Economic *Roundup*

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Urban congestion — why 'free' roads are costly

Paul Hubbard[1]

The inhabitants of Australia's larger cities suffer from frequent traffic jams. Many see this as an inescapable fact of city life, but its root cause is overuse of a common resource — the urban road network. Most roads are nominally 'free' to drive on, resulting in demand for many roads that exceeds capacity at relatively predictable times. This means that motorists do in fact pay — in wasted time — to drive on 'free' roads at peak periods. This disrupts the flow of people and goods in the economy, harming productivity and growth — as well as frustrating all road users.

Putting a price on access to roads at busy times might encourage individuals to change their travel plans, and reduce their vehicle's contribution to congestion. New South Wales has taken a first step in adopting time-of-day pricing on the Harbour Bridge and Harbour Tunnel.

In theory — unlike paying in time, which is wasted — the money paid by motorists to drive on busy roads at peak times could potentially be redistributed to ensure no one is worse off. Some potential compensation mechanisms currently available to governments include cutting taxes on vehicle ownership or use (such as registration or fuel excise), adjusting income taxes, and investing in alternative transport options for those 'tolled off' the roads.

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1 This article has benefited from comments and suggestions provided by Brad Archer, Jeremy Coghlan, Graeme Davis, Dimity Elson, Matthew Mansell, Jason McDonald, Brant Pridmore, Troy Sloan and Andrée Wheeler. The views in this article are those of the author alone and not those of the Australian Treasury.

Introduction

Cities are an economic success story, allowing for specialisation and networking, and contribute to the generation of technology, know-how and wealth. While the discomfort of traffic jams and the time they waste inevitably discourage people from living and working in busy cities, these disadvantages are outweighed by the opportunities available to firms and individuals from locating in populated areas (Arnott, Rave and Schöb 2005).

Individuals and businesses demand access to urban transport in order to reap the opportunities that the city has to offer. However, there is a limit to the supply of available road space. When roads become busy, particularly in peak times at the beginning and end of the working day, there is competition between commuters for limited road space. At these times, roads are not 'public goods' that anybody can use without imposing costs on others. The nature of roads changes to being more like 'private goods' — as an additional motorist must compete for access to the road. At this point, public roads are not 'free' — a cost is paid by all road users in wasted time.

This presents a 'tragedy of the commons', in which a commonly accessible (but unpriced) resource is over-exploited to the detriment of all. This occurs when people do not consider the costs that they are imposing on others who also want to access the same resource. In the context of roads, a road user accepts travel delay times as a cost of travel at peak times, but does not necessarily take into account the fact that their decision to put an extra vehicle on the road in a minor way will delay all other road users.

Individuals do attempt to minimise the cost of wasted time by adjusting their own behaviour. While these individual responses seek to reduce the private costs of congestion, one person's decision to avoid congested roads at peak periods might simply make room for another person to switch back into congested roads. The sheer number of motorists and the absence of tradeable access rights to roads means that uncoordinated individual actions will not solve the problem of congestion. Further, the resources expended by individuals to reduce their own costs of congestion are examples of the types of economic costs that the failure to properly ration road use by more efficient means imposes on society.

The Bureau of Transport and Regional Economics projects that the avoidable social costs of congestion in Australian capital cities will rise from $9.4 billion in 2005 to $20.4 billion in 2020 (Cosgrove et al. 2007). As Australia grows richer, the costs of allowing unpriced access to congested roads will become higher. However, while the aggregate congestion costs are large, these costs are spread across almost all road users at congested times. For this reason, it is possible for modest congestion charges to have

significant effects. In practice, the actual process of setting congestion charges is likely to be a process of continual adjustment.

Elimination of congestion should not be an end in itself — that would require a strict curtailment of economic activity or vast expenditure on roads that are used to capacity for a small proportion of the day. Some small amount of congestion may be efficient given the large capital costs of building additional roads supply and the technical difficulty in properly setting congestion charges. Nevertheless, if potential road users were required to pay the costs they impose on others then significantly less time would be wasted in traffic. Those trips for which the costs to society outweigh the benefits to the individual could be rescheduled for times when use of the road is less costly.

Faced with the true costs of their decisions, a potential motorist who is indifferent to taking public transport, travelling at a different time or not travelling at all, will leave the roads at peak times. This allows the resource — the road — to be put to its highest value use.

The method for pricing congestion depends on the underlying market structure. Where roads are treated as publicly owned, open-access resources, then there is a strong argument for a tax designed to correct price signals. Where the road is owned by a road agency or firm that can charge for access, then the presence of congestion limits the amount the potential road users would be willing to pay. In this case, the external costs that road users are imposing becomes a cost to the owner of the road. Alternatively, given adequate property rights and low transaction costs, externalities can be resolved within markets through voluntary trades.

The primary dividend from pricing congestion — whether through a tax, charge or market mechanism — is the more efficient use of an economic resource that is a vital input to much economic activity. Existing road users who value their journey less than the costs that they impose on others will need to adjust their behaviour, and might demand compensation. Road users who value their time highly would be better off.

Although optimal congestion charging improves overall social welfare, the transition from unpriced to priced roads would require compensation to ensure that all groups are better off. In theory, there are a range of instruments available to do this. For example, the transitional impact of new pricing could potentially be offset by reducing other transport-related taxes. Alternatively, taxes on income might be adjusted to offset the impact of congestion prices on the cost of living for people with lower values of time. An alternative approach is to compensate those who are ‘tolled off’ the roads, by investing some of the revenue in public transport. The desirability, and practicality, of different compensation arrangements depends partly on the ability of different levels of government to coordinate their revenue and spending decisions.

This paper briefly examines the economic theory of congestion, different approaches to reducing it to a socially optimal level, and concludes with a discussion of compensation options.

What is congestion?

When demand for a limited resource is greater than the supply at a particular time, it must be rationed in some way. For most goods and services in a market economy, the price system performs the rationing function. This allows scarce goods and services to be used by those who are willing and able to pay for them. Prices provide information to suppliers about the goods and services that consumers value, and, if accompanied by a transfer of money to the supplier, can provide resources to expand supply.

Queuing is a common non-price mechanism for allocating limited resources. In the most basic queue, access to a service is provided to consumers in the order in which they arrive. This is more or less the rule for accessing physical road space — although the 'first-come, first-served' queue discipline (Cox and Smith 1961) is mediated by traffic rules, which give right of way to some vehicles in certain circumstances. Provided that road users obey common rules, allocating roads in this way has the advantage of being easy to understand and implement.

Where the arrival of people in the queue is random, but average levels are predictable, queuing can smooth service. For example, a shop manager could significantly reduce queuing by keeping all checkouts open at all times. However, this could mean that some check-out staff were unoccupied, except at the busiest times. For this reason, the manager restricts the number of checkouts — saving on labour costs — and customers tolerate some queuing. These costs are kept in check through competition — as those consumers who are most inconvenienced choose to shop in more expensive, but less congested, shops or to choose to shop at less congested times.

Because there is only one road network, it is much harder for road-users to opt out of the queue. The first vehicle to arrive at a red traffic light is the first to move off when the light turns green, followed in sequence by those behind. Vehicles can overtake each other in some circumstances, but opportunities to do this are constrained by road rules, speed limits, and physical space.

In special cases, the law allows some vehicles to take priority. For example, traffic must yield to an ambulance with flashing lights or a siren. This is efficient given that the value of getting a patient to hospital earlier is very high, relative to the delay that this will cause other road users. In other cases, transit lanes are set aside for taxis, buses or cars with multiple passengers.

The costs of congestion

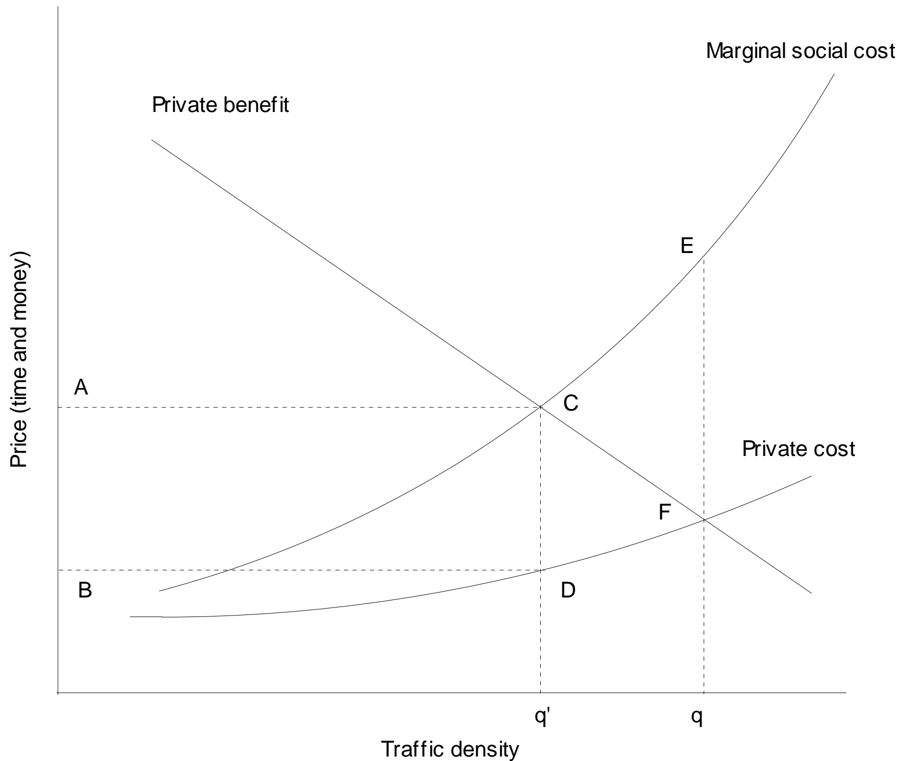
Motorists already pay to access congested public roads. This is not obvious because payment is made in time rather than money. As Becker (1965) demonstrates, the price of a commodity includes both the cost of acquiring it and the time taken to consume it. At the very least, even if there were such a thing as a free lunch, it would take time to eat.

In the same way, although access to the public road network is nominally free (although paid for in taxes), use of the network still involves a cost in terms of travel time. Those for whom the anticipated wait is too long forgo their trip — the private costs would be greater than the private benefit (see Chart 1) — while those who delayed forgo the benefits they could enjoy from other activities. In addition to the time costs, motorists also face increased costs in running their vehicles, including fuel and maintenance costs. Society also bears additional costs from increased local pollution, greenhouse gas emissions and noise.

Congestion does provide some social value in rationing road space, but it does so by imposing the greatest costs on those who are most sensitive to congestion (who value their time most highly) while imposing much lower relative costs on those who are indifferent to waiting. However, paying in time can be wasteful compared to paying in money, because others can reuse the money for beneficial purposes.

Queuing is a form of rationing ‘by ordeal’. Unlike rationing through price, the resources expended in rationing by ordeal are not transferred to the supplier and are lost to the economy. Without some transferable good to act as a medium of exchange, time cannot be transferred from someone who values it more to someone who values it less. This is illustrated in the following chart.

Chart 1: Optimal congestion pricing on a link



Congestion results in the inefficient use of a valuable asset. When deciding whether to drive a particular route, motorists consider whether the expected private benefit to them will outweigh the private cost — including the time cost (see Chart 1). The private cost rises as traffic density increases, as denser traffic results in more delay. Because people only balance private benefits with private cost (point F in Chart 1) the quantity demanded (where no money price is charged) is q. However, the marginal cost to society is higher, because other motorists are also delayed.

The marginal user of the road (the person who values it least, who is still willing to enter the road) receives only a marginal benefit, but imposes large costs (vector F, E) on others. By charging a money price that equates the private cost with the social cost (vector D, C), overall demand for road space is reduced to the socially optimal level (q’). This results in a social gain (area C, D, E, F) that outweighs the lost private benefit to marginal road users (triangle C, D, F).

If charged as a tax, then the tax authority receives revenue (rectangle A, B, C, D) which can be reused, although the amount is reduced by costs necessarily incurred in administering the scheme.

This applies to goods in general — not just to roads. If bakers could not charge for bread, but were instead paid by the government to produce a fixed quantity to be given away for free, then it too would need to be rationed. Bread would be cheap for those who could afford to wait longest in queues, and more expensive or inaccessible to those with pressing demands on their time. The baker also gets no clear signal about the degree to which their customers value different products, nor do they get additional resources or reward for providing better goods or services.

The costs of congestion can be estimated according to how much people are willing to pay to jump the queue. This varies between different individuals, in different circumstances and at different times. Faced with the same length of traffic delay, a parent taking time off work to take their child to the doctor would be more inconvenienced than a tourist on a campervan holiday. Becker (1965) gives further examples of how different individuals will economise on time by choosing less time-intensive goods.

Before actual prices are introduced, and people given the opportunity to react, it is uncertain what people would pay to avoid delay (Small 2005). As a general assumption, those with the potential to earn high hourly wages would be willing to pay more to avoid an hour in traffic. That said, those on higher incomes are also best placed to reduce the time they spend driving in congestion through more flexible working hours (Lindsey and Verhoef 2001) or living in more expensive housing closer to their workplace or reasonable public transport.

Individuals can and do make choices to reduce their personal cost of traffic congestion. For example, buying a more comfortable car can reduce the discomfort of delay. Over time, individuals may change their place or time of work, or move house, in order to save time (Downs and Downs 2004), although taxes that increase the cost of choosing appropriate vehicles or moving home act against this.

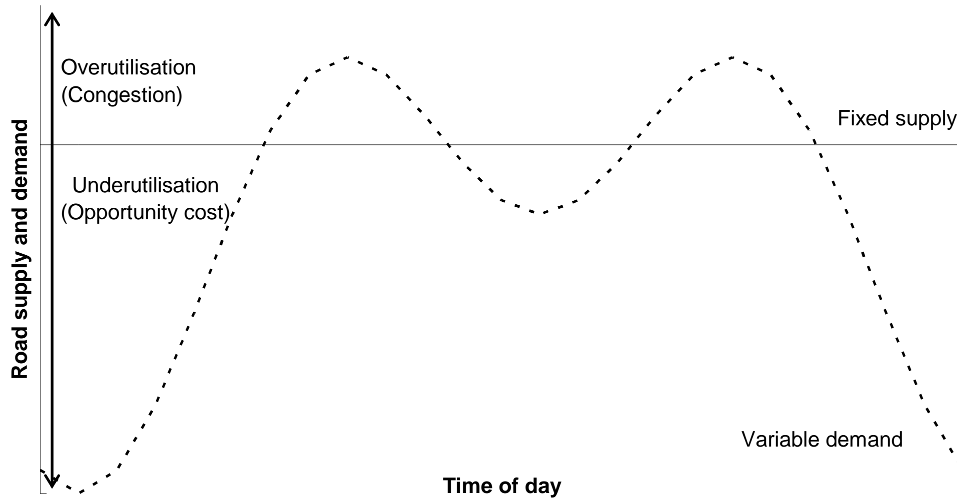
These choices reflect individual costs and benefits of transport choices. An individual decision to drive a private car or to take public transport may be influenced by the relative comfort, speed and private cost of different modes. On a free access road system, however, private users have neither the incentive nor the necessary information to consider the impact of their choices on others. The result is a set of decisions that make sense for each individual driver, but result in a poor outcome for society as a whole.

A resource management problem

A typical response to congestion is to attempt to increase the supply of roads. This can be done by adding lanes to existing roads or building new roads. However, increasing

supply — particularly in built-up urban areas — can be very costly. Moreover, increasing a fixed supply for the purpose of meeting peak demand increases the underutilisation (opportunity cost) of roads at off-peak times. To put it another way — increasing roads to meet peak demand (at a zero money price) entails overinvestment in roads at non-peak times (see Chart 2).

Chart 2: Peak-period congestion



Another problem is that by increasing supply alone, congestion costs will fall which will encourage more people to travel during these periods. Because it does not tackle the underlying cause of congestion (that potential motorists have little incentive to reduce the delay they impose on others), supply side expansion may simply encourage more motorists back onto the road. A study of urban congestion in Los Angeles by the RAND Corporation found that non-price strategies to mitigate congestion induced additional peak-hour traffic. (Sorensen and Rand Transportation, Space, and Technology 2008).

This suggests that supply side-measures are likely to be a very costly way of attempting to reduce congestion. The alternative approach is to correct the incentives facing users of roads at potentially congested times. This is sometimes called 'demand management'. A key part of the solution is to ensure that potential motorists face a price signal that reflects the impact of their choices on others.

The price mechanism (specifically, prices that vary over the course of the day based on congestion levels) is designed to flatten out demand and is aimed at reducing both congestion costs (by reducing demand at peak times) while making better use of infrastructure at non-peak time (by shifting some demand from peak to non-peak). Smoothing demand in this way allows more efficient use of existing road resources.

The decision about whether to deal with congestion by expanding supply or limiting demand should depend on the relative cost and benefits of each approach. The cost of implementing demand management strategies is partly a function of technology. Congestion pricing was first proposed in the 1950s when manual tolling options were not well suited to variable pricing. Existing technology now allows more timely and targeted road pricing.

Using technology for variable pricing

Electronic tolling using fixed gantries to identify passing vehicles using a tag mounted on the vehicle's windscreen. An example is the eTag system used in Melbourne, or Sydney's E-Toll system. This electronic tolling system is used to apply the time-of-day tolls on the Sydney Harbour Bridge and Harbour Tunnel. This technology has been used for more extensive congestion pricing in Singapore since September 1998 (Land Transport Authority (Singapore) 2009).

Automatic Number Plate Recognition uses cameras to identify cars passing a cordon. The London Congestion Charging Scheme uses a network of 340 high-definition closed-circuit television cameras to read number plates that are then cross-checked against a central database to ensure that charges have been paid. The charge is not payable on weekends, public holidays or between 6 pm and 7 am (Transport for London 2008).

Global positioning satellite (GPS) devices in vehicles can monitor use of the road network, and congestion levels, in real time. This means that congestion can be monitored across the entire road network, potentially alleviating the problems of vehicles shifting to unpriced roads to evade tolls. The feasibility of GPS to provide real-time price information to motorists has been trialled in Seattle, where it was found to be a 'mature and reliable' system (Puget Sound Regional Council).

In an efficient market, investment in transport infrastructure would follow demand for it. The introduction of congestion pricing also provides valuable information to transport authorities when planning new roads or public transport options. The advantage of pricing over simply counting vehicles with unpriced access to the road is that pricing reveals the value that motorists place on accessing a particular road at a particular time. This can help guide decisions about where funding is required for road upgrades and maintenance.

This suggests that measures to address urban transport congestion require coordinated action that addresses supply, demand (that is, efficient pricing) and planning issues (including the integration of transport systems). Leaving one of these out means that the other methods will be less effective — demand management is only a piece of the urban transport congestion puzzle.

Regulating demand for roads using markets, taxes or charges

Whether the price of a congested road is determined through market trades, imposing a tax or charging for access, the prime purpose is to manage demand for the resource to maximise the welfare of those involved.

Markets — tradeable permits

Where motorists with different values of time are competing to use the same street, there are potential gains from trade between members of the group. Although it would be impractical for all the potential motorists to negotiate and enforce individual contracts, those who face the greatest costs from delay may be willing to pay for priority over other road users when demand for roads outstrips supply. The potential of, and the impediments to, individuals acting in this way were identified by Coase (1960). Primarily, it is poorly defined property rights, and the costs of transactions that prevent trade occurring in many of these situations.

This approach provides insights into possible solutions to the market failure of congestion. One method of government regulation in traffic networks, over and above the regulation of traffic flows through road rules, would be to refine the property rights in roads. In most cases, the government is the owner of the road, to which it allows access to all registered motor vehicles (although some classes of vehicles are excluded from some roads). However, access to some roads at peak times could be restricted to those who hold a permit.

A fixed number of permits could be allocated, depending on the capacity of the road network, for a particular area at a particular time. These might be issued as part of motor vehicle registration. Permit holders could trade between themselves so that road rights would be allocated to their highest value use (Raux 2007). Those who only infrequently use these roads could sell their excess permits to those who value them more highly, resulting in a more rational allocation of road space.

Some local councils already adopt a similar approach for parking on public roads, whereby the right to park a car in particular zones is restricted to vehicles with a permit. While these permits do not tend to be tradeable between people, they are an example of property rights allowing better resource allocation.

Corrective taxes

Where one person undertakes an activity, and that activity has measurable negative effects on others, there is sometimes justification to impose a tax on that activity. Taxes, by definition, are a 'compulsory, unrequited transfer to the general government sector' (Australian Bureau of Statistics 2005). This type of tax — named after AC Pigou (Pigou

1920) — is designed to improve society's welfare by ensuring that individuals face the full cost of their actions. It is not designed primarily to raise revenue, but the consequence of the tax is to transfer resources to government to spend on goods or services, or to reduce other taxes.

Whether or not a tax is necessary or appropriate depends on the underlying market structure and the nature of property rights. If roads are generally treated as owned by society as a whole, with equal rights to all for public access, then the congestion tax model is appropriate.

To achieve an efficient outcome, the tax has to be closely targeted to the use of cars on congested roads. Fuel tax is sometimes seen as a proxy for charging the variable costs of road usage. However, there are serious limitations to this approach. First, the amount of fuel tax paid is strictly related to the amount of fuel consumed in a vehicle, not the variable use of public roads. The relationship between fuel consumption and road use has changed over time as vehicles have become more fuel-efficient. This fuel-efficiency has been, at least partly, induced by fuel tax (Parry and Small 2005).

In addition, discounts and exclusions from fuel tax for some transport fuels mean that any price signal provided through fuel tax would not affect all modes of transport. However, vehicles contribute to congestion because they take up space on the road. Whether the vehicle is fuelled by petrol, diesel or an alternative fuel is irrelevant to the congestion cost.

The major objection to fuel tax as a proxy for congestion charging — even if it were closely related to distance travelled — is that it does not reflect variable congestion costs. In many cases (as in rural areas), motorists can use road space without inconveniencing other road users,[2] in which case the efficient use of existing road infrastructure would entail charging no congestion fee. Hybrid electric-petrol motor vehicles do not use any fuel when stationary or at low speeds. Fuel taxes raise the cost of motoring relative to public transport or walking, but do not encourage motorists to shift from congested to uncongested roads, or from peak to off-peak times (Parry 2002). While this may marginally decrease the cost of congestion, it also increases the opportunity cost (underutilisation) of roads at times of no congestion.

By contrast, a well-calibrated congestion tax would regulate access to a limited resource (road space) at times when it is scarce. Unlike fuel taxes, it does not have the disadvantage of discouraging utilisation of the network at times when competition for road space is not an issue.

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2 The question of other social costs of motor vehicle use – like air pollution, accidents or noise, should be taken into account for more comprehensive road pricing, but is not discussed here.

User charges

Pigovian taxes are unnecessary where property rights in the road are clearly assigned and the owner of the road (whether a government authority or a private firm) is allowed to charge for access to it. Frank Knight, in response to Pigou, demonstrated that in this circumstance the owner of the road has incentives to charge a fee that takes into account the congestion (Knight 1924). When faced with an alternative between two roads, some consumers will pay a higher price to take the less congested road, even if the other is nominally free. This is because the time saving is worth more to some consumers than the monetary cost.

In Australia, private toll road concessions have tended to be negotiated to allow an adequate return on congestion, but not to allow efficient variable pricing of congestion (Clarke 2008). Restructuring tolls to allow them to respond to demand at peak periods may require renegotiation of existing contracts, but would unlock efficiency gains.

The introduction of the congestion premium on the Sydney Harbour Bridge and the Sydney Harbour Tunnel from the start of 2009 — after the introduction of electronic tolling — demonstrates the feasibility of this approach.

Congestion premiums on Sydney Harbour Bridge and tunnel tolls

From 27 January 2009, New South Wales introduced time-of-day tolling for the Sydney Harbour Bridge and Sydney Harbour Tunnel. Three levels of pricing are now charged for peak ($4), shoulder ($3), and off-peak ($2.50) tolls. The peak toll is not charged for weekends or public holidays.

The New South Wales Road Traffic Authority has noted that '[m]otorists have adapted well to the changes and traffic volumes reflect a marked increase in people travelling before the peak period, with numbers falling again during the peak period between 6.30am and 9.30am on all crossings, including the Ryde and Gladesville bridges, when compared to the same time last year.'

The additional revenue from the peak toll is to be invested in public transport (Roads and Traffic Authority (NSW) 2009).

Revenue and compensation

The primary purpose of pricing congestion is to encourage efficient use of roads — not to raise revenue. Economists have tended to focus on the efficiency benefits, rather than the distributional impact of road pricing. However, while overall welfare is increased from optimal congestion charging, those people who would have preferred to pay in time rather than money may need to be compensated to be better off.

In the absence of redistribution to road users, then the government or road owner (whether public or private) is the major financial beneficiary (Button 1993). The community may be concerned that, in the absence of independent pricing or regulation, the government or road owner might face incentives to maximise revenue rather than social benefit.

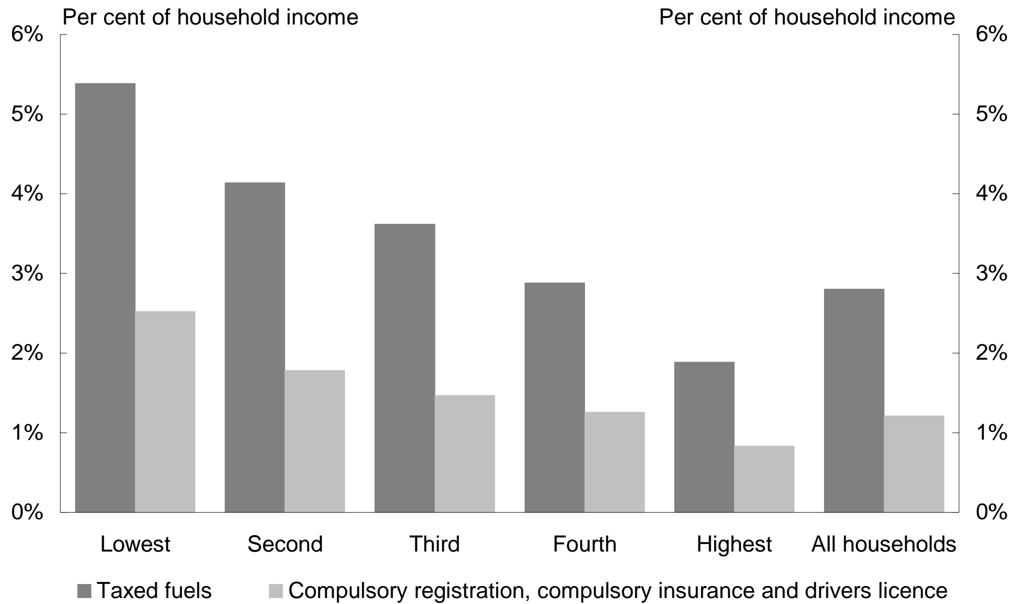
Because congestion charging provides efficiency gains, the additional benefits from congestion charging should be greater than the amount of compensation required to ensure that most individuals are better off. There are a number of theoretical options for providing compensation to motorists, although in practice options may be constrained by the degree to which compensation can be targeted effectively to particular groups, and coordination between the revenue and spending responsibilities of different levels of government.

The amount of compensation might be limited also by administrative costs of whichever scheme is chosen. These costs can be large, and should be considered when assessing the overall costs and benefits. For example, while the Central London Congestion Charging Scheme generated £268 million in total revenues for 2007-08, almost half of this was spent on operation, publicity, enforcement and other costs of the scheme (Transport for London 2008).

Adjusting transport-related taxes

Currently, most taxes on motor vehicles and motor vehicle fuels are designed for general revenue raising purposes, not to change a motorist's driving decisions. Expenditure on taxed fuels, and compulsory motor vehicle-related charges forms a much greater share of the budgets of low-income households than high-income households, and can therefore be seen as regressive (see Chart 3). For this reason, a reduction in these taxes might address concerns about the potential impact of congestion pricing on low-income motorists.

Chart 3: Household expenditure on taxed fuels and compulsory road charges
By gross household income quintile



Source: Australian Bureau of Statistics, *Household Expenditure Survey, Australia: Detailed Expenditure Items, 2003-04*, Australia, cat. no. 6535.0.55.001, Canberra, 2006.

This approach would require some coordination between different levels of government as fuel taxes and general motor vehicle taxes are levied at different levels. In addition, there may be difficulty in targeting compensation only to urban motorists (who would face the biggest effects of congestion charging).

An alternative approach might be to provide motorists, as part of existing motor vehicle-related taxes and charges, with a fixed entitlement to spend on congestion fees. Motorists who successfully reduce congestion could be given the opportunity to benefit by 'cashing-out' money that they do not spend on congestion (see box on Seattle pricing trial). The size of these initial endowments could be set to reflect equity concerns.

Seattle Pricing Trial — Providing benefits to those who reduce congestion

In a trial of congestion charging in Seattle, GPS-based tolling devices were placed in the vehicles of 275 volunteers. Their daily driving routines were monitored to collect comprehensive 'base-line' data on driving behaviour.

Participants received a 'travel budget' based on their previous driving behaviour. The GPS unit provided information on current tolls, and money was deducted when driving on congested roads at peak times.

The study found that drivers did make small changes to their behaviour that, if applied across the population, would create significant network efficiency gains.

In this case, some of those gains were returned to the volunteers. Motorists who did not use their full travel budget — by taking the opportunity to drive at less congested times and places — were able to 'cash out' their initial entitlement, and thereby receive a benefit from their private contribution to reducing congestion (Puget Sound Regional Council).

Interaction with taxes on labour income

It is sometimes argued that a government tax on an 'externality' (like congestion) creates a 'double dividend'. The 'double dividend hypothesis' holds that when Pigovian taxes are imposed by governments, there are two social benefits: reduced negative externalities (for example, less congestion) and the opportunity to reduce other taxes using the revenue generated.

However, while such a tax improves efficiency in transport markets, it can exacerbate the distortions caused by existing taxes. The interaction with the labour market and existing income taxes is generally taken to be the most significant (Parry and Bento 2001). Recent studies suggests that for many such tax, the additional labour market distortion can outweigh the benefits in correcting the externality itself (Bovenberg and Goulder 1996).

However, Parry and Bento (2001) found traffic congestion to be a rare case in which efficiency gains might also arise in the labour market. This is because better allocation of road resources might encourage labour force participation, therefore increasing the net return to labour.

Providing compensation through taxes on labour income might therefore be theoretically attractive, both for improving work incentives (efficiency) and addressing equity concerns. If done through the progressive income tax, then it might be easier to target compensation to wage earners on low or middle incomes. High-wage earners, to

the extent that they have a particularly high value of time, are likely to be better off even without compensation.

There are difficulties in targeting this form of compensation only to motorists affected by the tax. This approach might overcompensate those whose use of motor vehicles is already low, and undercompensate those who already depend on using motor vehicles in urban areas. This approach would also require coordination between governments.

Increasing funding to alternative forms of transport

An alternative approach is to provide compensation by providing increased public transport services to motorists who are 'tolled off' the roads. This provides a way of targeting compensation to those who are required to change their behaviour from the toll, although existing users of public transport would also receive benefits. Those who continue using roads but only marginally value the time saving would not receive compensation under this approach.

The Central London Congestion Charging Scheme adopts this approach and is required by law to spend the net revenue of the scheme to improve overall transportation. In 2007-08, around 80 per cent of the £137 million net revenue from congestion charging was spent on improving the bus network, with the remainder on planning, upgrading roads and bridges, road safety, environmental and walking and cycling measures (Transport for London 2008).

This approach has coordination benefits where the authority receiving the congestion revenue also has responsibility for public transport networks. Because public transport and urban road networks overlap in many cases, it may provide a good way of targeting compensation to those in the geographic area affected by the charge.

Funding public transport from congestion revenues may be consistent with compensation objectives desired by governments. However, to the extent that public transport is priced partly to take into account its contribution to reduced road congestion, the introduction of comprehensive congestion pricing for roads would reduce the efficiency arguments for subsidy (Smart 2008).

Conclusion

The net benefits of road congestion charging in major Australian cities may be considerable, but so are the challenges. Because congestion is a localised problem, most of the implementation issues for congestion pricing on key road infrastructure remain state and local government responsibilities. The slow progress of reform to date may reflect both the profound planning difficulties associated with introducing road congestion pricing, as well as community distributional concerns. Both of these

problems suggest attempts at further coordination by all levels of government may be worthwhile.

The principal purpose of charging for congestion is to encourage efficient market outcomes. For this reason, there are strong arguments for returning the revenue from congestion charging back to those who would be worse off under a system of pricing.

This paper has suggested three theoretical approaches to how this might be done, although the practical implementation of any of these, or a mixture of all three, is likely to depend on the degree of coordination between different authorities, the taxing and spending responsibilities of different levels of government, and the administrative arrangements for any charging system.

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How much inequity should we allow?

Dr Ken Henry

Address to the Australian Council of Social Service National Conference, 3 April 2009

Introduction

Firstly, a big thank you to Clare Martin and everyone at ACOSS for the invitation to take part in today's discussion.

It is not just an opportunity to get some important feedback for the review of Australia's tax and transfer system (and because it now appears to bear my name, I have even more incentive to get it right!). It is also a chance to do something for the battered reputation of the profession to which I belong — economics.

Over many years economists have developed a reputation for hostility to distributional issues. Some economists appear to treat them as 'soft' and secondary in importance to 'hard' issues like efficiency and productivity. That approach is a mistake. A mistake, I must confess, that I have made myself in the past. As a brash young Clerk Class 9 working on the Hawke Government's 1985 Tax White Paper, I pushed the line that the tax system was about maximising efficiency, with equity simply a constraint — rather than an outcome with intrinsic value in its own right. Fortunately, I was soon set straight by my then Deputy Secretary, Ted Evans — my immediate predecessor as Secretary to the Treasury. As a result of this and other on-the-job learnings, I am pleased to say that today equity is central to Treasury's mission and policy advice. How we distribute prosperity is absolutely inseparable from how we create it. This is something parts of the welfare sector have been arguing strongly for some time, and it has been pleasing in recent years to see welfare representatives developing this position further. It is something I would like to encourage and I hope what I have to say today adds to this important debate.

I chose the title of this speech — 'how much inequity should we allow?' — for a couple of reasons. For a start, it is mildly provocative, which I thought might help pique your interest. The instinctive response of many to the question would be to answer — none; a just society would not tolerate any inequity. Of course, beyond this instinctive reaction things get complicated. I will return to this later.

Secondly, I selected this title because I consider this to be one of the most significant choices society faces. Indeed, the question assumes inequity is a social choice.

And it is.

Leaving fairness solely to the market to determine should be unacceptable to a civilised society. Societies will choose how much inequity they allow according to the institutions, norms, laws, policies and programs they adopt.

As highlighted in Clare's introduction, my comments today are set against the backdrop of the review of Australia's tax-transfer system, the most extensive such

review since at least Asprey in the 1970's. Indeed, since the current review also includes state taxes and both Commonwealth and State transfers, it could be considered the broadest ever.

The tax-transfer system is the principal means of expressing societal choices about equity. The tax-transfer system is a reflection of the kind of society we aspire to be. As far as I am aware, every major tax review conducted in modern times in any developed country has nominated equity as one of its two or three most important objectives. In our case, the Panel's terms of reference refer to raising revenue in a way that provides equity and our Consultation Paper released in December identifies equity as one of five key design principles.

So, today, I will offer some reflections on my question of 'how much inequity should we allow'. I will reflect on the range of perspectives about equity so far put to the Panel, relate those to traditional concepts of equity and conclude with some personal perspectives on the benchmarks for testing the equity of the tax and transfer system.

Common sense views about equity

Let us start then by asking what we mean by equity. It is a notoriously slippery concept, which has stretched many great minds, and yet still means different things to different people. However, as I said in my speech to the National Press Club last November, wisdom can often be found in the common sense views of practical people. So, rather than starting with theory, let me share a few practical perspectives from the many submissions the review has received and in the public meetings held across Australia over the past two weeks:

- People in the same circumstances should be treated the same.
- If you have more, you should pay more (and receive less).
- You should not be able to avoid paying your fair share, or get more welfare, by cleverly arranging your finances.
- It is unfair that the system is so complicated that you need to pay someone to help you get what you are entitled to.
- We should look after the most disadvantaged in our communities, but welfare should not discourage people who can work from getting a job or improving their skills.
- It is not always about money. Some people need other help to improve their health, skills and chances in life.

These views can be related to traditional frameworks for analysing equity which offer useful insights into desirable design features for the tax-transfer system. But they also suggest the need to consider more contemporary approaches to reform of the tax-transfer system.

Traditional frameworks

There are two broad intellectual traditions relevant to an analysis of the equity of the tax-transfer system. The first is concerned with procedural fairness and is mainly the province of classical liberals. Under this tradition, a tax-transfer system is fair if it respects individual rights. Outcomes are not as important as ensuring processes are transparent and unbiased by the undue discretion by authorities. Such a system aspires to eliminate discrimination on the basis of race, religion, sex or sexual preference. Away from these heady heights, such a system should treat every member of society with respect and care.

In answer to my question — how much inequity should we allow — strong advocates of procedural fairness rarely condone any inequity; a fair process based on the protection of everyone's individual rights is the ultimate test of equity.

I am generally a supporter of the freedoms that this tradition of equity promotes. But not without qualification. More importantly, in my view an equitable tax-transfer system must deliver a lot more than procedural fairness.

The second tradition is concerned with distributive fairness — who should get what of the prosperity we produce. This tradition is often presented through a utilitarian framework where the 'social good' is determined by some aggregation of individual welfares. As individual welfare is not directly measurable, income is usually the focus in this tradition, though other measures — such as wealth, consumption or health — are also used.

Many economists have noted that under simple assumptions — such as people generally having similar likes and the next dollar of income being less valuable to the last — complete equality of income is desirable. But they also argue that complete income equity would also destroy incentives to work and reduce economic growth.[1] No one would have an incentive to work or save if the government were to fully redistribute the bounty of individual effort. This leads to the relatively orthodox view that the degree of income inequity we should allow should be that sufficient to maintain incentives conducive to earning income.

1 For an exposition, see Kaplow, Louis, The theory of taxation and public economics (2008), Chapter 3.

Of course, the relationship between equity and income growth can be complex. Not all redistribution policies are inimical to national income growth. Many redistributive policies seek to address market failures that reduce national income. For instance, capital market failures mean that those with low income are unable to borrow to properly invest in their own human capital despite high private and social returns. The tax-transfer system is one mechanism for allowing improved education of low-income earners, promoting both fairness and income growth.

On the other hand, take company tax, which at first glance would be of most interest to wealthier Australians. Reducing it would seem to be inequitable. But there are strong arguments to the contrary. In the face of competition from countries with low company tax regimes, higher company tax rates could work to reduce overseas investment in Australia, which could reduce the number of jobs available, lower the demand for Australian workers and, in this way, lower wages. This is the reason why many economists argue that, in the long run, company tax affecting mobile capital is paid by labour — predominantly geographically immobile unskilled labour.

So the optimal level of redistribution to maximise national income is by no means clear. But, even if it were, there could still be reasonable debate about the extent to which national income might be further traded off in the pursuit of even greater equity.

In addition, regardless of the precise level of inequity chosen, most would accept that a degree of redistribution still accords with a practical view of vertical equity. People with greater capacity to pay should be liable for more tax, and those with insufficient means to meet their basic needs should receive support in the form of transfers.

Redistribution is also consistent with the practical notion that you should not be able to get out of paying your fair share through concessions or loopholes, including those mostly available to the wealthy. Many have claimed in submissions to the review and at public meetings that aspects of fringe benefits tax, and the use of trusts and negative gearing, can lead to people not paying their fair share.

People have also pointed to the regressive impact of complexity in the system, which often falls most heavily on those with the least capacity to deal with it, including because they have the least means to get help. This can lead them to make poor decisions or simply missing out on entitlements. Welfare organisations will, of course, know a lot about this, as they devote much of their resources to helping low-income earners navigate the tax and benefit system. There is a perverse irony in the fact that much of this system complexity may have its roots in the quest for fairness.

As with the procedural fairness view of equity, I am a supporter of distributive fairness. Redistribution is a public good — left to the market, there would be serious

under-provision of income transfers. Distributive fairness has value because the community desires it; government is necessary to deliver it. But, again, my aspirations for an equitable tax-transfer system are for this and more.

Contemporary perspectives on equity

For some years I have been concerned about features of the tax-transfer system which cause, contribute to, or fail to redress significant inequities that chronically harm people's lifetime wellbeing.

Where I go beyond more traditional frameworks is my concern for wellbeing, not just income, and in a focus on lifetime, not just current circumstances.

Some of you would know that I have a deep respect for the writings of Amartya Sen. Sen argues that the true measure of human development is that a person has the 'capabilities' necessary to leading the kind of life they value and have reason to value.

Capabilities allow an individual to fully function in society; they are not 'income' and, while they include basic civil rights and political freedoms, they are not limited to 'rights'; they are 'substantive freedoms', including with respect to both processes and opportunities. Thus, its not enough to be concerned with procedural fairness issues if that means ignoring deprivation of substantive opportunity. But neither is it enough to be concerned only with the adequacy of opportunity, since the capability that people have to choose a life they value depends also upon the nature of the processes that bring the opportunities about.[2]

Sen points to some capabilities that are close to being absolute — 'to meet nutritional requirements, to escape avoidable disease, to be sheltered, to be clothed, to be able to travel, and to be educated.'[3] Others, like the capability to live without shame or to participate in the activities of the community, are relative to community standards. Being computer literate was not necessary to participate in society 30 years ago, but it is now. Sen views poverty as capability deprivation. And, seen in those terms, poverty is clearly intolerable. It is a form of personal injury that should not be abided in any just society.

Poverty is something that is of interest to all people concerned with equity. But it is not their only concern. And nor should it be.

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2 Sen, A 1999, Development as Freedom, Oxford University Press, p 17.
3 Sen, A 1983, 'Poor, relatively speaking', Oxford Economic Papers, 35, pp 153-69.

Yet even in the broader domain of equity considerations, Sen's approach — of focussing on individual capabilities, and the proper role of society in fostering those capabilities[4] — is instructive.

I know there is a risk that this highly abbreviated reference to Sen's valuable perspective will confuse rather than enlighten. For where I want to get to today, its enough that you accept that there might be a case for moving beyond a narrow focus on either rights or incomes, or even material wealth, to look at the capabilities that make a direct contribution to long-term wellbeing.

Implications for the tax-transfer system

What does this mean for tax-transfer design?

There are at least three important implications I would draw.

First, and most obviously, if a system of income redistribution is to ensure that people enjoy the capability of having basic needs guaranteed then the level of redistributed income must be adequate. As you may know, part of the tax-transfer review has been an examination of the adequacy of pensions, led by one member of the Panel Jeff Harmer Secretary of the Department of Families, Housing, Community Services and Indigenous Affairs.

Second, and perhaps most importantly, the system should not encourage decisions motivated by short-term benefit, but which compromise development of capabilities which could open up medium to long term opportunities of improved wellbeing. It should not discourage people from working or studying or retraining if they can.

Panel members have heard time and again of disincentives that do just this.

Many have pointed to the way in which the withdrawal of benefits combined with taxation of income lead them to deciding it is just not worth their while working. For example, a parent with a couple of young children who has to pay for child care will often find the current system of tax, benefit withdrawal and child care benefits offer minimal financial returns from moving to part-time paid work. The longer-term capability costs of the decision not to work, for both the parent and for the children of such households, should be of concern to policy makers.

Others point to differing rates of payment, work tests or rates of benefit withdrawal leading to preferences for receipt of particular benefits motivated by immediate

4 On this, see Sen A 1999, p 288.

advantages, but which lock people into the welfare system, potentially entrenching chronic deprivation of capabilities. Take the predicament of people with less severe disabilities who would be able, with help, to do at least some work. If they are single and on the Disability Support Pension (DSP) they will get around $70 a week more than single people on Newstart. On a pension, they can earn more than twice as much before their payment starts to reduce, and the payment reduces more gradually. They are also exempt from the activity test. In fact, if you are in the grey area between unemployment and disability it seems better in every way to be on DSP. But is it really? What concerns me is the extent to which the system could be discouraging some people from work that could make them happier and healthier and our society more equitable. While I recognise that many people on DSP cannot do any work at all, I wonder whether we could not redesign the system to reduce disincentives to workforce participation.

I should stress that the Panel has reached no conclusions on the categorical distinctions between payments like Newstart, Parenting Payment, Disability Support Pension and Carer Payment. There are good reasons for many of these distinctions. Nevertheless, the long-term incentive effects of these structures warrant careful consideration.

The third implication of a focus on capabilities is tied to the last of the practical observations about equity I referred to at the beginning of my comments today. It is not always about money. Indeed, studies of entrenched generational disadvantage, suggest that provision of additional income support can sometimes be counter-productive. Some people need other help to make the most of opportunities in life. Assistance that directly addresses capability deficits — in education and health, in particular — may be more effective at raising long-term wellbeing. In other words, we ought not think that the income redistributing tax-transfer system on its own will be sufficient to eliminate capability deprivation. Indeed in the absence of appropriate health, education or community services, government transfers may simply entrench disadvantage. And if they entrench disadvantage, whatever they might do to reduce dispersion in the short-term distribution of income is simply not important.

On the other hand, it may be that the tax-transfer system can be used as a tool to improve access to, and tailoring of, services and other supports. For example, Australian governments target housing assistance to people who are least likely to find adequate housing without public assistance. However, people eligible for help receive different levels of aid and face markedly different incentives depending on whether they receive rent assistance or public housing.

Public housing generally provides a greater level of housing subsidy than rent assistance, with public rents generally set at 25 per cent of income. Compared to rent assistance recipients, public renters also face lower risk, as their rent is not influenced by movements in market rents and their tenure is generally guaranteed.

However, the provision of public housing can discourage workforce participation to a far greater degree than rent assistance. As public housing tenants' rent is linked to their income, their effective marginal tax rate is 25 percentage points higher than if they receive rent assistance, which is not subject to a separate taper. Further, a public housing entitlement is linked to a specific house and may be lost if a person needs to move for work or other reasons. Rent assistance, by contrast, is fully portable, which may enable recipients to choose housing that they prefer.

It is not obvious why we should use such different mechanisms for people who are in need of housing assistance, particularly if one approach carries with it the greater risk of entrenching long-term capability deprivation. Perhaps it would be better if low-income earners received the same assistance, irrespective of whether their landlord was the state or in the private sector. Of course, it is likely that compromise would be needed to balance incentives to work with some stability of tenure for tenants. It would also need to recognise the increasing role community housing is playing in the delivery of housing assistance.

By investigating such ideas, the tax-transfer review gives us the opportunity to debate how best to create a more equitable tax and transfer system, better suited to the needs of the 21st Century.

Before I conclude, let me make a final point. All this raises wider questions about how we think of equality and about redistribution in a modern economy. The way we think about these things has changed profoundly over the course of the last hundred years. During the early years of the Twentieth Century — during the age of steam power, when this magnificent building we are in today was a locomotive workshop and the centre of intense trade union agitation — Australians thought equity could be improved primarily through the industrial relations system. After the Second World War, in the eras of Keynes and post-war reconstruction, we thought it could be solved through the provision of universal pensions and a commitment to full employment. Still later, we thought equality required steeply progressive taxation and the further expansion of the welfare state, notably into areas like public housing. But today — when this old workshop we are in is a centre for high-tech research; and the blue collar jobs it once housed have gone; and many of the people who would have performed those jobs are now long-term unemployed or even on the DSP and perhaps living in public housing estates which offer few chances of improved wellbeing — our answer to inequity also needs to change. In my view, the answer should lie to a large extent in building up people's capabilities. Investing in people. And the tax review has a big role to play in this. We have had debates about capital versus labour, about public versus private, about the state versus the individual. Today we should be thinking about the role of public policy in giving people the capabilities to choose lives of value for themselves.

Conclusions

So — how much inequity should we allow?

My comments today suggest the answer requires a value judgement. Different people have different views and different priorities for what it means for our tax-transfer system.

Today, I will offer just three of my own conclusions.

First, I would support a system that operates fairly; free from bias and arbitrariness. A system that treats people in the same circumstances the same way. If you like, a system that is procedurally fair.

Second, while some level of inequity in the distribution of income and wealth may be necessary to induce national income growth, the relationship between growth and equity is important — redistributive policies can be anti-growth, but they can also be pro-growth. In addition, an equitable tax-transfer system would not allow two people with the same means and undertaking the same activities, to pay less, or receive more, simply depending on the way they organise their affairs.

And third, while we may need to tolerate some inequity in the distribution of income and wealth, we should have zero tolerance for severe capability deprivation. And more generally, an equitable society is one in which every citizen has the capabilities necessary to be able to choose lives they value. As to this, the complexity of tax-transfer arrangements can be a particularly pernicious form of capability deprivation.

Perhaps a simpler way of distilling all three points is to say that rights are important and income redistribution worthy, but on their own they not enough. What is essential to equity is to develop people's capabilities. The tax-transfer system must be designed with this goal firmly in mind.

Thank you.

The future of state revenue

Dr Ken Henry

Address to the Commissioners’ Conference, Sydney, 27 March 2009

Introduction

I would like to start by thanking the organisers for the invitation to talk to you about state taxes and their administration.

I have the chance to meet with my Heads of Treasuries colleagues a number of times each year — most recently, only a couple of days ago in Canberra. The HoTs, as it is called, provides a valuable forum for exchanging ideas, including about state and territory taxes. So it is great also to have the opportunity to talk with those deeply involved on the administration side. After all, the state revenue offices are responsible for the collection of over $45 billion in taxes each year, playing an extremely important role in Australia's tax-transfer system.

Australia's future tax system

Much of what I have to say today will be in the context of the opportunities and challenges that the Australia's future tax system review presents for state taxes and federal financial relations.

The tax review panel is part way through a review that has been described as the most comprehensive review of the Australian tax-transfer system for at least the last 50 years. The terms of reference set an objective for the review of creating a tax-transfer structure that will position Australia to deal with its demographic, social, economic and environmental challenges, and enhance Australia's economic, social and environmental wellbeing.

With that objective, it was crucial that the taxes and transfers administered by the States and Territories be included in the terms of reference for the review. Their inclusion has given the review panel the scope for a comprehensive review of all taxes and transfers across all three levels of government in Australia.

It means that the Panel can assess not only how different taxes and transfers rate against the standard policy assessment criteria, but also how appropriate it is for the different taxes and transfers to be assigned to a particular level of government.

In the Panel's view, it is not possible to assess the current structure of federal, state and local taxes and transfers without also considering the appropriate financial relationships between Australia's three levels of government.

In Australia's history, federal financial relations, primarily the financial relationship between the Commonwealth and the states, have changed in an ad hoc way, with reforms often designed to support other policy objectives or to address a crisis at a particular point in time.

In contrast, our review is explicitly forward looking and comprehensive. And it is certainly our intention that its recommendations not appear ad hoc. We have the opportunity to think about how governments at all levels might, even should, operate in the future and how the tax-transfer system might best be designed to support this.

While the review is comprehensive, there are some issues which the Panel will not be considering in depth. For example, given the recent commitment in the *Intergovernmental Agreement on Federal Financial Relations* and the Commonwealth Grants Commission's current methodology review, the Panel considers that reviewing the principle of horizontal fiscal equalisation is beyond its scope.

Today I want to talk about some of the challenges that will be faced in the future and how they will impact on state finances. And then I want to discuss how these challenges influence the way we think about the design of state taxes in terms of policy, administration and revenue distribution before looking at a few examples of how our thinking might be applied in practice.

Challenges and opportunities for reform

In our consultation paper released in December last year, the review panel identified a number of broad issues to frame consideration of Australia's future tax-transfer system. Three of those issues — increasing globalisation, demographic change and the role of technology — are particularly relevant to state finances.

Just as economic activity expanded beyond local communities in the distant past, recent decades have seen the increasing integration of economic activities across countries. Despite concerns from some about its impact, we can expect the process of globalisation to continue. Globalisation means that the things governments tax are becoming increasingly mobile. This has implications for tax system design.

For example, while the real employment consequences of the global financial crisis are obviously highly significant, and will have a substantial impact on global migration flows in the short-term, the long-term trend is that increasing numbers of highly skilled individuals are operating in a global labour market. This international mobility will impact on the way that labour is taxed at a national level, let alone at a sub-national level.

But there are some inherently immobile tax bases, such as land. The importance of taxing these bases effectively is likely to increase in the future.

The second challenge, the challenge of demographic change, has been highlighted by the Intergenerational Reports, and by the Productivity Commission in its complementary report 'Economic Implications of an Ageing Australia'.

Demographic change will affect different tax bases and types of government expenditure in different ways. Governments at the federal, state and local level will face fiscal pressures at different times. And these pressures will influence the financial relationship between the different levels of government.

The third challenge highly relevant to state finance concerns how well we are able to use and adapt to new forms of technology. Emerging technologies have the potential to redefine the way we design and administer the tax-transfer system, with significant implications for both compliance and operating costs.

One of the best illustrations of this is in the area of road pricing, where new technologies can allow for more efficient charging for road use, leading to reductions in congestion and improvements in traffic flows. For example, in Singapore the road pricing system charges each car a price to use the busiest roads at the busiest times of the day. The price varies according to the day and time and users can have complete information about the cost of their trip before it is undertaken.

The geography of Singapore is a bit different from most Australian cities. But the fact that the Singaporeans have been pricing road access since the mid 1970s, and have been doing so electronically for the last decade, shows that variable road pricing is not science fiction. I will say a little more about this later.

Technology can also improve the timeliness and reliability of information flows and the capacity for people to access and understand information about the tax-transfer system. This not only creates the potential to reduce administration and compliance costs, but gives us scope to rethink the way that each level of government may best contribute to the administration of taxes and transfers.

Views from submissions

So there are both challenges and opportunities for governments at all levels to improve the way they levy taxes and provide transfers and government services. And there is much that can be improved upon.

As part of the review, we have invited the public to make submissions on their views about the future challenges and current problems facing the tax-transfer system. We have received over 1,000 submissions to date from people and organisations across the entire community — an extremely valuable resource.

While taxes in general are — unsurprisingly — not popular with the community, the submissions reveal that state taxes are among the least popular.

There were many submissions which called for the abolition of particular state taxes, noting specific inefficiencies, inequities and complexities with these taxes. Some submissions went as far as to advocate the abolition of all state taxes.

On the positive side, there were submissions noting that the states have access to some potentially good tax bases and recommending improvements in the form of base broadening.

Many submissions also raised the issue of the complexity created for businesses operating across state borders from each state and territory government having its own administration responsible for the collection of taxes.

To paraphrase one submission, while legislation has been harmonised for some taxes, there are still areas where there is a significant difference in the application of taxes. This adds a burden to those businesses that operate across state borders and makes it harder for them to expand. Consistency in the design of state taxes would help businesses operating across state borders to reduce compliance costs and better understand their obligations.

Taxation in a federal system

Given the challenges and opportunities that we face and the concerns that have been expressed about the operation of state taxes, how should taxes be levied across the federation in the future? First of all, we should not forget that taxes need to rate well against the principles of fairness, efficiency, simplicity, sustainability and coherence. And then we should consider how taxes meeting these criteria can best be applied in the federal system.

We can think of three dimensions to this assignment exercise — the level of government responsible for the design of the tax; the level of government responsible for administration and collection of the tax; and the level of government that receives the revenue raised by the tax.

The design dimension is centred on the question of who is responsible for setting the rate and base for the tax. The theory of tax assignment developed by Richard Musgrave and others suggests that in a federal system, lower level jurisdictions should avoid using taxes for the purposes of income redistribution and macroeconomic stabilisation. These functions are more appropriately assigned to the national level. And since the mobility of tax bases impacts on how effectively governments can levy taxes, in general lower level jurisdictions should avoid tax bases with high inter-jurisdictional mobility.

It is normally the case that the rate and base of a tax is set by the one government. But it is also possible that the rate and base be set by different levels of government. For example, one can conceive a set of arrangements in which states levy different rates on a nationally consistent tax base.

Such an approach could avoid problems with tax base erosion from interstate competition, and make it easier for businesses to understand and comply with their obligations, while still providing the states with a policy lever to respond to jurisdiction-specific preferences.

The administrative dimension is a question of which level of government is more appropriately responsible for administering and collecting the tax. In many cases, the answer to this question will be dependent on the policy dimension — the level of government that sets the policy will usually be better placed to determine how that policy should be implemented.

However, if several governments at a sub-national level levy taxes which are very similar, then there may be economies of scale from a centralised administration. The realisation of these economies becomes more feasible as better flows of information between taxpayers and administrators.

Thus, it seems to me to be a genuinely open question whether, in years to come, Australia should persist with state and territory revenue offices.

The third dimension concerns how the revenue from taxes is distributed between levels of government. It is usually the case that whoever controls the policy and administration will also receive the revenue — and it is important that governments have some capacity to alter revenue consistent with their marginal expenditure choices.

But it is also usually the case in federal systems that there is an imbalance between the revenue that each level of government raises and its expenditure requirements. For some taxes, therefore, part or all of the revenue may be given to another level of government. Then there is the question of how this revenue is distributed among governments at the same level and with what conditions.

There are trade-offs to be made in this three-dimensional assignment task. The more the policy and administration of the tax system is centralised at the national level, the greater the opportunity to develop a less complex and more efficient tax system.

However, centralisation obviously also means that sub-national governments have a greater reliance on revenue from the national government. And this may influence their spending decisions.

The arrangements supporting the GST provide one answer to the three-dimensional assignment question, reflecting a serious consideration of these trade-offs. The policy for the GST is legislated by the Commonwealth. Under our constitution, there is no alternative. But the Commonwealth is also responsible for the administration and collection of the tax, while the states receive the revenue from the GST, fund its administration, and have to agree to any legislative changes to the GST base. These arrangements mean that the tax base and rate is consistent across all states and both levels of government have an interest in both the tax base and how well the tax is administered.

Some submissions to the review noted that a similar model could be applied to payroll tax, or some other form of a broad-based labour tax. In these submissions, the base would be completely harmonised across the states, the administration and collection of the tax would be carried out by the Commonwealth, while the states would receive the revenue and — a key difference from the GST — maintain the ability to set different rates.

Some of the submissions acknowledged the benefits of the recent process of payroll tax harmonisation undertaken in recent years. But they argued the case for taking this next step. Without explicitly endorsing the proposal at this time, I would note that it would also provide the opportunity to link payroll tax to the PAYG regime, and to broaden the base of one of our potentially least distorting taxes.

Taxing resources in a federal system

A more complex area is resource taxation. I have noted that the taxation of immobile bases will become an increasingly important matter in the context of increasing globalisation. One of those bases is our non-renewable resources.

Referring to our non-renewable resources as a tax base is rather crude. While it is convenient to refer to the 'taxation' of resources, the royalties and other charges imposed by the Commonwealth and the states represent a return to Australians for assigning certain rights to appropriate — exploit, if you prefer — those resources. They represent a disposal price. It is always interesting to hear people refer to the various royalty regimes as secondary taxation when their very nature indicates a primacy.

The three dimensions of taxation in a federal system are also relevant here: Who should design the tax? Who should be the administrator? Who should get the money?

The system for ensuring that the Australian community receives an appropriate return on the disposal of its non-renewable resources is multi-faceted to say the least. All states have resource charging arrangements that vary in type, the resource upon which

they are imposed and the rate. The Commonwealth is a big player in resource charging for our offshore petroleum resources — again with a variety of arrangements. Company tax also plays a role in ensuring a community return on the disposal of its non-renewable assets.

Given this starting point, it is worth asking if there could be any gains from the Commonwealth exercising a greater role. First, there is the 'David and Goliath' argument that states may be in a weak bargaining position when negotiating with the developer of the resource. Notwithstanding the fact that the location of a resource is fixed, resource firms will typically present themselves to a state as having to make decisions about competing projects, perhaps in other states. While it is one thing to compete internationally for investment, bargaining between states does not benefit Australia overall.

Second, a single comprehensive regime at the Commonwealth level could be seen as being less likely to be subject to change, therefore reducing sovereign risk. This, at least, is the experience with the Commonwealth's Petroleum Resource Rent Tax, which has not been subject to significant change since its introduction.

Third, there are tax design issues. It is generally accepted that a profits-based royalty arrangement, particularly one based on capturing a share of the economic rent (or above normal profits) of a resource project, is more economically efficient than an output-based royalty arrangement. The petroleum resource rent tax is a type of profits-based royalty designed to capture economic rents. Submissions to the review suggest some private sector support for profits-based royalties.

In contrast, the states have favoured output-based royalty arrangements, whether fixed rate or ad valorem, in part because of their more predictable revenue stream and low administration and compliance costs. An exception to this is the Northern Territory, which operates a profits-based royalty regime. Interestingly, it is the only State or Territory where resource charging arrangements are administered by the revenue agency as opposed to the mining or resource department.

The issue of unifying resource charging arrangements, or at least a common regime, has been tested in recent times in a review conducted by the relevant ministerial council on resources. The outcomes of the review suggest that the states are comfortable with their heavy reliance on output-based royalties. That there was not a lot of support for profits-based royalty arrangements suggests unease about the potential lack of revenue flows in the early years of a resource project and the risk of lower revenue flows because of lower profitability.

The attraction of output-based royalties for the states, notwithstanding their potentially negative impact on low profit or marginal projects, is that stable revenue

flows better match the states' expenditure responsibilities. Even so, resources are finite. So even output-based royalties will not be stable in perpetuity. This explains the creation, by countries with large resource endowments such as Norway, of sovereign wealth funds that accumulate revenue from resource charging.

If the most efficient charge is a profits-based royalty, but the states would prefer a less volatile revenue stream we might have an argument in favour of the Commonwealth taking the lead in policy. There may also be an argument in favour of Commonwealth administration. But the third dimension of the assignment problem — who gets the revenue — becomes really tricky.

In the examples thus far I have pointed to factors, or arguments often raised, for a greater role for the Commonwealth in policy design and administration. But such arguments do not support the greater centralisation of all taxes and charges. Where bases are relatively immobile and the collection of revenue is dependent on localised information, then lower levels of government will usually have a comparative advantage in policy and administration.

The example of road pricing is again instructive. It would be impractical for a national government in a very large country with diverse cities to try to design road pricing policies across all major urban areas. Pricing arrangements would need to be city-specific, because of the variability in the risk and character of spill-over effects, including impacts on public transport systems. On the other hand, new and emerging technologies increasingly support the feasibility of one administration agency. And, as in the case of non-renewable resource taxation, the most interesting issues relate to the third dimension of the assignment problem; that is, to the question of revenue flows.

But imagine this: a national system in which the driver is charged — on a per-kilometre basis — for access to the road network, with the charge depending upon the incremental damage to the road surface, quality of the road (whether dirt or sealed), and so on. Imagine a system that ensured that a local council in the west of NSW, responsible for the maintenance of a timber bridge, received a small payment every time a car travelled over the bridge, a larger payment from a two tonne truck driver, and an even larger payment from an articulated lorry driver.

Improving the federal structure of the tax-transfer system is a key issue for the review. And it is one in which we all have a stake since it is an important determinant of governments' ability to enhance economic performance and the broader wellbeing of Australians. I look forward to discussing these issues with you.

Confidence in the operation of the tax system

Dr Ken Henry

Address to the Taxation Institute of Australia conference, Sydney, 13 March 2009

Introduction

I would like to thank the Tax Institute for the opportunity to speak to you this morning. It is pleasing to see so many of you prepared to spend these early hours of the day reflecting on Australia's tax system.

My theme for this morning is drawn from recent reporting of a roundtable discussion between representatives of some of Australia's largest companies.[1] It was reported that uncertainty in Australia's tax system is damaging our international competitiveness. In particular, these business representatives expressed concern about their inability to get objective, timely and reliable advice from the Tax Office. They called for the tax law to be as clear as possible to minimise the need for Tax Office advice. They also suggested that the Tax Office's approach should take into account the attractiveness of Australia as a place to invest and do business. And they proposed a governance structure to support the Tax Office in this approach — specifically, a board of directors to oversee the Tax Office.

Confidence in the operation of the tax system is an important concern for the Australia's Future Tax System Review. These issues have been raised directly with the Review Panel and I would like to share with you some initial thoughts on them.

Review's approach

But, before I do so, I would like to touch briefly on the Panel's overall approach to the review, and in particular on a question I am asked regularly — what does the global financial crisis (GFC) mean for the tax review?

My response is this. While the GFC is certainly the most challenging economic environment any of us have experienced, it will pass. I expect that our final report will contain observations about the medium-term implications for government budgets of short-term macroeconomic shocks of the sort we are presently experiencing. This is likely to be a topic of considerable interest to all governments around the world for years to come. But the task of the review is, principally, to look beyond the immediate downturn and to redesign our tax-transfer system to meet the profound demographic, social, economic and environmental challenges of the coming decades. We are not simply developing a package of initiatives for the next Budget. We are developing a long-term blueprint for a tax-transfer system that is focused on sustainable prosperity for Australia. Naturally, our proposals should also support recovery from economic downturns by ensuring that when resources become available they are directed to their most productive use.

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1 *Australian Financial Review*, 23 February 2009, pp 1, 9, 52 and 53.

Given the broad scope of the review, and the high level economic, social and environmental challenges to be addressed, it might be tempting to avoid more practical issues about the operation of the system — but we know that we must understand these dimensions to properly comprehend and adequately address the impact of complexity. This is a focus for the Review Panel.

Of course, it is wrong to assume that all complexity can be eliminated. That would not be realistic or even desirable — taxes serve sophisticated objectives in an increasingly complex world. Ultimately, the challenge is to deal with the inevitable uncertainty in a fair and efficient way. This morning, I am going to focus on the role of tax administration in addressing this challenge, particularly for businesses.

Certainty and self-assessment

The administration of the tax system is an important way in which the costs of uncertainty are allocated between government and taxpayers. The income tax system principally distributes the costs of uncertainty through a process of self-assessment.

Self-assessment was introduced in 1986 to improve system efficiency — it shifted the Tax Office's focus from processing returns to helping taxpayers to comply with the law and taking enforcement action against those who do not. The introduction of self-assessment shifted the distribution of cost and risk between the government and taxpayers, exposing taxpayers to more risk by removing some of the finality of the assessment process.[2]

To address concerns about the imbalance of risk created by self-assessment, a system of binding rulings was introduced in 1992 to give taxpayers greater certainty about the application of the law. Further refinements have been undertaken since. For instance, Treasury's 2004 review of self-assessment led to changes that made even more Tax Office advice binding; reduced the periods in which the Tax Office can amend assessments; and reduced penalties.[3]

Interestingly, there have not been any serious calls for self-assessment to be abolished. But there have been calls for changes that would further rebalance costs and risks in favour of taxpayers. In thinking about these proposed changes, it is important to look critically at where these risks can be borne at least cost — remembering, of course, that the costs borne by government are ultimately met by taxpayers.

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2 The Treasury 2004, *Review of Aspects of Income Tax Self Assessment Discussion Paper*, Commonwealth of Australia, Canberra.

3 *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 1) 2005* and *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005*.

Certainty and tax administration

The move to self-assessment confirmed the dual roles of the Tax Office — to advise taxpayers about their obligations and to collect revenue. Self-assessment heightened the importance of voluntary compliance and of taxpayers properly understanding the tax law in order to meet their obligations.

As the tax system has become more complex, Tax Office advice has arguably become even more important. The simple fact is that fewer taxpayers now have the capacity to understand their obligations without that advice. Over time, the certainty offered to taxpayers by a tax ruling seems to have become more highly valued. Large businesses are telling us that they are increasingly looking for the comfort of a ruling before they will enter into transactions and arrangements.

In response to the desire of large businesses for more certainty and more timely advice, the Commissioner has initiated a number of administrative changes, in partnership with the business community. This work was motivated by a desire to see the tax administration support business: to make Australia a more attractive place to invest and do business.

For example, last year the Commissioner launched a new process where the Tax Office reviews — and ticks off — transactions as they happen. Initially, these arrangements are being offered to top 50 companies. This initiative potentially offers real-time certainty that will allow businesses to plan their arrangements with confidence about the tax risks involved, while also providing the revenue with an assurance that these risks are being managed appropriately.[4]

Another initiative to help businesses manage commercially significant and time-sensitive transactions is the Tax Office's priority rulings process. The process features greater openness and commitment by both parties to ensure the facts are identified and the right experts are involved to resolve the issues quickly.[5]

Despite these improvements, there is obviously some discontent with the performance of the Tax Office in helping businesses manage the complexity and uncertainty of the tax system. In particular, large businesses have told us they are concerned there are inadequate checks against the Tax Office's compliance responsibilities influencing their

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4 These 'annual compliance arrangements' were announced in A New Dimension, a speech by Michael D'Ascenzo, Commissioner of Taxation to the Corporate Tax Association Convention, Sydney, 12 May 2008.

5 The Tax Office's *Law Administration Practice Statement PS LA 2005/10 Priority private binding rulings.*

advice. In other words, they are concerned that the Tax Office's advice is motivated, at least at the margins, by a pro-revenue bias.

Perceptions of a pro-revenue bias seem to be based on an assumption that the Tax Office is out to maximise collections, rather than to administer the law objectively. If this were true, it would undermine the efficiency and equity of the tax system. Large numbers of disputes would be created and, for those who could afford to contest the Tax Office opinion, it would be necessary to resolve issues by getting an impartial view of the law through the courts. Obviously, this would impede business and detract from our ability to attract international investment.

This perception, of a pro-revenue bias, has persisted for at least as long as I have had any involvement in tax. Yet it seems at odds with the reality of those Tax Office initiatives I have just mentioned.

The Inspector-General of Taxation examined allegations of a pro-revenue bias last year and found no evidence of bias in private rulings involving complex matters.[6] Even so, it is clear that perceptions of bias are firmly held in some quarters.

In response to similar concerns, several countries have separated the interpretation of the law from the mechanical aspect of revenue collection. In Sweden, private rulings are given by a judicial body. Taxpayers and the tax administrator can request a ruling, which is binding only when the taxpayer chooses to apply the ruling. The body seems to be respected for the quality of its decisions. However, it has been criticised for the time it takes — the average ruling takes six to eight months.[7] If timeliness of rulings is a driving concern, this might not be the path to follow.

It seems likely also that an independent rulings body might not be as flexible and responsive as taxpayers have demanded the Tax Office to be. While the Tax Office is sometimes criticised for being too legalistic and pro-revenue, it needs to be recognised that the Commissioner often exercises his powers to make it easier for taxpayers to comply. Arguably, a more independent body — divorced from the practical implementation of its rulings — would have less of an appreciation of the impacts of its decisions.

Obviously, we need to know more about the nature of the problems before we go too far in thinking about the solutions. For some, the problems seem to be about getting better access to decision-makers in the Tax Office. The Commissioner's initiatives I

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6 The Inspector-General of Taxation 2008, *Review of the potential revenue bias in private binding rulings involving large complex matters*.

7 ibid.

have just outlined might satisfy these concerns. However, for others there are deeper issues that go to the accountability and independence of tax administration.

Accountability and independence of tax administration

As I mentioned at the outset, there was some reporting a couple of weeks ago that covered a suggestion from the Group of 100 that the Tax Office should be overseen by a board, which would include directors drawn from the private sector. The Corporate Tax Association has made similar submissions to the Review Panel.

These groups suggest that the level of uncertainty in Australia's tax system is damaging our international competitiveness and inhibiting domestic business decisions. They allege the Tax Office fails to provide timely and reliable advice and argue that this is evidence of the Tax Office being out of touch with the needs of business for practical certainty in the tax system. It is maintained that this is a problem of culture, focus and governance of the Tax Office.

These are serious matters.

I would like to take a moment to outline some of the governance arrangements that currently apply to the Tax Office and to consider some other options.

The Commissioner of Taxation has statutory independence to administer the principal Australian taxes. Independence means that he is responsible for making decisions about how to implement and apply the tax laws. This independence has been supported by successive parliaments and is founded on strong equity arguments — namely, that it would be undesirable for the day-to-day administration of the tax laws to be influenced by political or other forces.

However, independence does not mean there are no accountabilities. The Tax Office is an agency in the Treasury portfolio. As such, Treasury ministers are accountable to the Parliament for the performance of the Tax Office in line with the principle of responsible government. As part of this relationship, ministers get information from the Tax Office to fulfil their parliamentary responsibilities.

Parliament also requires the Commissioner to report annually on the operation of the Tax Office. Of course, the Commissioner also appears before Parliamentary committees to explain his administration of the tax laws. In addition to the normal Senate estimates hearings, the Tax Office attends biannual hearings of the Joint Committee of Public Accounts and Audit.

A number of executive government agencies complement these parliamentary accountabilities by scrutinising different aspects of the Commissioner's work. The

Inspector-General of Taxation looks at systemic tax administration issues; the Ombudsman investigates specific taxpayer disputes; and the Australian National Audit Office carries out performance and financial statement audits.

In addition, the Board of Taxation provides a business and broader community perspective on the tax system. While the focus of the Board is on the quality and effectiveness of tax legislation, it also advises the Treasurer on improvements that may be made to the implementation of those laws.

While these arrangements are numerous, they are sometimes criticised for not including a power to direct the Commissioner in his administration. In considering this criticism I think it is important to look at how things are working in practice. For instance, while the Inspector-General has no power to compel the Commissioner to accept and implement his recommendations, in practice we can see that the Inspector-General has had a significant impact in the areas he has examined.[8] There is clearly support in the community for the work being performed by the Inspector-General.[9]

In several other countries, a board of directors oversees the revenue body to provide the government with a further source of independent advice on the performance of the revenue body. The revenue authorities in Canada,[10] the United Kingdom[11] and the United States[12] are all overseen by boards that include representatives with backgrounds outside the bureaucracy.

A key function for these boards is to inject a range of experiences and perspectives into the management of those tax authorities. In line with this objective, all of these boards have a role in developing corporate strategies and plans. Importantly though, in all cases, board members are not involved with the affairs of specific taxpayers and do not have access to taxpayer information.

8 Of the 73 recommendations made by the Inspector-General in his first three years, the Tax Office accepted 65 of these and has implemented 62. *Follow up review into the Tax Office's implementation of agreed recommendations included in the six reports prepared by the Inspector-General of Taxation between August 2003 and June 2006*, publicly released 5 March 2008.

9 Media release of Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP, No. 022, 9 April 2008, *Inspector-General of Taxation to be Retained as a Stand Alone Office.*

10 See:http://www.cra-arc.gc.ca/gncy/brd/menu-eng.html

11 See http://www.hmrc.gov.uk/board/index.htm.

12 See http://www.treas.gov/irsob/

Similar suggestions have been considered in Australia, though the case for change has never been found to be compelling.[13] Instead, the Tax Office has established a large number of consultative forums to ensure that it understands external perspectives. It also discusses its strategies and plans with parliamentary committees, such as the Joint Committee of Public Accounts and Audit.

The governance models used in the private sector can provide some insights about appropriate arrangements for the public sector. But it is important not to lose sight of the public sector context and to think about how this might limit the usefulness of private sector models.

In large public companies, dispersed ownership means it is impractical for shareholders to be directly involved in management. A board of directors is delegated the power to manage the company in shareholders' interests. A critical feature of this governance arrangement is that the board has the power and responsibility to act, including the ability to appoint and remove the chief executive officer.[14]

In relation to the Tax Office, the ultimate 'owners' are the Australian community, whose interests are represented through the Parliament. This institution might be thought of as the ultimate board of directors. Of course, Parliament leaves to the Executive the powers of appointment and dismissal. But it insists that the Commissioner is accountable to it — that is, the Parliament — for the administration of his office. Given the importance of the Commissioner's role in the relationship between the Executive and taxpayers, governments would properly be uncomfortable with delegating to anybody else their power to appoint and remove the Commissioner. It is not surprising that the boards that oversee other tax authorities do not have this power to directly appoint or dismiss the CEO.[15]

Similar arrangements are in place for a number of Australian regulators, including ACCC, APRA and ASIC — which, incidentally, are all in the Treasury portfolio. Like the Tax Office, these regulators are independent statutory authorities, led by commissioners, appointed by the government. However, a key difference between the Tax Office and these other bodies is that tax commissioners have largely been appointed from within the ranks of the Tax Office. To some extent, this may have contributed to perceptions that the Tax Office could be more 'outward looking'.

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13 Joint Committee of Public Accounts and Audit, Report 410: Tax Administration (2008); Review of Business Taxation, *A Tax System Redesigned* (1999); Joint Committee of Public Accounts, Report 326: *An Assessment of Tax* (1993).

14 Uhrig, J, *Review of Corporate Governance of Statutory Authorities and Officeholders*, Commonwealth of Australia, June 2003.

15 Although, in the United States the IRS Oversight Board recommends candidates to the President to serve as IRS Commissioner, and can recommend a commissioner's removal.

More facts are needed

Confidence in the administration of the tax system is clearly important. The Review Panel is examining the concerns that have been expressed, seriously and critically.

I have intended, with my remarks this morning, to illustrate three features of the Panel's approach to these, and indeed other, issues we are addressing.

First, we need to be clear about the nature of the problem. We need to be fully apprised of the facts driving perceptions about the Tax Office. It is important that we test the assertions being made and make sure we have quality information about what is really going on. If we are to address these concerns, we need to be sure about the underlying problem.

Second, we need to understand the features of the current system that have been developed in the past to respond to these types of concerns. The existing governance arrangements for the Tax Office were developed in response to the changing nature of the tax system and the changing expectations of the Tax Office. It is important to acknowledge these features of the current system and understand how they are performing before we make changes.

Finally, we should recognise that proposed solutions may also have some problems of their own, and these need to be explored before we can settle on any particular path.

The Review Panel is far from settled on its response to specific suggestions to change our tax administration. We are continuing to consult and, over the coming months, we will be looking for more facts about the difficulties facing business. As in all areas of our work, our goal is to best position the tax administration so that it can support the tax system that Australia needs.

Reflections on the Global Financial Crisis

Dr David Gruen[1]

Address to the Sydney Institute, 16 June 2009

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1 I am grateful to Robert Seaton for his enthusiastic assistance with this speech, and to Mike Callaghan, Guy Debelle, Nick Gruen, Steve Morling and Jenny Wilkinson for helpful comments on an earlier draft.

It is a pleasure to be here at the Sydney Institute talking about a topic that has consumed a good proportion of my waking hours, and a few of my non-waking hours, over the past 18 months or so.

Let me begin my remarks by paying tribute to Gerard and Anne Henderson for their many years of dedicated work, building up and nurturing this fine Institute. In the years up to 2002, when I lived in Sydney, I used to come to Sydney Institute functions when I could, and I have always been impressed by the range and quality of speakers they have attracted, and the discussions and debates they have fostered.

Turning to the topic at hand, I confess to being continually amazed, and shocked, by the still evolving Global Financial Crisis. If this crisis has not changed at least some of your views about how the world works, then I reckon you have not been paying attention — or, alternatively, your views are so tightly held as to be impervious to the arrival of new information.

The Global Financial Crisis is a huge event and a huge topic, and with the limited time available, I will be selective in my comments.

Let me start with a sound bite, from January this year, from Alan Blinder, Princeton Economics Professor and former Deputy Chairman of the US Federal Reserve:

> 'Nobody thought this might happen. Things can go wrong. But the number of things that have gone wrong, and the ferocity with which they have gone wrong I think was beyond the imagination of almost everyone.'[2]

That is a sentiment with which I agree. There were economists who warned about aspects of this crisis, and I am going to touch on some of them in my remarks today, but almost nobody thought that something as severe as this was remotely likely.

I do not intend to give a blow-by-blow account of the financial crisis, nor a detailed analysis of the reasons for the crisis. But I thought it would be helpful to provide a list of the factors or causes that I think made a material contribution to the crisis.

I have divided my list into those causes that were directly related to the US housing market — the proximate causes — and those that should be considered wider causes of the crisis.

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2 Alan Blinder, Interview on US Public Broadcasting Service, 9 January 2009. In its early stages, after July/August 2007, there was always the possibility that the financial crisis would intensify, but the extent of the intensification after the mid September 2008 collapse of Lehman Brothers caught almost everyone by surprise.

I have been mindful to keep my lists as short as possible, but I have still ended up with 13 items on one or other of my lists.

Let me start with five proximate causes.

- First, global imbalances implied a huge flow of funds from developing countries (particularly in Asia) to developed countries (particularly the US).
- Second, low global real interest rates contributed to strongly rising asset prices and, eventually, to house price bubbles in the US and several other countries. Global real interest rates were low both because of the global savings-investment balance (the 'global savings glut'), and because of expansionary monetary policy, particularly in the United States.
- Third, there was incoherent financial regulation in the US mortgage market. There were at least four relevant regulators in the prime mortgage market and, in the subprime mortgage market, many of the largest lenders were not subject to any supervision by bank or thrift regulators.[3]
- Fourth, there was long-term public sponsorship of home ownership for low-income households in the US, many of which ultimately could not afford to own homes.[4]
- Fifth, there were serious flaws in the 'originate to distribute' model for mortgages. This model involved mortgages being bundled up and 'securitised' and, in the case of many financial instruments based on sub-prime mortgages, given inappropriate AAA credit ratings and then spread to the winds, via global capital markets. The consequence of a loss of integrity in the relationship between original borrowers and final investors was that eventually no-one was doing due

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3 The four relevant regulators in the market for prime mortgages are the Office of the Controller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board. In the subprime market, many of the largest subprime lenders were independent mortgage companies, not subject to any supervision by bank or thrift regulators (Gramlich 2007).

4 The long—standing US government regulations designed to encourage mortgage lending to low and moderate income families were put in place for noble reasons. They might have had a long—term beneficial effect had there been much stricter financial regulation in the US mortgage market, particularly the subprime market. In particular, the Community Reinvestment Act 1977 was designed at its inception as an antidote to 'redlining', a practice involving real estate brokers drawing red lines around districts, often disproportionately populated by racial minorities, where lenders would refuse to make loans. The US Federal Department of Housing and Urban Development also had housing goals for the two huge semi—private secondary market mortgage purchasers, Fannie Mae and Freddie Mac. These goals required Fannie and Freddie to buy certain proportions of low— and moderate—income mortgage loans (Gramlich 2007).

diligence on borrowers' ultimate capacity to repay their loans. In theory, risk was supposed to be spread to those most able to bear it; as events turned out, it was instead spread to those least able to understand it.[5]

Let me turn now to the wider causes, of which I have three.

- First, financial instruments became so complex that eventually literally no-one understood fully the nature of the instruments they were buying and selling.[6]
- Second, there was a range of perverse incentives in financial markets — too much pay for short-term returns, and not enough downside for losses. Many individuals faced strong financial incentives to take risks with other people's money — risks that generated good returns most of the time, but with a small probability of disaster.[7] When the disaster struck, it was a disaster for the other

5 To paraphrase Professor John Kay's memorable phrase from 'Same old folly, new spiral of risk' (August 2007). The non—recourse nature of mortgage loans in many US States compounded the problems.

6 Andy Haldane (April 2009) analyses the problem as follows: '[C]onsider an investor conducting due diligence on a set of financial claims: RMBS, ABS CDOs and CDO^2. How many pages of documentation would a diligent investor need to read to understand these products? … For simpler products, this is just about feasible — for example, around 200 pages, on average, for an RMBS investor. But an investor in a CDO^2 would need to read in excess of 1 billion pages to understand fully the ingredients ['billion' is not a misprint]'. As he puts it dryly: 'With a PhD in mathematics under one arm and a Diploma in speed—reading under the other, this task would have tried the patience of even the most diligent investor. With no time to read the small—print, the instruments were instead devoured whole. Food poisoning and a lengthy loss of appetite have been the predictable consequences.'

7 As Alan Blinder (Wall Street Journal, May 2009) put it: 'Take a typical trader at a bank [or] investment bank … Darwinian selection ensures us that these folks are generally smart young people with more than the usual appetite for both money and risk—taking. Unfortunately, their compensation schemes exacerbate these natural tendencies by offering them the following sort of go—for—broke incentives when they place financial bets: Heads, you become richer than Croesus; tails, you get no bonus, receive instead about four times the national average salary, and may (or may not) have to look for a new job. These bright young people are no dummies. Faced with such skewed incentives, they place lots of big bets. If tails come up, OPM [other people's money] will absorb almost all of the losses anyway. Whoever dreamed up this crazy compensation system? That is a good question, and the answer leads straight to the doors of the top executives of the companies. So let us consider the incentives facing the CEO and other top executives of a large bank or investment bank … For them, it is often: Heads, you become richer than Croesus ever imagined; tails, you receive a golden parachute that still leaves you richer than Croesus. So they want to flip those big coins, too.
From the point of view of the companies' shareholders — the people who provide the OPM – this is madness. To them, the gamble looks like: Heads, we get a share of the winning; tails, we absorb almost all of the losses. The conclusion is clear: Traders and managers both want to flip more coins — and at higher stakes — than the shareholders would if they had any control, which they do not.'

people whose money had been put at risk, for the financial firms that had put it at risk, and for the wider financial system.

- Third, large banks and the financial system more generally, mainly in US, UK, and Europe, gradually became more highly leveraged (more loans for each dollar of bank assets).

This final cause is one of the most important, because it rendered the global financial system much more fragile than most people realised. And so it is worth spending a little time fleshing out in some detail why the financial system gradually became more highly leveraged.

This leads me to a third list, which enumerates the reasons why the financial system gradually became more highly leveraged. There are five items on this list.

- First, the 1999 repeal of the US Glass-Steagall Act — which had been enacted in the teeth of the Great Depression in 1933 — allowed commercial banks to run large investment banking businesses.

- Second, regulatory frameworks encouraged banks to shift loans 'off balance sheet' and encouraged growth in the 'shadow banking system', largely outside the regulatory net.

- Third, times were good and it was therefore very profitable to become more highly leveraged.[8]

- Fourth — and this is another implication of low global real interest rates combined with investors continuing expectation of high returns — financial firms were searching for innovative ways to generate higher returns, and more leverage was a natural way to achieve this.

- But surely that meant that financial firms were taking huge risks to their own solvency? This leads to the final reason for the increased leverage, and therefore the crisis: a widespread failure of risk management. Banks thought they had a better understanding of financial risk than ever before, based on sophisticated mathematical models of risk and return. The banks' new risk-return models were indeed sophisticated, but as it turned out, they were also fatally flawed.[9]

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8 'When the music stops … things will be complicated. But as long as the music is playing, you have got to get up and dance. We are still dancing', Chuck Prince, former Citigroup CEO, July 2007. Prince retired later that year in the face of collapsing Citigroup profits.

9 Haldane (February 2009) provides a compelling exposé of the fatal shortcomings of the banks' risk models.

As a result, as house price bubbles collapsed in the US, UK, and several other countries, the cascading of problems from one counterparty to another, and from one financial market to another, generated a shock well outside the experience of the banks' risk models and this, combined with their high degree of leverage, bankrupted large parts of the global financial system.

We are all now living through the global recession that followed inexorably from this near-collapse in the global financial system.

Before leaving these lists, there is one item that deserves further comment — the role of expansionary US monetary policy. Some have suggested that, rather than simply being a contributing factor, expansionary US monetary policy in the early 2000s was the main cause of the crisis.

Expansionary US monetary policy undoubtedly contributed to rising US asset prices, including house prices, at the time. Indeed, that is the point of the policy — rising asset prices constitute one of the ways that expansionary monetary policy works.

But I have less sympathy with the argument that monetary policy should explicitly 'lean against the wind' of a suspected inflating asset price bubble, which is implicit in the criticism of US monetary policy at that time.

In my view, to lean against the wind and do more good than harm requires a level of understanding about the likely future path of a suspected asset bubble that is simply unrealistic. Without that understanding, attempting to use monetary policy to lean against the wind is as likely to be destabilising for the wider economy as it is to be stabilising.[10]

Let me now leave discussion of these lists of contributing causes of the crisis, and turn to a couple of interesting and important questions: Where were the voices warning of the possibility of such a financial disaster? And why were those voices, such as they were, largely ignored?

There were, in fact, quite a few warnings issued. Let me start with Gerald Corrigan, ex-President of the New York Fed, who said ahead of the crisis:

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10 See Gruen, Plumb and Stone (2005). Central banks are not, however, impotent in the face of strongly rising asset prices. They can use their considerable credibility and authority to raise community awareness – via speeches, parliamentary testimony and research papers – about the risks people are taking plunging into an overheated market. The RBA had some success with that approach during the housing price boom in the late 1990s and into the 2000s, as indicated by statements from the real estate industry at that time (Macfarlane 2006).

> 'In recent years the pace of change and innovation in financial markets and institutions here and around the world has increased enormously as have the speed, volume and value of financial transactions. The period has also seen a greatly heightened degree of aggressive competition in the financial sector. All of this is taking place in the context of a legal and a regulatory framework which is increasingly outdated and ill-equipped to meet the challenges of the day. This has led to … concern that the fragility of the system has increased, in part because the degree of operational, liquidity and credit interdependency has risen sharply.'

But Corrigan was speaking in January 1987, and the crisis he foretold was not the current crisis, nor the collapse of the tech bubble in 2000, but the stock market crash in October 1987. Sometimes the lessons learnt from earlier crises were only partially learnt, and then subsequently ignored when the crisis turned out to be more benign than originally feared.

More recently, a number of high-profile, credible economists and policy makers, in positions of influence and very much part of the mainstream, have issued prescient warnings about the nature of the financial risks to which the world was being exposed.[11] Let me mention just a few of them.

It is perhaps appropriate to start with developments in the US subprime mortgage market. Ed Gramlich, Governor of the US Federal Reserve Board from 1997 to 2005, was a frequent and energetic critic of the dangers inherent in the explosive growth of that largely unregulated market. Putting the words 'Gramlich subprime speech' into the search engine on the US Federal Reserve Board's website brings up over 16,000 documents, including many many speeches by Governor Gramlich in the first half of this decade, warning of the dangers of what was then going on in the US subprime market.

Turning to the wider global financial system, there were several high-profile mainstream economists and institutions warning of impending danger. Economists Robert Shiller and Nouriel Roubini, as well as the Bank for International Settlements all provided notable warnings to this effect well in advance of the crisis.

But rather than quote from each of them, let me report on another particularly memorable warning that went unheeded.

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11 There were also warnings of impending financial disaster from beyond the mainstream of economics. These warnings were even less influential, for reasons not entirely well—founded.

Each year, the US Federal Reserve Bank of Kansas City runs a two-day conference on a topic of contemporary macroeconomic policy interest. These annual conferences have become arguably the most prestigious macroeconomic policy conferences held anywhere in the world. This is partly because they are held in magnificent surroundings in Jackson Hole, Wyoming, but more importantly because Alan Greenspan made a habit of attending them while he was Chairman of the US Federal Reserve Board.

Conscious of Chairman Greenspan's imminent retirement, the organisers of the 2005 Jackson Hole conference chose the topic 'The Greenspan Era: Lessons for the Future'. One of the papers commissioned for that 2005 conference was presented by Raghu Rajan, Director of Research at the IMF, and before that Professor of Finance at the University of Chicago. The title of his paper was: 'Has Financial Development Made the World Riskier?'

There are a couple of interesting things about Professor Rajan's paper. The first is that it was remarkably prescient about the possibility that financial market developments and the incentives at play in financial markets might be increasing the fragility of the global financial system and rendering it more prone to catastrophic collapse.

Time permits only few quotes from the paper, but they give a sense that Professor Rajan was definitely onto something.

> 'While the [financial] system now exploits the risk bearing capacity of the economy better by allocating risks more widely, it also takes on more risks than before. Moreover, the linkages between markets, and between markets and institutions, are now more pronounced. While this helps the system diversify across small shocks, it also exposes the system to large systemic shocks — large shifts in asset prices or changes in aggregate liquidity.
>
> … [There is now an] incentive [for investment managers] to take risk that is concealed from investors … Typically, the kinds of risks that can be concealed most easily … are risks that generate severe adverse consequences with small probability but, in return, offer generous compensation the rest of the time.
>
> … While it is hard to be categorical about anything as complex as the modern financial system, it is possible that [recent] developments are creating more financial-sector-induced procyclicality than in the past. They also may create a greater (albeit still small) probability of a catastrophic meltdown. Unfortunately, we will not know whether these are, in fact, serious worries until the system has been tested.'

Prescient words indeed. But apart from its prescience, the other thing of interest about Professor Rajan's paper was the lukewarm reception it received from the crème de la crème of the macroeconomics policy fraternity who had assembled in Jackson Hole to comment on it.

By and large these commentators were not very sympathetic to the idea that the seeds had been sown for a potential financial system disaster just around the corner. They looked at the same financial system and saw instead the benefits of the wide diversification of risk, and the capacity of self regulation of the market to achieve an acceptable degree of financial stability.

Why were these commentators not able to see what Professor Rajan was seeing? Of course, hindsight is a wonderful thing. But I think it is fair to say that they, along with most economists, were influenced by the mainstream intellectual fashions of the time.

As Barry Eichengreen (2009) puts it:

> 'It was not the failure or inability of economists to model conflicts of interest, incentives to take excessive risk and information problems that can give rise to bubbles, panics and crises. It was not that economists failed to recognize the role of social and psychological factors in decision making or that they lacked the tools needed to draw out the implications. … Rather, the problem was a partial and blinkered reading of that literature. The consumers of economic theory, not surprisingly, tended to pick and choose those elements of that rich literature that best supported their self-serving actions. Equally reprehensibly, the producers of that theory, benefiting in ways both pecuniary and psychic, showed disturbingly little tendency to object. It is in this light that we must understand how it was that the vast majority of the economics profession remained so blissfully silent and indeed unaware of the risk of financial disaster.'

In order to understand these arguments in more detail, I seek your indulgence for a brief diversion into the history of economic thought. It may all sound rather esoteric, but it will end up being rather important for the story I am telling.

The important developments date from the late 1960s and into the 1970s. At that time, leading finance economists began to realise the power of the 'efficient markets hypothesis' to explain the apparently chaotic behaviour of financial markets.[12] Around the same time, macroeconomists were becoming disillusioned with the state of their discipline in the face of the stagflation that was then gripping the developed world.

12 Eugene Fama and others introduced the term 'efficient market' into the economics literature in 1969. See Beechey, Gruen and Vickery (2000) for a survey of the efficient market hypothesis.

Partly in reaction to that disillusionment, theoretical macroeconomists embarked on a grand project, the aim of which was to build macroeconomics on solid microeconomic foundations.[13]

Stripped of econospeak, that means that what macroeconomists say about big policy issues — economic growth and inflation, booms and busts — should be grounded in the study of individual behaviour. Put like that, the project sounds eminently desirable. Indeed, how could anyone object? And indeed, the project has been enormously influential on mainstream macroeconomic thinking ever since.

The problem comes when we discover how individual behaviour is to be understood. The individuals who populate this theoretical world have characteristics that most of us might find a little quaint, to say the least.

These individuals are assumed to be far-sighted and rational, and to understand, in extraordinary detail, the economic world in which they live and make decisions.[14]

It is true that they are subject to continual economic shocks, which are genuinely unforseen. But in responding to these shocks, these individuals are blessed in ways that the rest of us can only envy. Not only do they craft their responses confident in their complete understanding of the economic structure in which they live and work, but they also sleep safe at night confident that this economic structure will never change.

The financial markets in which these individuals borrow, lend and invest, are efficient and well functioning. They are certainly unencumbered by any of the dysfunction we have seen in global capital markets over the past two years. No perverse incentives, no herd-like behaviour, no periods of irrational exuberance or unwarranted pessimism, no information problems that might give rise to financial market bubbles, panics or crises.

It is as if, as the Titanic was sailing into iceberg-infested waters, those with the requisite skills and training to warn of the impending danger were instead hard at work, in a windowless cabin, perfecting the design of ship hulls… for a world without icebergs.

13 See also, John Kay, 'How economics lost sight of real world'.

14 Sometimes, only a proportion of the individuals in these theoretically constructed worlds have these features. But that does not diminish the intellectual influence of this strand of thought.

As George Akerlof and Robert Shiller put it in an insightful little book written earlier this year:

> 'So many members of the macroeconomics and finance profession have gone so far in the direction of 'rational expectations' and 'efficient markets' that they fail to consider the most important dynamics underlying economic crises. … the [theoretical] macroeconomics of the past 30 years has gone in the wrong direction. In their attempts to clean up macroeconomics and make it more *scientific*, [15] the standard macroeconomists have imposed research structure and discipline by focusing on how the economy would behave if people had only economic motives and if they were also fully rational. Picture a square divided into four boxes, denoting motives that are economic or noneconomic and responses that are rational or irrational. The current model fills only the upper left-hand box; it answers the question: How does the economy behave if people only have economic motives, and if they respond to them rationally? But that leads immediately to three more questions, corresponding to the three blank boxes: How does the economy behave with noneconomic motives and rational responses? With economic motives and irrational responses? With noneconomic motives and irrational responses?
>
> We believe that the answers to the most important questions regarding how the macroeconomy behaves and what we ought to do when it misbehaves lie largely (though not exclusively) within those three blank boxes.'
>
> [italics in the original][15]

Does any of this matter? I would argue that it has mattered. These developments in mainstream theoretical macroeconomics and finance have influenced the intellectual environment in which policymakers, regulators and analysts operate and form their views. For many, the central ideas from these mainstream disciplines have set the benchmark from which to judge real world developments in markets. And they have influenced the burden of proof: What makes you think that you know better than the market what is the appropriate price for shares/property/risk?

They have added intellectual weight to the argument that, by and large (though clearly not in all cases), individuals and firms in financial markets understood their economic environment, knew what they were doing, and could be left largely, if not wholly, to

15 Or, as Paul Krugman put it in answer to a question after his first Lionel Robbins lecture on 8 June, 2009: 'In macroeconomics … [over recent years, US] graduate schools were divided between those that devoted most of their time to teaching models in which this sort of thing [the global financial crisis] could not happen and Departments that devoted all of their time to teaching models in which this sort of thing could not happen.'

their own devices. Lightly regulated financial markets, dominated by well-resourced institutional investors with their own best interests at heart should be thought of as largely self-correcting, or so the mainstream view suggested.

As it was put by one of the commentators on Professor Rajan's 2005 Jackson Hole paper that I discussed earlier:

> '[In financial markets] the actions of private parties to protect themselves — what Chairman Greenspan has called private regulation — are generally quite effective. Government regulation risks undermining private regulation and financial stability by distorting incentives through moral hazard and by promising a more effective role in promoting financial stability than it can deliver.'[16]

But as the crisis has demonstrated, relying on financial market firms to self-regulate turns out to be the economic equivalent of letting children decide their own diets.[17]

Macroeconomics as a discipline was born out of the Great Depression. As we have seen, it has undergone a radical transformation over the past few decades. But the Global Financial Crisis should be a wake-up call to the discipline. A new transformation is needed — one more firmly grounded in the real-world behaviour of markets.

Let me conclude with some remarks about Australia.

Interestingly and importantly, Australian policymakers and financial regulators seem to have been relatively immune from the intellectual fads I have been discussing. Certainly, I cannot recall any time over the past several years when an Australian policymaker has extolled the virtues of leaving the financial system largely to regulate itself.[18]

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16 Donald L Kohn, p 372, 'The Greenspan Era: Lessons for the Future', 2005.

17 To use Barry Eichengreen's (2009) memorable phrase.

18 In case I am being interpreted as pouring scorn on the benefits of more deregulated markets generally – as opposed to financial markets in particular – let me dissuade you from that view. The broad range of pro—market and other economic reforms undertaken in Australia over the past few decades – including the float of the currency; the dismantling of the protective wall of tariffs and quantitative import restrictions; making labour markets more flexible; tax reform; competition policy; the development of credible medium—term frameworks for monetary and fiscal policy – appear to have been beneficial for both the longer—term productive capacity of the economy, and for its flexibility in responding to shocks.

And the Australian financial system has clearly avoided the excesses seen elsewhere — for a series of reasons.

Australia has a more coherent regulatory structure with a single institution, APRA, as the prudential regulator for the financial services industry. Furthermore, the 'four pillars' policy has contributed to financial stability by eliminating the possibility of takeovers between the major banks, thereby reducing their incentives to become more highly leveraged.

The structure and recent experiences of Australia's financial system have also contributed to its stability. Australian banks have focused on their highly profitable domestic lending businesses, which require them to raise significant offshore funding rather than casting around for foreign financial assets in which to invest. They have therefore avoided buying significant quantities of what are now toxic assets. And finally, past adverse experiences, including banking system losses exceeding 5 per cent of one year's GDP in the early 1990s, and the 2001 collapse of HIH Insurance, have had salutary effects on the attitudes of both the regulator and private firms to risk taking within the Australian financial system.[19]

Australia has also been well served by the substantial and rapid easing of monetary and fiscal policy in the aftermath of Lehman's collapse last September, as it became clear just how severe the Global Financial Crisis was becoming.

All of these things are counting in Australia's favour, and will continue to do so.

But celebration would be premature. The fall in Australia's terms of trade that is just now hitting the economy on the back of re-negotiated contract prices for iron ore and coal will strip about 3 per cent from national income over the coming year. That is about the same magnitude (though of the opposite sign) as the boost to national output from the government's discretionary fiscal stimulus measures over that time.

It is encouraging to see the gathering signs that the Global Financial Crisis is abating. Australia should continue to do better than the rest of the advanced world. But the global recession, and its Australian counterpart, still has some way to run.

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19 See also Ellis (2009) and Macfarlane (2009).

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Key themes from Treasury's Business Liaison Program

As part of Treasury's Business Liaison Program, staff held discussions with around 25 businesses in Sydney, Melbourne, Brisbane, Perth and Adelaide during May 2009.[1] Treasury greatly appreciates the commitment of time and effort by the organisations that participate in the program.[2]

In general, the retail sector experienced quite strong conditions in the March quarter and into April, buoyed by the impact of interest rates, Government stimulus payments and petrol prices on household incomes. Pockets of the residential property sector also experienced robust conditions on the back of lower interest rates and the First Home Owners Boost.

Outcomes in the mining sector were better than expected earlier in 2009, and a number of firms reported their optimism that robust demand from developing markets would return. Contacts in the manufacturing and construction sectors generally reported in much weaker terms, with difficult conditions anticipated to continue.[3]

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1 A detailed explanation of the Treasury Business Liaison Program is provided in the Treasury *Economic Roundup*, Spring 2001.

2 This summary reflects the views and opinions of participants in the liaison program, which are not necessarily shared by Treasury. While Treasury's evaluation of the economic outlook is informed by findings from business liaison, a much wider range of information and data are utilised to ensure a rigorous assessment of the Australian economy.

3 This liaison round focused on the construction, manufacturing, resources and retail sectors. Additional meetings were held with representatives from the financial and transport sectors and the general themes arising are reported. The program encompasses the full range of sectors and Treasury aims to meet with a broad cross-section of the business community over time. Companies are invited to register their interest in participating.

Trading conditions

Lower interest rates and the Economic Security Strategy were reported as having helped to keep retail sales reasonably buoyant through the March quarter. With payments under the Nation Building and Jobs Plan beginning to flow in late March, some retailers also noticed an impact on sales in April and expected similar results in May. In any case, retail sales remained stronger than expected, and were tracking moderately higher than in the corresponding period last year. The strength in sales appeared to be more broadly based than in the previous liaison round, where the impact had been found to be more concentrated among supermarkets and value-based retailers.

The First Home Owners Boost was continuing to have a strong impact on that market segment, with first home buyers representing a much larger share of the market than usual. There were signs that this had begun to translate into building activity, and several contacts anticipated a relatively busy second half of 2009.

A broader recovery in residential construction, driven by lower interest rates, was expected to gather strength in 2009-10, with demand returning among owner-occupiers. Prospects for a recovery in medium- to high-density residential construction and the investor market more generally, while also improving, were considered to be heavily finance-dependent.

Private non-residential construction activity began to contract sharply as completed projects were not being replaced by new projects. There was a broad-based weakness across offices, retail, warehouses and storage, factories and hotels. A number of contacts reported a change in their business focus toward public sector projects which should help to fill the gap in private activity in the short to medium term. Once again, there were widespread concerns about the prospects for an early recovery in the sector given the anticipated economic downturn and difficulties in accessing finance.

Manufacturing contacts offered mixed reports, with those operating in the food and beverage sector or supplying lower value retailers generally enjoying relatively benign conditions considering the weakness in the economy. Those engaged in the production of consumer durables and business plant and equipment were less sanguine. Among the latter group, several contacts believed the bottom of the current economic cycle may have been reached, even if there was little prospect of a resumption of strong growth in the near term.

A number of mining sector contacts reported 'cautious optimism' about a recovery on the basis that the March quarter had been better than expected in terms of export volumes, particularly for those exporters targeting the Chinese market. The fiscal

stimulus being applied by Chinese authorities was considered to be producing the intended outcomes.

Business credit

Concerns about the availability of finance were once again most widespread in the property sector. Contacts agreed that the combination of market conditions and tighter lending practices was to blame for a lack of available credit and excessive borrowing costs in the commercial property market.

A thin volume of sales of commercial properties and an overhang of unsold property on the market were leading to considerable uncertainty about property values, which was also contributing to lending becoming more restricted. More conservative valuations of residential property were also reported as contributing to a tightening of credit for the investor market.

Elsewhere, lower demand for business credit was clearly linked to firms scaling back on planned capital expenditure, with many expansion projects and discretionary spending being deferred where possible, pending a clearer view of market conditions.

Investment plans

While the retail sector was experiencing relatively good trading conditions and low vacancy rates, broader weakness in the commercial property sector and the unfavourable employment outlook were factors weighing against planned expansions. Retailers were also targeting lower inventories as a capital management strategy, with flow-on effects for warehousing space. However, projects that had been planned and financed before the current downturn were not at risk, and a number of firms reported that their longer term expansion strategies remained intact.

Once again there were few examples of major energy and minerals expansion projects having been cancelled, although delays caused by financing concerns or anticipated weak demand for commodities had become more common. On balance, the flow of news in relation to prospective energy and mineral investment was positive.

Employment and skills

Reports of planned job cuts were less prevalent than in past months, with the outlook relatively steady among those firms contacted, subject to the economic outlook holding up. Contractors and staff engaged for expansion projects were particularly vulnerable to job loss, but the firms contacted were generally attempting to retain skilled staff and preferred to vary their hours of engagement.

There were several reports of firms adding staff in the retail sector, where employers had also noticed application numbers rising, and in relation to construction of public sector projects.

Prices and wages

Retail sector contacts reported that the rate of price increases had slowed over the course of 2009, and was probably tracking at less than 4 per cent. While the exchange rate depreciation was having an impact on the cost of imported items, competition was considered to be squeezing retail margins and reducing the extent of pass-through to consumers.

Wage pressures were reported to have eased considerably. There were numerous reports of white collar salaries having been temporarily frozen. Collective negotiations were typically aiming at wage increases of somewhere between 2.5 and 4 per cent, although in certain sectors that were more exposed to the downturn, lower outcomes were being pursued in order to support employment outcomes.

Within the construction sector there were varying reports. Several organisations involved in resource-sector construction projects in remote areas noted that recent wage claims had remained high. However, elsewhere in the non-residential building sector, claims had weakened considerably.

Joseph Cook: the reluctant treasurer

John Hawkins[1]

Sir Joseph Cook, somewhat reluctantly, served for 16 months as Treasurer near the end of his political career, one of two former Prime Ministers to hold the position. By then he had left his radical origins well behind him and was a very conservative Treasurer. He transferred the note issue to the Commonwealth Bank.

Source: National Library of Australia.

1 At the time of writing, the author worked in the Domestic Economy Division, the Australian Treasury. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

Joseph Cook PC GCMG is one of only two Prime Ministers to serve as treasurer *after* he held the higher office.[2] By some accounts he is one of the most obscure Prime Ministers.[3]

Cook was physically robust and hard-working, tall and strongly-built. He did not drink or swear and had 'no time for frivolity'.[4] He was uninterested in sport, dancing or music. He opposed Sunday opening of Taronga Zoo lest it distracted people from church.[5] But he was known outside the parliamentary chamber for his good manners, with a cheery smile for friends and 'a tranquillity of soul'.[6]

He was 'devoted to self-improvement'.[7] While from the humblest of origins, by the latter stages of his parliamentary career, 'in manner and language, he comported himself as though born to a public school and Oxford'.[8] Initially a poor speaker he trained himself to become a parliamentary dalek: it was said 'when he started out to deal a blow to a minister … he will not desist until he has exterminated him utterly'.[9] Spending most of his career in opposition, 'the habit of a decade of criticism never left him and … he had not developed that constructive side which is so essential for both ministerial and cabinet life'[10] and possessed 'few skills in negotiation.'[11]

Cook spent most of his federal parliamentary career as a loyal deputy, first to Reid, then Deakin and finally Hughes. He was 'never anyone's tool, though he was often somebody's willing instrument'.[12]

2 The other is Arthur Fadden.
3 Prior (1978) ranks him as probably the least known Prime Minister. The electorate of Cook and the eponymous suburb in Canberra are named after James Cook rather than Joseph.
4 Buchanan (1940, p 4).
5 Murdoch (1966, p 6).
6 Clark (1987, p 109). See also Murdoch (1998, p 110).
7 Edwards (2004, p 115). However, Murdoch (1968, p 17) suggests that being self-taught he did not develop critical skills.
8 Smith (1933, p 49).
9 Comment in *Daily Telegraph* 1908, cited Murdoch (1966, p 6). Ellis (1962, p 20) describes him as having 'a resilience unparalleled in Australian political history'.
10 See, for example, Murdoch (1966, p 7) and Pearce (1951).
11 Edwards (2004, p 115). A contemporary columnist accused him of a lack of perspective; 'he deals you out the one violent bash in the eye whether you merely mis-spelled a word or ruined an empire', *Australian Magazine*, 1 July 1909, p 563.
12 Ellis (1962, p 20). Murdoch (1996, p 95) attributes this characteristic to Cook losing his father as a child, and then attaching himself to a series of father-figures as the loyal deputy.

While he was 'never troubled by personal doubt',[13] Cook had a reputation for changing his beliefs a lot.[14] But despite the possibility he would later find himself holding them, 'he had great difficulty in appreciating other points of view, and seldom made any real attempt to do so'.[15]

Cook's life before politics

'Joe' Cook[16] had probably the harshest upbringing of any Treasurer. He was born in the Staffordshire mining village of Silverdale on 7 December 1860, and when he was only nine, Joe started working in a coal mine.[17] A new Education Act saw him back in the classroom not long after, but at twelve he was back in the mine after his father died in a mining accident. For him 'Sunday' had a very literal meaning for it was the only day he might see the sun.

In 1885 he married Mary Turner, a teacher from a nearby village, already pregnant with his child. After Cook's mother remarried, the couple decided to emigrate to Lithgow in New South Wales, following in the footsteps of Mary's brother. Cook found a job in the Vale of Clwydd colliery in March 1886 and Mary and their son joined him in January 1887. They went on to have nine children.[18]

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13 Rickard (2000, p 97).

14 Thomas Ewing said of him, 'Mr Cook's view upon any subject is important, but unfortunately it is almost certain to be ephemeral, so we must make the most of it while it lasts … [he] has no political roots. He will transplant readily, and grow in any soil'; *Sydney Morning Herald*, 16 February 1906, p 5. 'He could change his political beliefs completely without once feeling he had been untrue to himself', wrote his biographer, Murdoch (1979). Among the many diverse issues on which he changed his mind were tariffs, trade unions, old age pensions, smoking, republicanism, land nationalisation, anti-trust legislation, federation, land taxation, appointments of lawyers to arbitration courts, a national bank, deficit budgeting, federalism, primitive versus mainstream Methodism, compulsory arbitration, conscription and possibly teetotalism. Cook attempted to defend himself by arguing 'wise men change their views. Fools never'; cited by Murdoch (1996, p ix). He also justified some of the change by cabinet solidarity; 'every individual who enters a cabinet must surrender something of his private opinions in order to reach a point of agreement and concerted action'. This line was cited by Murdoch (1979, p 8) who points out it is much like the Labor pledge, which was ostensibly the reason Cook left that party. Cook destroyed most of his personal papers so there is little record of his private views to assess how they differed from those expressed publicly.

15 Murdoch (1996, p 19). A more positive view is that Cook possessed 'a breezy independence, and plenty of common sense, which has sometimes been described as genius in its working dress'; Turner (1911, p 195).

16 He dropped the 'e' from his name after arriving in Australia; Murdoch (1996, p 24).

17 As Buchanan (1940, p 22) notes, another future Australian Treasurer, Andrew Fisher, had a similar upbringing at the same time, only a few score miles away. But he stayed loyal to his roots; see the essay in the Autumn 2008 *Economic Roundup* and Hawkins (2008).

18 Cook recalls his early life in Bright (1896), including his liking for Emerson and Whitman.

Cook was long keen on improving his lot in life, studying shorthand and book-keeping during lunch-breaks and after his shift. Deeply religious, he passed some exams to enter the Methodist ministry, but was prevented from doing so by the need to support his family after the death of his brother and father.[19] Nonetheless, he retained something of the pulpit about his speechmaking for the rest of his career. By 1890 he was a part-time auditor with the local council. Cook was involved with many local charities. He also became secretary of the local Miners' Association.[20] In May 1891 he was president of the first Labor Electoral League in Lithgow. The next month, with some luck, he won Labor preselection and then the Lithgow-based seat of Hartley in the New South Wales parliament.[21] He advocated the eight hour day, free trade (abandoning earlier beliefs in protectionism), better education, female suffrage and land reform. In the latter he was so influenced by Henry George's advocacy of a single tax on land that he became the local secretary of the Land Nationalisation League.

From state to federal, from Labour to Liberal and from free trade to protection

With a group of like-thinking fellow members, Cook founded a Labour Party in the parliament and by October 1893 was leading it. In January 1894 he chaired the first Intercolonial Parliamentary Labour Party conference. However, he was not to stay with Labour for long. Two future Prime Ministers, Watson and Hughes, were pushing for Labour members to be bound by a pledge to support all caucus decisions, and Cook was too independently minded to accept this. In July 1894 he defeated an official Labor candidate for his seat of Hartley.

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19 His religious beliefs led him to different conclusions than did those of Fisher. Cook's branch of 'primitive Methodism' overlapped with trade unionism but only wanted the government to remove the impediments to self-advancement.

20 Murdoch (1966, p 2) suggests this form of self-improvement may have been a substitute for the white collar jobs that eluded him in the 1890s depression. A contrary view is expressed by P Cook (undated) who suggests he forsook the chance to become an accountant due to his commitment to unionism.

21 Cook only came second in the preselection ballot but the winning candidate withdrew due to ill-health. Cook states in Bright (1896) that he was reluctant to stand but if this is true it says more of his caution than any modesty.

The Free Trade premier, George Reid, offered Cook the portfolio of Postmaster-General and he accepted, serving for four years of great activity.[22] He then briefly served as Minister for Mines and Agriculture, where he appointed William Farrer to experiment with wheat strains to great success, before Reid's government fell in 1899. By this time Cook had moved into the middle class.[23] When Reid announced his move to the federal parliament, Cook saw himself as a future NSW premier.

However, the Free Trade Party prevailed on Cook to contest the seat of Parramatta (which then extended west to Lithgow) at the federal election. Cook won and lined up behind Reid in opposition to the Barton-Deakin Protectionist government. He missed out on the deputy leadership when it became vacant in 1903 and was not offered a ministry in Reid's cabinet in 1904. This was likely due to suspicions of residual radicalism and led him to adopt more conservative stances.[24] The trade union movement which had provided his ladder up was now dismissed as 'an organisation for developing class feeling and disseminating hatred in the community'.[25] He now attacked Labor for 'preaching the doctrine that men will necessarily become better if you improve their environment'.[26] Trusts and monopolies were now regarded as part of the 'natural law' rather than a problem to be addressed.[27]

This makeover succeeded and in 1905 he became the deputy leader of the Free Trade party (by then often called 'anti-Socialist'). With Reid often attending to his legal practice in Sydney, Cook was frequently leading the party in the House. Cook was a hard-working and shrewd parliamentarian, with a reputation for dry speeches but witty interjections.[28] He succeeded Reid as party leader unopposed.

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22 Murdoch (1966, p 9) claims Cook was the first member elected by Labor anywhere in the world to become a cabinet minister. Buchanan (1940, pp 5-6) suggests Reid's more likeable personality appealed more to Cook than the protectionist leader Dibbs' patrician hauteur, although Cook would have found Reid too frivolous on occasions. Ellis (1962, p 20) suggests he also felt Labor had not shown him enough gratitude. Childe (1923, p 60) denounces Cook as 'the chief of the *rats* '.While with Labor, Cook prophetically warned of parliamentarians that 'the moment they get into a state of comfort, respectability and decency, they seem to forget all about those who are not so well circumstanced as them selves'; *NSW Hansard* 16 November 1893.

23 In June 1901 he moved from Lithgow to Sydney, first to the then middle class suburb of Marrackville and then in 1908 to the patrician Baulkham Hills.

24 As Murdoch (1996, p 68) points out, around this time he started referring to 'the workers' in the third person. He was no longer one of them.

25 *Hansard*, 4 August 1910, p 1208.

26 *Hansard*, 19 June 1906, p 363.

27 *Hansard*, 19 June 1906, p 363.

28 See, for example, Crowley (1981).

Cook became Deakin's Deputy Prime Minister, and Minister for Defence, after the 'fusion' of the non-Labour parties in 1909.[29] But the sweeping Labor victory of April 1910 returned him to opposition. Deakin's declining physical health and mental abilities left Cook the effective leader of the opposition for much of the time and, unlike Deakin, Cook was very experienced at being in opposition. When Deakin retired in January 1913, Cook beat John Forrest by one vote to become leader of what was by then termed the Liberal Party. Cook was soon thrown into an election where he ran a very negative campaign.[30]

Prime Minister and after

The narrowest of victories at the May 1913 election saw Cook Prime Minister (and Minister for Home Affairs) but facing a hostile Senate. Cook appointed Forrest back to the Treasurer's position.[31] Cook stated in August 1913 that his government planned to take the Commonwealth Bank out of savings bank business, but the required legislation had not passed the House before it was dissolved. Campaigning in 1914 Cook described the Commonwealth Bank as 'a wicked and costly and unnecessary proceeding … however it was there and they must make the best of it'. In the 1911 Budget debate, Cook had advocated a comprehensive scheme of national insurance and this formed part of the Liberal Party's platform in 1913.

Frustrated by the block the Senate placed on his legislation, Cook elected not to play safe and serve out his term but instead set up the conditions for the first double dissolution in Australian history by passing legislation opposing union preference and restricting maternity allowances which he knew the Labor majority in the Senate would reject. Cook set out his credo as 'liberalism stands in the first place for encouragement of individual effort. Then it stands for equality of opportunity all round.'[32]

The ensuing election resolved the political impasse but not in Cook's favour, with Andrew Fisher leading Labor to a clear majority in both houses.[33] Cook led the 'loyal opposition' during World War I (which had broken out during the campaign).[34] When

29 Although Free Trade was the largest of the three fusing parties, Cook made no serious attempt to wrest the leadership from Deakin; Murdoch (1996, p 79).

30 Murdoch (1965, p 224).

31 According to Glynn, Cook might have preferred Irvine for the post but Irvine preferred to be Attorney-General; O'Collins (1965, p 237).

32 Buch (1940, p 21).

33 Cook himself was unopposed in his seat of Parramatta after Billy Hughes lent on the NSW Labor Party to withdraw their candidate as part of a failed attempt to persuade Cook to postpone the election until after the war, an idea Cook dismissed as 'impractical'; J Hume Cook (1936, p 9).

34 One of the first men to sign up was Cook's own son.

Fisher retired, his successor Billy Hughes split the Labor government by his advocacy of conscription and led a band of rebels to form the National Labor Party. Well short of a majority, Hughes opened discussions with the Liberals, and they agreed to form a 'win the war' coalition which successfully contested an election.[35] The two parties then merged to form the Nationalists. Cook served loyally as Hughes' deputy prime minister for the next five years, initially also serving in the relatively junior post of Minister for the Navy.[36] Cook accompanied Hughes to the UK for a war conference in June 1918 and the two remained there for the peace conference, signing the Treaty of Versailles and not returning to Australia until August 1919.[37] On their return Hughes took all the credit and did not support Cook when it was proposed that Watt replace him as deputy prime minister.[38]

Treasurer

In March 1920 Cook became Acting Treasurer, when Watt left for a trip to London. Cook then reluctantly became Treasurer following Watt's resignation in July 1920.[39] It was a challenging period. This was the height of the post-war boom, and the government was concerned about inflation. At the same time, unemployment remained high. Global interest rates were high due to war debts and a shortage of ships impeded trade.

Cook thought it was 'the main financial duty of a government to keep its commitments as low as possible and to balance the budget'.[40] He was focused on reducing inflation. In his first budget (16 September 1920) Cook aimed to reduce borrowing and set the country up for repaying war debt quickly, but was only willing to raise taxes modestly

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35 They worked together despite Hughes reputedly regarding Cook as 'the biggest damn fool in creation'; J Hume Cook (1936, p 79).

36 As in 1909, Cook appeared not to covet the leadership despite the Liberals being the larger component of the new party; Murdoch (1996, p 116) and J Hume Cook (1936, p 80). Cook supported slightly less conservative policies under Hughes' influence; Murdoch (1968, p 381).

37 There are various conjectures about the reason. One possibility is that Hughes was too suspicious of Cook to leave him in Australia as Acting Prime Minister. Another is that the ex-Liberals wanted Cook to go to keep an eye on Hughes. Hughes delegated very little to Cook during their time in the UK, but Cook took solace from a knighthood and the chance to return as 'the local boy made good' to his birthplace. He was involved in redrawing the borders of Czechoslovakia. He enjoyed his time in the UK so much he set his sights on becoming High Commissioner; Murdoch (1996, p 131).

38 Murdoch (1968, p 378). Despite Cabinet support, Watt declined the post due to ill-health.

39 The post was reputedly first offered to SM Bruce who declined; Murdoch (1996, p 132). Cook had earlier seen the Treasurer as an important position; 'in the glass of the budget we behold the face of the nation'; Cook (1912, p 1). But now he was impatient to become High Commissioner in London. Nonetheless, he 'held it with his usual aplomb'; Ellis (1962, p 22).

40 Murdoch (1996, p 132).

from fear of discouraging investment. This forced him to be very parsimonious with spending, and ruled out any expansion in public works to ease unemployment. The only large expenditure initiative was on ships to alleviate export problems. Labor and the Country Party criticised him for not making further cuts in spending.[41]

His second budget (29 September 1921) continued this deflationary policy, although by now the Australian and global economies were slowing, Australia was suffering from drought and inflation had fallen. His 'stand-pat budget' was closely debated but the critics proposed no clear alternative.[42]

Also while treasurer, Cook transferred banknote issue to a department of the Commonwealth Bank. 'His intention was for the note issue to contract and expand automatically according to business needs, so that no political activity could interfere adversely with the needs of private enterprise'.[43] But as he did not want the note issue under the sole control of the Bank Governor, he constituted a board of four including the Governor and a representative from Treasury.

Cook was an unimaginative treasurer, although admittedly, Hughes would probably not have encouraged him. Nor was he a very confident one, saying 'the position of the Commonwealth Treasurer is more difficult today than it has ever been … I do not pretend to be an expert'.[44] He also said 'I am a bit tired of being 'shot at' both inside the House and outside by every one who thinks he can teach me how to *do the job*.'

From April to September 1921 Cook was also Acting Prime Minister, while Hughes attended an imperial conference, bringing a greater harmony to party and cabinet.

Elder statesman

Once Bruce agreed to become Treasurer, Cook resigned from parliament in November 1921 to become High Commissioner in London, again following in the footsteps of Reid and Fisher. While there he also represented Australia at numerous conferences including the Genoa Economic Conference in 1922 and meetings of the International Labour Organisation. He did much to promote immigration to Australia and trade.

41 Sawer (1956, p 205).
42 Sawer (1956, p 205).
43 Murdoch (1996, p 133). See Coleman (1999, 2001) for an account of the Board's operations. Cook had advocated this idea as far back as 1914; *Hansard* 13 November 1914, p 671. But now he described it as 'merely a machinery measure'; *Hansard* , 4 November 1920, p 6174. The Commonwealth Bank governor saw it as a big deal, suggesting to the former treasurer that it would be 'the first and most important step in the enlargement *int*o a national bank in every sense of the word'; Sir Denison Miller, cited by Harper and Schedvin (1998, p 220).
44 *Hansard*, 30 September 1920, p 5211.

The former free trade leader now defended protectionist sentiments.[45] When his term ended in 1927 he returned to Australia, farewelled on the dock by Dame Nellie Melba.

Aged 67 by the time he reached Australia, he was not interested in resuming a political career. However he did serve as chairman of a royal commission into South Australia's share of federal funding in 1930. The former postmaster-general participated in the first telephone call between London and Sydney in 1930, during a long and pleasant retirement before his death on 30 July 1947.

45 He defended imperial preference in Cook (1924).

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What's new on the Treasury website

The Treasury's website, www.treasury.gov.au, includes past issues of the *Economic Roundup*. Some of the other items posted on the website since the previous issue of *Roundup* that may be of interest to readers are listed in the following section.

Budget Statements

2009-2010 Commonwealth Budget

http://www.budget.gov.au/2009-10/

2009-2010 Commonwealth Budget website includes the following papers: Budget Speech, Budget Strategy and Outlook, Budget Measures, Federal Financial Relations and Agency Resourcing.

Four Budget Overviews were released with the 2009-10 Budget: Budget Overview; Secure and Sustainable Pensions; Nation Building for the Future; Universities, Innovation and Education Revolution.

Portfolio Budget Statements 2009-10

http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1539

The purpose of the 2009-10 Portfolio Budget Statements (PBS) is to inform Senators and Members of Parliament of the proposed allocation of resources to government outcomes by agencies within the portfolio. Agencies receive resources from the annual appropriations acts, special appropriations (including standing appropriations and special accounts), and revenue from other sources.

Working Paper

http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1512

2009-03: The Accuracy of Predicted Wages of the Non-Employed and Implications for Policy Simulations from Structural Labour Supply Models

Robert Breunig and Joseph Mercante

The main focus of this paper is on the accuracy of predicted wages for the nonemployed.

The paper's results may have important implications for policy simulations from structural labour supply models.

Review

http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1549

Findings of the Review of Non-Forestry Managed Investment Schemes

On 1 August 2008, the Government released an issues paper regarding non-forestry managed investment schemes (MIS).

Non-forestry MIS are a type of collective investment that has grown rapidly in recent years. There has been significant debate over the merits of this investment structure.

The issues paper outlined the areas that the review would cover and the various claims that have been made regarding MIS, as well as the information that Treasury sought from contributors. Seventy-nine submissions were received in response.

On 29 May 2009, the Government released the findings of the review.

Consultations

http://www.treasury.gov.au/content/consultations.asp?ContentID=1013&titl=Reviews,%20Inquiries%20%26%20Consultations

Treasury conducts many consultations on behalf of the Government. The following consultations are open for public comment:

- Exposure Draft – Non-Commercial Losses
- Draft - Private Ancillary Fund Guidelines 2009
- Creeping Acquisitions - The Way Forward
- Improving Fairness and Integrity in the Tax System - Tightening the Non-Commercial Loan Rules in Division 7A of the Income Tax Assessment Act 1936
- Issues Paper: Improving Australia's Framework for Disclosure of Equity Derivative Products
- Discussion Paper: Improving the Taxation Treatment of Off-Market Share Buybacks
- Discussion Paper: Managed Investment Trusts - Capital Account Treatment

- Options Paper: Access to Share Registers and the Regulation of Unsolicited Off Market Offers
- Review of the GST Financial Supply Provisions - Consultation Paper
- GST Margin Scheme Review - Consultation Paper
- Extra-statutory concession power for the Commissioner of Taxation discussion paper
- Consumer Voices: Sustaining Advocacy and Research in Australia's New Consumer Policy Framework
- Australia's Future Tax System

Sources of economic data

The following table provides sources for key economic data. Australian Bureau of Statistics (ABS) data can be obtained over the internet at http://www.abs.gov.au. The Reserve Bank of Australia information is available at http://www.rba.gov.au. Similarly, OECD information is available at http://www.oecd.org. Information on individual economies is also available via the IMF at http://www.imf.org.

International economy	
Output, current account balance, interest rates and consumer price inflation	OECD Main Economic Indicators
National accounts	
Components of GDP, contributions to change in GDP	ABS cat. no. 5206.0
Incomes, costs and prices	
Real household income	ABS cat. nos. 5204.0 and 5206.0
Wages, labour costs and company income	ABS cat. nos. 5204.0, 5206.0, 5676.0 and 6345.0
Prices	ABS cat. nos. 6401.0 and 5206.0
Labour market	ABS cat. no. 6202.0
External sector	
Australia's current account, external liabilities and income flows	ABS cat. nos. 5368.0, 5302.0 and 5206.0

Past editions of *Economic Roundup*

A full index to articles published in *Economic Roundup* was included in the Spring 2006 edition. Details of articles published in recent editions are listed below:

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A history of public debt in Australia

Using evidence well

What evidence should social policymakers use?

The importance of evidence for successful economic reform

Why health matters for economic performance

Key themes from Treasury's Business Liaison Program

William Watt: the great orator

Issue 4, 2008

Towards a tax and transfer system of human scale

The smarter use of data

The economic costs of reducing greenhouse gas emissions: Understanding the Treasury modelling

Opening statement to the Senate Standing Committee on Economics

The macroeconomic implications of financial 'deleveraging'

Household saving in Australia

Harnessing the demand side: Australian consumer policy

Key themes from Treasury's Business Liaison Program

Alexander Poynton – the caretaker

Copies of these articles are available from the Treasury. Written requests should be sent to Manager, Domestic Economy Division, The Treasury, Langton Crescent, Parkes, ACT, 2600. Telephone requests should be directed to Mr Chris McLennan on (02) 6263 2756. Copies may be downloaded from the Treasury web site http://www.treasury.gov.au.