducing the overall regulatory burden in Australia, it will be important that new regulation in other parts of the economy is also stemmed.

8. Conclusion

Australia faces a productivity challenge if it is to sustain growth in living standards over the next decade. In this context, deregulation is a potential driver of productivity growth to offset the negative growth effects of the end of the terms of trade boom and Australia's ageing population.

Deregulation can take two substantive forms: deregulation to address economic efficiency costs and deregulation aimed at reducing compliance costs. In general, the former will provide the largest productivity gains, but the two forms of deregulation are not mutually exclusive.

The largest gains will come from freeing up the economy to reduce efficiency costs and improve competition in remaining markets where it is currently constrained. It is intended that the current Competition Policy Review will provide a mechanism for taking these opportunities forward.

The benefits of reducing compliance costs are also significant. Therefore, maximising the living standards of Australians will require that unnecessary or inappropriate regulatory compliance costs are also addressed. In this context, recent changes to regulatory policy provide a new opportunity to realise these benefits. To ensure the greatest gains, deregulatory efforts should be prioritised by reducing compliance costs relating to regulations that apply to large numbers of people and businesses, including small business and taxation regulation.

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Jim Cairns: The Dreamer

John Hawkins[1]

Jim Cairns was the only academic economist to become Treasurer. But despite his qualifications, even his own assessment was that his tenure as Treasurer was unsuccessful. While a driving force behind the 1974 budget, he was Treasurer for only seven months and was one of only a handful of Treasurers not to bring down a budget. Cairns was an idealistic dreamer, but did little to realise his visions of a fairer society during his troubled treasurership.

1 At the time of writing the first draft of this article the author worked in the Domestic Economy Division, the Australian Treasury and an abridged version appeared as Hawkins (2007). Thanks are due to Barry Cairns and Selwyn Cornish for helpful comments but the views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

Jim Cairns is today best remembered, or at least most fondly remembered, for his role in the protest movement against the Vietnam war, leading a crowd of 100 000 through the streets of Melbourne.[2] Cairns was the only Treasurer to earn a PhD in economics, and the only academic economist to become Treasurer. He once said to Bill Hayden, however, that he was more of an economic historian and found some aspects of economics confusing.[3] He was a prolific author.[4] Despite his academic qualifications, even his own assessment was that his tenure as Treasurer was unsuccessful. He was one of only a handful of Treasurers not to bring down a budget.[5]

Cairns' early days

James Ford Cairns was born in Carlton on 4 October 1914. His parents, James John Cairns and Letitia Ford had married on 30 April of the same year. His father left to fight in World War I and chose not to return to Australia. Unusually for the times, Cairns consequently grew up in a home dominated by women and spent his childhood on a farm outside Melbourne before attending Sunbury State School and Northcote High School.

He first showed some interest in economics as a teenager during the Depression. A teacher gave him a copy of William Morris' Utopian novel *News from Nowhere*. In 1930 he suggested as a topic for a school debate 'that prevention of depression requires more money to spend, not less' and successfully argued the affirmative. But he was not a keen student, taking a greater interest in athletics. This was a long-standing passion. He won the Victorian decathlon championship in 1938 and might have represented Australia in the 1940 Olympics had they gone ahead.

After leaving school, he worked as a clerk in 1932-1934 and a policeman 1935-1944, where he won commendations for his performance, notwithstanding some misgivings about the nature of the work. Cairns joined the army briefly in 1945 but the war ended shortly after. In 1938 he had met Gwendolyne Robb and they married on 7 February 1939. Jim and Gwen had no children together, but brought up two boys, Philip and Barry, from Gwen's annulled former marriage.

Cairns started studying economics by reading two old texts in the late 1930s; Henry George's radical *Progress and Poverty* of 1879 and Alfred Marshall's classical *Principles of Economics* of 1890, moving on to Keynes' *General Theory* in the early 1940s. These must have stimulated his interest, for he subsequently enrolled as a part-time student for a Diploma in Commerce at the University of Melbourne in 1941.[6] He had also been influenced by his own experiences of the Depression: in 1931

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2 His predecessor as treasurer, Frank Crean (1983, p 8:19) said 'Jimmy Cairns was a kind of folk hero'. The main march was in May 1970 and there was another in November that year.

3 Hayden (1996, p 178).

4 The National Library catalogue lists 17 full-length books by Cairns, including one co-written with his wife Gwen, as well as numerous shorter pamphlets and speeches. This makes him the most published of the Australian Treasurers. A study by the Parliamentary Library (which excluded self-published works) had Cairns ranked equal second (out of almost 1500 parliamentarians) with his contemporaries 'Doc' Evatt and Paul Hasluck for number of books written.

5 The others were Chris Watson whose pioneering Labor government only lasted a few months, Percy Spender, and two Prime Ministers (Whitlam and Hawke) who held the position for a few days before appointing a treasurer. Alexander Poynton did not deliver a budget while Treasurer, but did present one later. A later treasurer, Ralph Willis, quoting Tacitus said of Cairns as treasurer 'everyone would have said he was qualified for the job if he had not held it'; Willis (2013, pp 124-5).

6 Unfortunately he missed studying under two of Australia's greatest economists, Copland and Giblin, as by then they had moved to Canberra to help with the war effort.

the bank foreclosed on his grandparents' farm, and he was unemployed for months after leaving school.

Cairns specialised in economic history and recollected in 1970 that his studies convinced him that economic factors were the main causes of changes in the structure of society. In 1946 Cairns became an academic, taking a post as tutor in economic history. His first article 'Wot, no socialism?' appeared in *Meanjin* and in 1950 he wrote on Australian history for the *Encyclopaedia Britannica*. In the early 1950s he wrote a textbook on Australian history and society. He continued his studies, gaining his Bachelor of Commerce in 1947 and a Master of Commerce in 1950 with a thesis on theories of economic growth. Cairns won a Nuffield Scholarship to study at Oxford in 1951. He worked there for ten months under the supervision of G. Cole on his PhD thesis on the historical links between the British and Australian labour movements. Over time, the topic was revised to cover the development of the Australian welfare state, and he had Deakin's biographer La Nauze as his Australian supervisor. The thesis was not finally submitted until June 1957. Its main argument concerns the primary role of organised labour rather than Deakinite liberals in the emergence of the welfare state.[7]

His academic career progressed quickly; he was appointed a temporary then permanent lecturer and a senior lecturer in 1953. The distinguished Australian and Cambridge academic, Geoff Harcourt, was one student inspired by Cairns' 'exhilarating' lectures.[8] Others found his delivery dull, but he was widely respected as approachable.[9]

In 1947 he questioned the *White Paper on Full Employment* in broadly Marxist terms. However, while a socialist, Cairns never supported violent revolution, and regarded Marxism as a 'method of inquiry, not a dogma'. He was not convinced by Marxist predictions of an imminent collapse of capitalism; as he later wrote, 'history is not on the side of the left'; Cairns (1972). While supportive of extra-parliamentary activism, he saw it as a complement rather than a substitute for parliamentary action. He was chair of the Victorian Fabian Society for part of the 1950s. He was an admirer of Aneurin Bevan and later described Chifley as the 'moving spirit of post-war reconstruction'. Despite some misgivings, he joined the Australian Labor Party in 1947.

Cairns as politician

In 1955 Cairns became MHR for Yarra, defeating a renegade Labor member standing for the DLP, and when Yarra was abolished in the late 1960s, Cairns moved to being MHR for Lalor, covering some outer suburbs of Melbourne. Cairns joined the front bench in 1960 and spent most of his remaining parliamentary career there, although sadly most of it in opposition.

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7 A comment in it which turned out not to be very prescient was that 'Australia has always been very limited in resources'.
8 Cited by Stangio (2002, p 76).
9 Ormonde (1981, p 37).

He unsettled conservatives by being 'able to discuss economic issues with academic expertise and compelling fluency'.[10] Speaking on the 1957-58 Budget, he argued that excessive profitability of large companies and increasing concentration was fuelling inflation. Cairns much later claimed to have influenced Menzies to include the reference to full employment in the Reserve Bank's charter.[11]

In 1966 he stood unsuccessfully for the ALP leadership when Calwell stood down.[12] He was then narrowly defeated by Lance Barnard for the deputy leadership, by 35-33 votes. When Whitlam initiated another leadership contest in 1968, Cairns stood again, asking memorably 'whose party is it — ours or his?'. Cairns lost 38-32 but it was a closer margin than many had expected. A visiting British academic regarded Cairns as among seven Australian politicians who were among the world's best.[13]

Cairns (1963) said 'Labor views the human essence is in relations between men' rather than in the individual. 'Within the social environment … the Labor view identifies economic factors as of great importance'. He was sceptical of perfect competition models. He advocated a 'national plan', which would encompass the 2,000 largest companies, on the grounds that rather than correct an unfair distribution of income with taxation, it was better to start with a fair distribution. He observed (1966) the gap between rich and poor countries widening.

While shadow minister for trade and industry, he wavered in his attitude to tariffs. In 1967 he was critical, although not unambiguously. In 1968 he was more reticent to see tariffs cut.[14] In 1971 he called for planning, and cuts to tariffs so long as they did not lead to unemployment.

Outside parliament Cairns was the leader of the 'moratorium' demonstrations against the Vietnam War, and led 100,000 people through the streets of Melbourne. In his best-known book, *The Quiet Revolution*, he raised doubts about what could be accomplished by parliament: 'power is not located mainly or wholly in parliament'. He was disappointed that the Vietnam protests had not evolved into a broader movement for social reform. In 1972 he regained some prominence opposing French nuclear testing in the Pacific.

Cabinet minister

Cairns had played only a small role in Labor's 1972 campaign. But after the four parliamentary leaders were re-elected unopposed, Cairns topped the subsequent poll for the ministry. He had wanted the Foreign Affairs portfolio but Whitlam retained this himself and appointed Cairns Minister for Overseas Trade and Minister for Secondary Industry. As he later mused, 'ironically for one who was by conduct and philosophy among the most radical in the government, I had the ministries which most required one to be concerned with jobs and money and private enterprise'.[15] As Trade Minister he led the first trade delegation to China. In October 1973 he lost the Secondary Industry

10 McMullin (1991, p 287).
11 Interview for *Australian Biography*, 25 May 1998. This is not quite as implausible as it sounds for Menzies and Cairns were unlikely friends, sharing an enthusiasm for the Carlton football club and sometimes attending their matches together. But Menzies may have been more influenced by his adviser and Commonwealth Bank Governor Nugget Coombs to just carry over the provisions from the earlier legislation when the Commonwealth Bank was reorganised in the mid-1940s.
12 In the final ballot, after Beazley and Daly had been eliminated, the votes were Whitlam 39, Cairns 15 and Crean 14.
13 David Butler, cited in *Sun-Herald*, 10 December 1974, p 4.
14 Rowse (2002, p 294).
15 Cairns (1976, p 75).

portfolio in a reshuffle, with many industrialists sorry to see him go.[16] As a senior economic minister, Cairns believed 'economists are too narrow in their view of life'.[17]

Whitlam transferred the Tariff Board into the Prime Minister's Department. Cairns supported the 25 per cent across-the-board tariff cut, suggested by Coombs and a committee of advisers, in cabinet, although by 1975 he viewed it as a mistake.[18] Treasury had opposed the cut, preferring tighter monetary and fiscal policy and another revaluation to lower excess demand.[19] The tariff cut is now viewed as the start of microeconomic reform as it was partly aimed at improving productivity (although reducing inflation was another goal).

In 1973 Cairns unsuccessfully advocated an increase in income tax. He campaigned for the December 1973 referendum to give the government power to legislate over prices and incomes but it was rejected.

Cairns played a more prominent role in the 1974 than 1972 campaign. Following the election, he defeated Barnard 54-42 to become Deputy Prime Minister. The usual convention is that deputies can choose a portfolio and Whitlam offered Cairns Treasury but he declined, partly fearful of the detail and complexity, partly to avoid being tied down and partly out of a reluctance to hurt the incumbent treasurer, Frank Crean.[20]

A combination of the OPEC oil shock (which damaged almost all Western economies) and a domestic push to boost the wages share by using the public service as a pace-setter, had further boosted an already rising inflation rate and depressed economic activity, giving rise to 'stagflation'.

In mid-1974 Treasury presented a grave economic prognosis to senior ministers and advocated a policy of deflationary measures that became known as the 'short, sharp shock'.[21] Though at first supported by Whitlam it was rejected by caucus.[22] Cairns expressed concern that demand was already weakening.

Cairns wrote to the Reserve Bank Governor in July arguing for selective controls on bank lending.[23] The following month the Governor called on Cairns to discuss his concerns that policy was too tight.[24]

As far back as November 1973 Whitlam declared publicly that he conferred with Cairns on economic matters more than with anyone else. Cairns continued to increase his role in economic policy, meeting the Reserve Bank in July 1974 to discuss his concerns about the credit squeeze. By September 1974 Cairns had become the dominant force in the government on economic policy. The *Bulletin* of 21 September 1974's cover was headlined 'Cairns running the economy'. However, he still declined to take on the Treasurer's role himself. Cairns presented a paper by his adviser Brian Brogan to the Caucus Economics Committee on 12 August 1974 that formed the basis for the September budget. The Committee members 'viewed unemployment … as much more important than inflation'.[25] Stone

16 Oakes and Solomon (1974, p 123) comment they had found him 'far more reasonable and responsive than they could have guessed from the criticisms which had been made of him'.
17 Rowse (2002, p 295).
18 His initial advocacy is reported in Strangio (2002, p 263) and Bowman and Grattan (1989, p 73).
19 Whitwell (1986, p. 214).
20 Oakes and Solomon (1974, pp 527 and 528); Crean (1983, p 9:1).
21 Later referred to by Whitlam as a 'long savage beating'.
22 Whitwell (1986, p 215).
23 RBA archives BM-75-160.
24 6 August 1974, RBA archives BM-75-153.
25 Dairy note by Bill Norton of discussion with Tony Cole, 13 August 1974, RBA archives RD-NS-178.

(2006) said 'the 1974-75 Budget was effectively framed in Cabinet by Cairns and his friend Tom Uren (on the basis of advice provided by the latter's economics advisor Michael Keating)'. Many referred to the 1974 budget as the 'Cairns Budget'. Treasury prepared a cabinet submission, presented by Crean, warning of the risks it posed.[26]

In a September 1974 lecture, Cairns surprisingly called inflation 'our main problem today' and was sceptical about the prices and wages referenda the previous December. He worried that increasing interest rates would hurt small business but have little impact on large companies. Cairns argued 'if the growth in the money supply were unduly restricted, unemployment could also grow. This he thought was unacceptable'. This put him at odds with Whitlam, who 'recognised the need to reduce the growth in the money supply and said that he felt that inflation was becoming a more important political problem than unemployment at its present level'.[27]

In the 1974 Budget, Crean said 'the conventional response to inflation has relied almost entirely on the creation of mass unemployment … crucial as the fight against inflation is, it cannot be made the sole objective of Government policy. This Government is committed to the program of social reform'. The Budget planned large increases in spending but, due to high inflation interacting with a non-indexed tax scale, also large increases in revenue, such that a smaller surplus was budgeted.

At a meeting between the RBA and Treasurer Crean in September 1974, 'the Treasurer asked the Governor's opinion on the proposal from Cairns to float the exchange rate'.[28] However, it is not clear whether by 'floating' was meant allowing the exchange rate to be market-determined or just administratively varying its value day-by-day; the wording used was 'vary the rate from day to day to reflect the basic position of the balance of payments'. [29] But it got little official support. 'The Governor said he was not sure what was meant by floating and that he personally was strongly against a clean float … Treasury was against floating the rate, despite the comment in Dr Cairns' letter about 'outmoded ideas' on exchange rate regimes'.[30] Coombs expressed opposition to a managed float. It was agreed not to proceed at this time, and there seems no record of the matter being revisited. A few days later the Prime Minister announced an immediate 12 per cent devaluation, which Cairns supported.

In November a mini-budget was introduced, cutting taxes and easing credit. The mini-budget 'marked the virtual eclipse of Treasury as a source of economic advice'.[31] It has been claimed that this led to 'sullen resentment' in Treasury.[32] This mood would not have been improved by Cairns' attacks on Treasury.[33]

Treasurer

In October 1974, Whitlam decided that as Cairns was effectively determining economic policy, he should bear responsibility for it by being appointed Treasurer. When Cairns hesitated, Whitlam said he would otherwise appoint Lionel Bowen from the party's right wing, which led the left wing of the

26 It is reprinted in Sexton (1979, pp 58-9).
27 14 April 1975, RBA archives, BM-75-101.
28 Record of meeting, 22 September 1974, RBA archives RD-NS-182.
29 RBA archives BM-75-153.
30 Record of meeting, 22 September 1974, RBA archives RD-NS-a82.
31 Starngio (2002, p 291). Similar sentiments are expressed in Fruedenberg (1977, p 307).
32 Fruedenberg (1977, p 307).
33 *The Age*, 22 November 1974.

party to press Cairns to accept.[34] Cairns took over as Treasurer on 11 December 1974, days after the September quarter 1974 national accounts showed the economy was contracting markedly.

Cairns remarked on his appointment that 'it's a very difficult job to do. I feel quite inadequate about it.' Asked 'do you think it will be your job to convert Treasury?', he replied 'it will certainly be to make clear to Treasury what the policy of the government really is'. Then asked 'do you think Treasury has failed in that in the past?', he replied just 'yes'.[35] His successor, Bill Hayden, believed Cairns 'did not take easily … to the detailed but essential humdrum of developing policy'.[36]

It has been claimed that Cairns' appointment as Treasurer was not popular within Treasury, and 'transformed sulkiness to hostility', to such an extent that some senior Treasury officials are alleged to have started leaking information to the Opposition, using the pseudonym of Mr Williams.[37] There was speculation that Cairns wanted to remove Treasury Secretary Wheeler. But while Cairns thought Wheeler 'hasn't the kind of philosophy that I would like to see running a department like Treasury', he thought this was true of Treasury as a whole and did not want to move against Wheeler until he had got to know him better.[38]

Treasury was also annoyed by the prime minister's department becoming a rival source of economic advice.[39] It was further concerned about plans for a Department of Economic Planning, for which Cairns secured approval at the ALP's national conference in Terrigal in February 1975. Whitlam favoured Lenox Hewitt to lead it, while Cairns had in mind his former student, Cambridge academic Geoff Harcourt, neither of whom would have pleased senior Treasury officials.

By the time Cairns became Treasurer, the Australian economy was reeling under the effects of the OPEC oil price shocks, compounded by an inflationary wages policy. Treasury's note to Cabinet in mid-January 1975 did not mince words; 'The economic situation is very bad. It is very bad, not only because of the evident weaknesses in the economy, but because there are no quick solutions'.[40] It referred to a severe profit squeeze. Cabinet decided not to proceed with the capital gains tax announced in the 1974 budget. A temporary cut in sales tax on cars from 27½ to 15 per cent was announced.

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34 The Left's Tom Uren now reflects that 'one of the greatest errors of my life is that I talked Cairns into becoming treasurer'; cited by Bramston (2013, p 403).

35 Ormonde (1981, p 187). Much later Cairns was asked if he had success with Treasury. He replied 'No. None at all. Treasury had a lot of success with me. They were instrumental in getting rid of me in very quick time, really'; Interview for *Australian Biography*, 25 May 1998. Whitlam (1985, p 184) was similarly disillusioned, remarking 'I believed that the Australian Treasury could be absolutely relied on for loyal, disinterested and frank economic advice. I shared that mistake with my immediate predecessor and immediate successor'. Cairns' closest friend in politics, and fellow minister, Tom Uren (1994, p 246) remarked 'in the end it was Treasury and the responsibility of being Treasurer that destroyed Jim. He was up against Canberra mandarins who were protecting their domain and whose influence within conservative political forces was enormous'. Cairns himself later regarded taking on the treasurer's job as 'a mistake. I should have known, for whatever were the limitations on being in government, on being a minister, they would be much more severe on being treasurer'; Bowman and Grattan (1989, p 74).

36 Hayden (1996, p 261).

37 Fruedenberg (1977, pp.307-8).

38 Cairns, interviewed in *Nation Review*, 25 July 1975, retained among the Wheeler papers in the National Library (MS 8096). Cairns was open to outside appointments as he had asked the Australian left-wing Cambridge economist Geoff Harcourt whether he would consider the Reserve Bank governorship; Harcourt (2001, p 13). He reportedly also approached British monetary economists Charles Goodhart and Michael Artis.

39 Freudenberg (1977, p 308).

40 16 January 1975, National archives A5915/Cabinet submission 1534.

On 17 February 1975, Cairns suggested to cabinet a publicity campaign about the relationship between excessive wage increases and unemployment.[41] At this meeting Hayden challenged Cairns on his insouciance towards the budget deficit.[42]

Around April 1975 Cairns, against Treasury advice, approved payments to Associated Pulp and Paper Mills and EZ Industries to try to stave off job losses. It was around this time he earned the sobriquet 'Dr Yes'. Facing both rising inflation and unemployment, Cairns was floundering. In early May 1975 Cairns said 'the main problem facing Australia today is inflation', but in a Budget strategy paper the same month argued it was better to lose office than to pursue policies that would increase unemployment.[43] While sometimes taking the Treasury line, on other occasions he would table a Treasury paper in cabinet and then argue against it.[44]

The loans affair and Cairns' fall from office

A factor complicating virtually all Cairns' term as Treasurer was his involvement in the possible raising of a foreign loan for major resource developments. While Cairns did not initiate this, he was one of the four signatories to the Executive Council minute of 13 December 1974 authorising the Minister for Minerals and Energy, Rex Connor, to borrow foreign funds for major resource projects via the agency of unknown intermediaries and without the approval of the Loans Council.

Treasury and the Reserve Bank both sharply opposed dealing with unorthodox lenders such as Tirath Khemlani.[45] Wheeler, always uncomfortable with what he termed Labor's 'instant coffee' decisions, strove mightily to warn Cairns of the folly of what became known as the 'Khemlani Loans Affair'. Cairns felt 'that the Treasury line was too timid and conservative'.[46]

On 7 March a Melbourne businessman, George Harris took from Cairns' office a letter offering a 2.5 per cent commission on any foreign loan he arranged. The Departmental Liaison Officer found a copy of a letter and sent it to Treasury. Wheeler forwarded the letter to his frequent lunch partner Clarrie Harders, the head of the Attorney-General's Department for a legal opinion and asked Scotland Yard for information on Khemlani.[47] On 4 June Cairns denied to parliament ever offering Harris a commission. Cairns later admitted the letter appeared to bear his signature but he denied recalling signing it, and explicitly rejected such a proposal when Harris had raised it.

The loans affair was not Cairns' only distraction. Influenced by his new private secretary, Junie Morosi, Cairns became more interested in personal liberation than economics. As one book puts it,

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41 17 February 1975, Cabinet submission 1570, National archives A5915.

42 Strangio (2002, p 333).

43 Ormonde (1981, p 215) and Strangio (2003, p 364).

44 Emy (1978, p 290).

45 A 10 December 1974 minute to Cairns is reprinted in Reid (1976). The Reserve Bank Governor also expressed 'continuing concern at the dealings with Mr Khemlani'; memo of 10 February 1975 describing meeting on 7/2/75. RBA archives BM-175.

46 Cairns (1976, p 94).

47 The Solicitor-General later described Wheeler's actions as 'not consistent with responsible government'; *The Age*, 21 December 1978, p 9. Wheeler's actions reputedly annoyed Prime Minister Whitlam. In late 1974, Whitlam is supposed to have told Wheeler 'Fred, you are on the skids'. Wheeler is supposed to have replied 'I wish to inform you of facts, your ignorance of which will bring you down'; Brown (2002). Whitlam offered Wheeler the job of Reserve Bank Governor in 1975, but Wheeler declined, although accounts vary of his reasons. According to Schedvin (1992) he 'refused' as he did not want the more interventionist Lenox Hewitt appointed Treasury Secretary, whereas in other accounts he declined for family reasons.

'his politics have undergone a huge transformation, a move from a concern with changing the system to a belief that the individual must change before the system can improve fundamentally'.[48]

On 5 June Whitlam replaced Cairns with Hayden as Treasurer. Whitlam offered Cairns the Social Security portfolio, but Cairns chose instead to be Minister for the Environment. Whitlam cited his unwise actions in giving Harris a letter, even if it did not mention any commission. Cairns himself believed he was sacked for his unorthodox economic views and because Whitlam saw him as a leadership rival.[49]

Cairns' latter career

Cairns lasted only a month in his new post before being dismissed by Whitlam on 2 July 1975 for apparently misleading parliament over the Harris letter. The matter went to caucus which voted 55-33 to declare the deputy leadership vacant. Cairns contested the ministerial vacancy, losing to Joe Berinson in the final ballot by 54-37.

After the 1975 election, Cairns rejected pressure to vacate his seat to allow Bob Hawke to enter parliament. But he did not seek a frontbench position, and appeared more interested in alternative lifestyles than parliamentary activities. He chose not to contest the 1977 election. Cairns later moved to a small farm on the outskirts of Melbourne and during the 1980s and 1990s wrote a number of self-published books which he would sell at markets. Uren (1994) suggests *Towards a New Society* (1994) is the best of them. This book, which Cairns described as a 'biography of my ideas' also marked something of a return to discussing economics. He criticised how foreign debt had returned to the high proportions to GDP characteristic of 1900-1940, after being low during what he termed the 'modified capitalism' of Chifley, Menzies and Whitlam. He complained about the dominance of 'economic rationalism' in both the Labor and Liberal parties, and blamed the deregulation of the financial system for leading to a boom and subsequent recession.

In 1983 Cairns made a quixotic bid as an independent candidate for the Senate, winning only 0.5 per cent of the vote. This should have got him expelled from the Labor Party but he remained a member until he allowed his membership to lapse in 1991. He rejoined in 1996 and was made a life member in 2000.

Jim Cairns passed away on 12 October 2003. Whitlam paid a generous tribute to his former deputy, saying he 'bought a nobility to the Labor cause which has never been surpassed. It is a great thing for me that throughout our political careers I had such a colleague, a friend, sometimes a rival, but always a benchmark, in doing the great and good things in the cause of Australia and the Australian Labor Party'.[50]

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48 Bowman and Grattan (1989, p 69). As Snedden and Schedvin (1990, p 188) put it, 'he never really came to terms with the society in which he lived; he was always looking for an alternative society and ultimately he took himself off to that alternative society'.

49 Interview for *Australian Biography*, 25 May 1998. Cairns had been acting Prime Minister when Cyclone Tracy devastated Darwin. He rushed to see the devastation wrought on Darwin, where the compassion he displayed led to a short-lived surge in his public approval.

50 *The Age*, 13 October 2003.

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