

Economic *Roundup*

Spring 2003

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This issue includes data up to 24 October 2003.

2002-03 in review: continued growth despite global weakness

The Australian economy grew solidly in 2002-03, despite the impact of a severe drought, a weak world economy and a number of temporary international shocks. Growth was below that forecast in the 2002-03 Budget, but broadly in line with the Mid-Year Economic and Fiscal Outlook (MYEFO) forecast, which was revised down from Budget mainly due to the expected impact of the drought on the economy.

Domestic demand grew strongly, underpinned by solid consumption growth, continued dwelling investment growth and a strong pick-up in business investment. The domestic strength more than offset the decline in net exports associated with weak world demand, reduced farm production, and the effects of the Severe Acute Respiratory Syndrome (SARS) epidemic and security concerns on tourism.

In 2002-03, employment grew strongly, with the unemployment rate declining from 6.3 per cent in the June quarter 2002 to 6.1 per cent in the June quarter 2003. Inflation remained moderate and labour costs were well contained.

Overview

The Australian economy grew by 2.7 per cent in year-average terms in 2002-03 after growing by 3.8 per cent in 2001-02. This outcome was below the 2002-03 Budget forecast but broadly in line with the MYEFO forecast. The solid outcome was against a backdrop of a weak international environment and a severe drought. Growth was driven by strong domestic demand which more than offset a large subtraction from net exports. Household consumption was solid, business investment grew very strongly, despite the gloomy international environment, and housing investment continued to hold up for longer than expected, providing a solid fillip for domestic spending.

Growth in the world economy and Australia's major trading partners (MTPs) was subdued for much of the year. In 2002, the world economy and MTPs each grew by 3 per cent, after weak growth in the previous year. Growth in the United States (US) and Japan picked up in the latter part of 2002-03, while Europe remained weak.

Geopolitical tensions associated with the war in Iraq, higher oil prices and the outbreak of SARS weighed heavily on the world economy in 2002-03. These events adversely affected world growth and reduced demand for Australia's exports. Services exports were badly affected with short-term visitor arrivals to Australia dropping substantially.

The worst drought on Australian record unfolded over the year. Farm production declined by around 28 per cent, subtracting around 1 percentage point from GDP growth in 2002-03. The decline in farm production was driven by a decline of around 60 per cent in the production of cereals and grains. The impact on GDP in 2002-03 was greater than the effects on GDP of droughts in 1982-83 and 1994-95.

With an adverse external environment, the drought and strong domestic demand, the current account deficit (CAD) widened to 5.6 per cent of GDP.

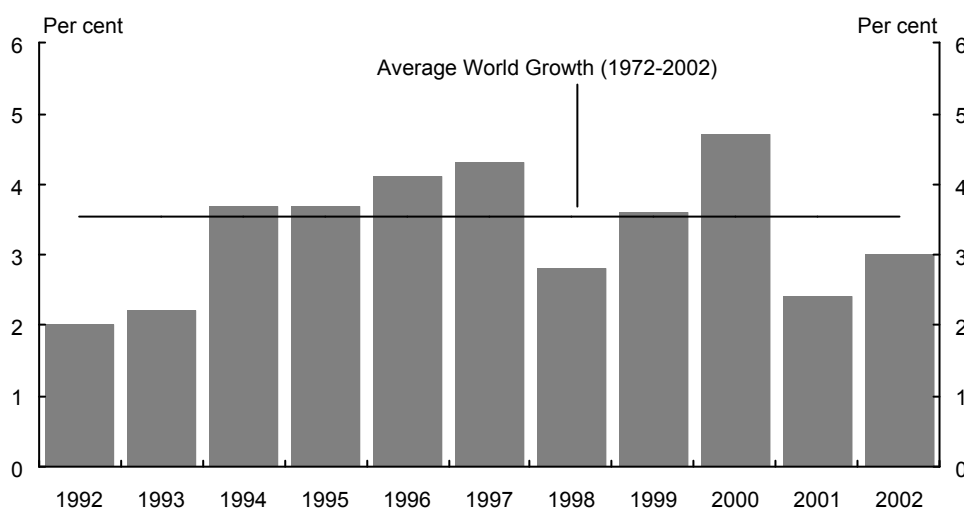
Employment grew by 2.5 per cent in 2002-03 following subdued growth in the previous year. The largest increases in employment were primarily in retail trade and property and business services. The unemployment rate declined slightly to just over 6 per cent.

Wages growth picked up in 2002-03 in line with strengthening labour market conditions, although the level of wages growth remained well contained. Inflation was moderate, with prices increasing by 2.7 per cent through the year, consistent with the Government's medium-term inflation target.

The world economy

The world economy grew by 3 per cent in 2002 after growing by 2.4 per cent, the slowest rate of growth in almost a decade, in 2001 (Chart 1). This outcome was broadly consistent with the 2002-03 Budget and MYEFO forecasts for world growth of 2¾ per cent. Australia's MTPs grew by 3 per cent in 2002, after growing by 1.5 per cent in 2001. The MTP growth forecasts were revised up in MYEFO to 2¾ per cent for 2002, primarily reflecting the improved outlook for Japan.

Chart 1: World growth^(a)



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity. Source: National statistical publications, International Monetary Fund (IMF) and Treasury.

The world economy staged a modest recovery in the first half of 2002 before losing momentum on the back of sharply lower global equity prices and persistently higher oil prices (Box 1). These influences persisted through the first half of 2003 and, together with heightened international political tensions, the conflict in Iraq and the outbreak of SARS, undermined consumer and business confidence.¹

In the US, GDP growth was 2.7 per cent in 2002-03, with the pattern of recovery broadly consistent with the growth profile following the last US recession in 1990. However, employment growth out of the recession was much weaker than that coming out of previous recessions.

¹ For a discussion of the effects of SARS see 'The economic impact of Severe Acute Respiratory Syndrome' in the Winter 2003 edition of the Economic Roundup.

2002-03 in review

In 2002-03 consumer spending was an important source of support for overall US demand, while US export performance remained lacklustre, reflecting economic weakness in its MTPs. The faster growth of imports relative to exports pushed the US CAD to a record high of 5.2 per cent of GDP during the year, raising concerns about its sustainability. With short-term US interest rates below those in the Euro area and continued concerns about the large US CAD, the US dollar depreciated from its early 2002 peak.

Monetary and fiscal policies in the US were very supportive of growth in 2002-03. The Federal Reserve Board reduced the federal funds target rate by 75 basis points in 2002-03 to 1 per cent, its lowest level in 45 years. The target rate has been eased by 550 basis points since 2001. The fiscal deficit widened from about 1.5 per cent of GDP in 2001-2002 to around 3.5 per cent of GDP in 2002-2003, due to increased Government spending, particularly defence and security-related expenditures, and tax cuts.

Euro area GDP growth in 2002-03 was 0.7 per cent, with Germany, Italy and the Netherlands entering recession. Investment spending and external trading conditions were areas of weakness, reflecting highly leveraged corporate balance sheets, weak demand among the major industrial economies and an appreciation of the Euro.

Consumption in the Euro area picked up slowly over 2002-03 and household balance sheets appeared to be in good shape. However, household confidence remained low, reflecting high and rising unemployment. The European Central Bank lowered interest rates by 50 basis points in June 2003 taking the official interest rate to 2 per cent.

Growth in the United Kingdom weakened in late 2002, as consumption growth slowed and investment remained weak. Net exports contributed to GDP growth in the first half of 2003. Annual house price inflation remained high but showed signs of moderating during 2002-03.

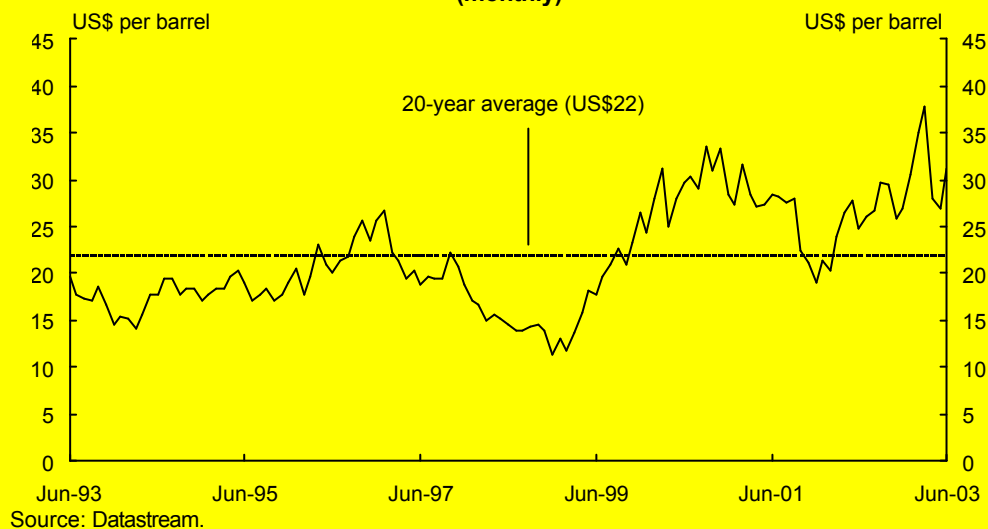
In 2002-03, GDP growth in Japan was 2.5 per cent, exceeding expectations. External demand was an important driver of growth. Profitability remained weak in the Japanese corporate sector and resulted in job losses and wage cuts. However, private consumption remained resilient. Structural problems continued to hamper the Japanese economy, particularly persistent deflation and the weak financial system.

Non-Japan East Asia recovered in the first half of 2002-03, as the influence of the global economic slowdown on investment, exports and industrial production dissipated. This recovery saw a rebound in the electronics sector, which had been in decline for almost two years. The Bali bombing on 12 October 2002 provided a setback to the recovery, undermining the confidence in stock markets and currencies in South East Asia.

Box 1: Oil demand and supply issues

Oil prices averaged around US\$30 per barrel over 2002-03, well above their 20-year average of US\$22 per barrel. Already high oil prices were supported further by a combination of oil supply disruptions in Iraq, the loss of oil supplies from Venezuela and Nigeria, declining commercial crude oil inventories in the OECD and increasing global demand. This confluence of events led to the price of oil reaching highs not seen since the 1991 Gulf War (Chart A).

Chart A: West Texas intermediate oil prices (monthly)



In March 2003, the increase in geopolitical uncertainty and possible supply disruptions associated with the war in Iraq resulted in an estimated 'premium' of over US\$4 per barrel. Despite oil prices falling from 12-year highs once the war in Iraq commenced, oil prices remained well above their long-run average due to unresolved oil supply constraints, ongoing high demand and uncertainty surrounding the resumption of Iraqi oil exports. Total world oil demand in 2002-03 was boosted by colder-than-normal weather in North America and Asia, a sharp increase in Chinese imports of oil and a decline in Japanese nuclear energy output.

2002-03 in review

A slowdown in the region became evident early in 2003, mostly due to weaker domestic demand. Domestic demand slowed markedly, initially reflecting war-related uncertainties and surging oil prices, and subsequently SARS. Notwithstanding the rapid expansion of intra-regional trade, export growth slowed in early 2003 in several countries, including Korea, the Philippines and Singapore.

Hong Kong, Taiwan and Singapore were severely affected by SARS, as tourism and retail sales plummeted. This led to downward revisions to growth for most countries in the region as consumption slowed and investment moderated. Foreign direct investment to China was reduced as the full impact of SARS on the economy was assessed. With inflation contained in the region, monetary policy was eased in a number of East Asian economies and fiscal stimulus increased to offset the negative impact of SARS.

In spite of SARS and the general weakness in the global economy, China and Thailand continued to grow strongly through the first half of 2003.

Domestic economy

Table 1 compares the actual outcomes for the domestic economy in 2002-03 with both the 2002-03 Budget and MYEFO forecasts.

At the time of the 2002-03 Budget, the Australian economy was continuing to grow solidly, underpinned by strong domestic demand.

Household consumption and business investment were expected to contribute strongly to growth in 2002-03. However, dwelling investment was anticipated to decline moderately over the course of the year as a result of the unwinding of the bring-forward of building activity related to the First Home Owners Scheme (FHOS).

At Budget export growth was forecast to rebound in 2002-03 as the world economy recovered. Reflecting the relative strength of the Australian economy, net exports were expected to subtract from domestic growth and the CAD was expected to increase moderately.

At MYEFO, the growth forecasts for the Australian economy were revised down by $\frac{3}{4}$ of a percentage point, mainly due to the expected impact of the drought, which by then was affecting large parts of Australia. The 2002-03 Budget forecasts assumed average seasonal conditions in 2002-03. Offsetting this, the forecast for dwelling investment in MYEFO was revised up as, despite first home owner activity falling as expected, the underlying drivers of housing remained firm and building activity continued to grow strongly.

Table 1: 2002-03 Budget and MYEFO forecasts and outcomes^(a)

	Outcomes(b) 2001-02	2002-03 Budget Forecasts	2002-03 MYEFO Forecasts	Outcomes(b) 2002-03
	Year Average	Year Average	Year Average	Year Average
Panel A - Demand and output(c)				
Household consumption	3.3	4	4	3.9
Private investment				
Dwellings	19.5	-3	9	15.9
Total business investment(d)	4.3	12	11	16.4
Other buildings and structures(d)	9.9	14	18	31.3
Machinery and equipment(d)	2.4	12	11	15.0
Private final demand(d)	4.7	4 3/4	5 1/4	6.5
Public final demand(d)	4.0	3 1/4	3 1/4	3.1
Total final demand	4.6	4 1/2	4 3/4	5.8
Change in inventories(e)				
Private non-farm	-0.2	1/4	1/4	0.3
Farm and public authorities	0.1	0	- 1/4	-0.1
Gross national expenditure	4.6	4 3/4	4 3/4	5.9
Exports of goods and services	-1.4	6	2	-0.7
Imports of goods and services	2.2	11	10	13.8
Net exports(e)	-0.8	-1	-1 3/4	-3.1
Gross domestic product	3.8	3 3/4	3	2.7
Non-farm product	3.8	3 3/4	3 3/4	3.9
Farm product	5.1	3 3/4	-17	-28.5
Panel B - Other selected economic measures				
Prices and wages				
Consumer Price Index	2.9	2 3/4	2 3/4	3.1
Gross non-farm product deflator	2.0	2	2 1/4	3.0
Average earnings(f)	4.3	4 1/4	4 1/4	3.4
Labour market				
Employment (Labour Force Survey basis)	1.1	1 3/4	1 3/4	2.5
Unemployment rate (per cent)(g)	6.3	6	6	6.1
Participation rate (per cent)	63.7	63 3/4	63 3/4	63.9
External accounts				
Terms of trade	2.0	2 3/4	2 1/4	2.2
Current account balance				
\$ billion	-21.9	-29	-33	-42.5
Percentage of GDP	-3.1	-4	-4 1/2	-5.6

(a) Percentage change on preceding year unless otherwise indicated.

(b) Calculated using original data, except average earnings and the labour market measures which are calculated using seasonally adjusted data.

(c) Chain volume measure.

(d) Excluding transfers of second-hand asset sales from the public sector to the private sector.

(e) Percentage point contribution to growth in GDP.

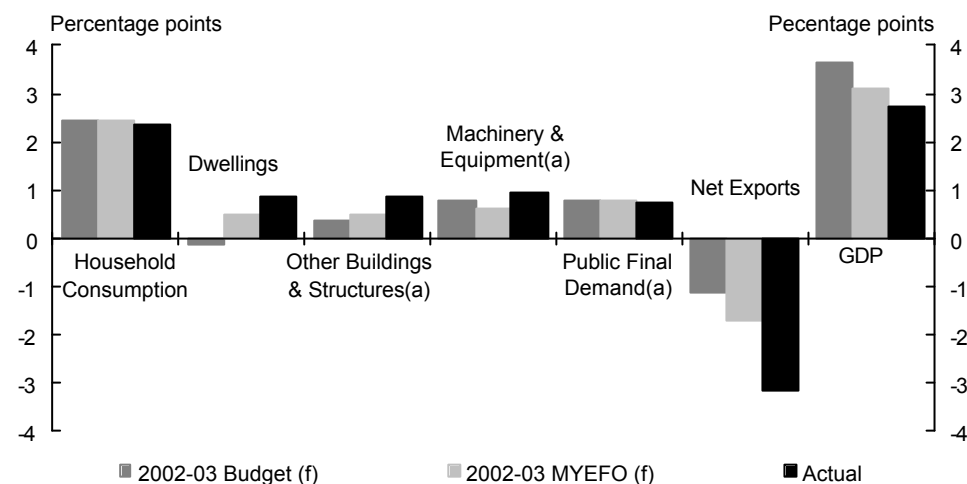
(f) Average non-farm compensation of employees (national accounts basis).

(g) The rate in the June quarter of each year.

Source: ABS Cat. No. 5206.0, 2002-03 Budget, 2002-03 MYEFO.

As it turned out, growth in domestic demand was higher than forecast reflecting stronger dwelling investment and non-residential construction. In contrast, net exports subtracted more from growth than forecast due to the severity of the drought, the effects of the war in Iraq and SARS on exports, and strong import growth. Overall, economic growth was slightly lower than forecast at MYEFO (Chart 2).

Chart 2: Contributions to GDP growth 2002-03



(a) Adjusted for second hand asset sales.

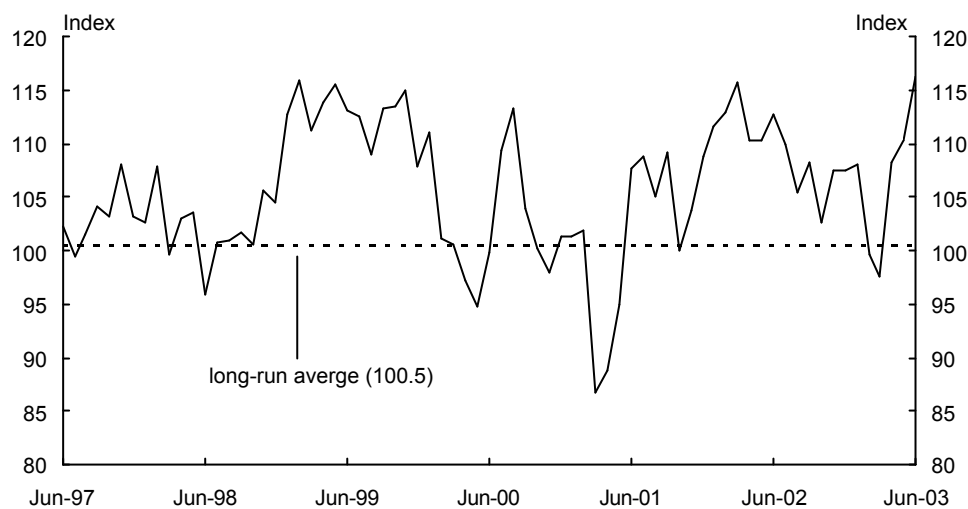
Source: ABS Cat. No. 5206.0, 2002-03 Budget, 2002-03 MYEFO.

Domestic demand

Household consumption

Household consumption was again one of the key drivers of economic growth in 2002-03, rising by 3.9 per cent. This outcome was consistent with the forecasts in the 2002-03 Budget and MYEFO.

Consumer spending was supported by sustained income growth, historically low interest rates and a solid increase in household wealth, associated with rising house prices. Consumer confidence held up well, despite ongoing global uncertainty and one-off shocks, such as the Bali bombings and the war in Iraq (Chart 3). Traditional retailing, such as clothing and household goods, grew strongly in 2002-03 along with sales of motor vehicles. Consumption spending continued to grow faster than disposable income, leading to a further decline in the household saving ratio, and household debt increased.

Chart 3: Consumer sentiment

Source: Westpac-Melbourne Institute Consumer Sentiment.

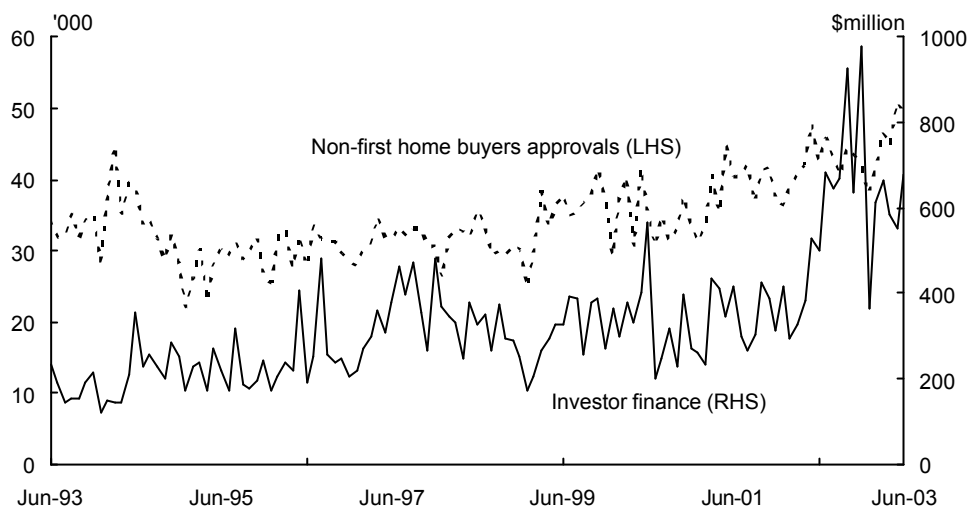
Dwelling investment

Dwelling investment continued to grow strongly in 2002-03, rising by 15.9 per cent and contributing around 0.9 percentage points to GDP growth, well above the 2002-03 Budget and MYEFO forecasts.

At the time of the 2002-03 Budget, the additional FHOS grant, which had caused a short-term bring-forward of new building activity, was being phased out and the bring-forward in activity was expected to be unwound over the course of 2002-03.

There were also emerging signs of an excess supply in some segments of the housing market, particularly for medium/high density dwellings in Sydney and Melbourne, with rental vacancy rates rising to around historical highs. This was expected to deter investment in new dwellings.

After continuing to grow in the second half of 2002, new dwelling investment fell in the first half of 2003, driven by the unwinding of FHOS. However, the rest of the market remained strong for longer than expected (Chart 4). Low interest rates, easy access to finance, an expectation of large capital gains and the poor performance of alternative investments continued to make investment in residential rental property attractive. As a result, investor activity hit record levels. Between February and December 2002, the value of finance approvals for investors in residential property more than tripled (Chart 4). Spending on alterations and additions also grew very strongly.

Chart 4: Housing finance

Source: ABS Cat. No. 5609.0 and 5671.0.

Business investment

Private new business investment grew by around 16 per cent in 2002-03. This was a little higher than the 2002-03 Budget and MYEFO forecasts. Economic conditions, such as low interest rates and high levels of corporate profitability, remained supportive for business investment. Investment intentions generally held up well despite the uncertainties surrounding the global outlook. Moreover, agriculture investment, which was expected to fall sharply in 2002-03 as drought-affected farmers deferred investment plans, did not decline as much as expected.

Investment in other buildings and structures grew by around 31 per cent in 2002-03 in year-average terms and contributed 0.9 percentage points to GDP growth, driven by a boom in engineering construction (Box 2). This outcome was well above both the 2002-03 Budget and the MYEFO forecasts. Engineering construction was underpinned by several large mining and infrastructure projects.

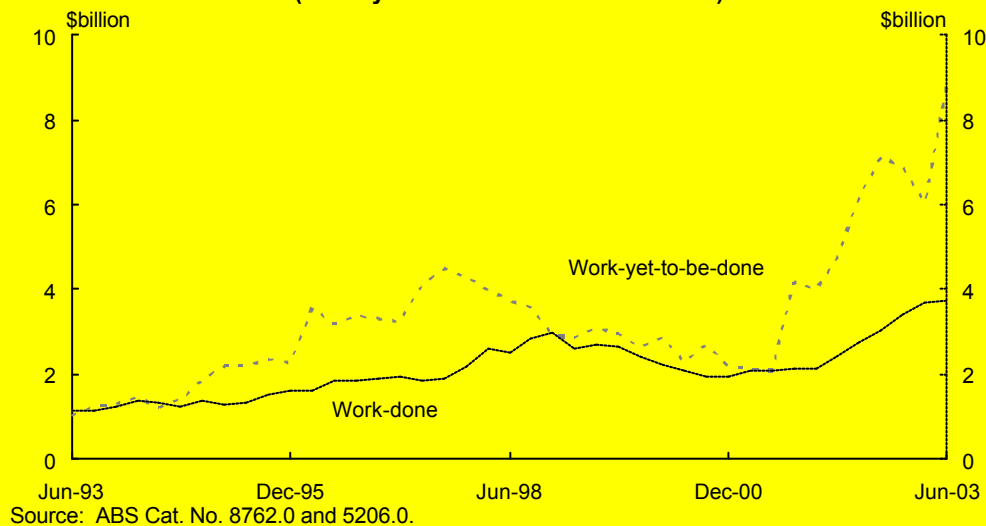
Investment in new machinery and equipment rose by 15 per cent in 2002-03, following modest growth in the previous year. The growth in new machinery and equipment was driven by the mining sector and the upgrade of the aviation industry's fleet of aircraft.

Box 2: Engineering construction boom

In 2002-03, Australia experienced a boom in engineering construction. While engineering construction, which includes mines, minerals processing, transport infrastructure and utilities, only accounts for around 12 per cent of total business investment, it added 0.6 of a percentage point to growth in GDP in 2002-03.

Engineering construction grew by 36 per cent through the year to the June quarter 2003. The ABS estimate of engineering construction work-yet-to-be-done was at its highest level ever in the June quarter 2003 (Chart A).

**Chart A: Engineering construction
(Work-yet-to-be-done and Work-done)**



Investment in mining projects was strong, including projects such as the LNG Fourth Train, the Bayu-Undan platform in the Timor Sea and Comalco's Aluminium Refinery.

There were also a number of large infrastructure projects under way or nearing completion in 2002-03, including for example: the Western Sydney orbital; the Sydney cross city tunnel; and the Alice Springs to Darwin railway.

External sector

Net exports subtracted 3.1 percentage points from GDP growth in 2002-03, substantially greater than the subtraction forecast at Budget and MYEFO. Part of the deterioration was due to the Australian dollar appreciating by around 16 per cent against the US dollar and 7 per cent in trade weighted terms through the year to the June quarter 2003.

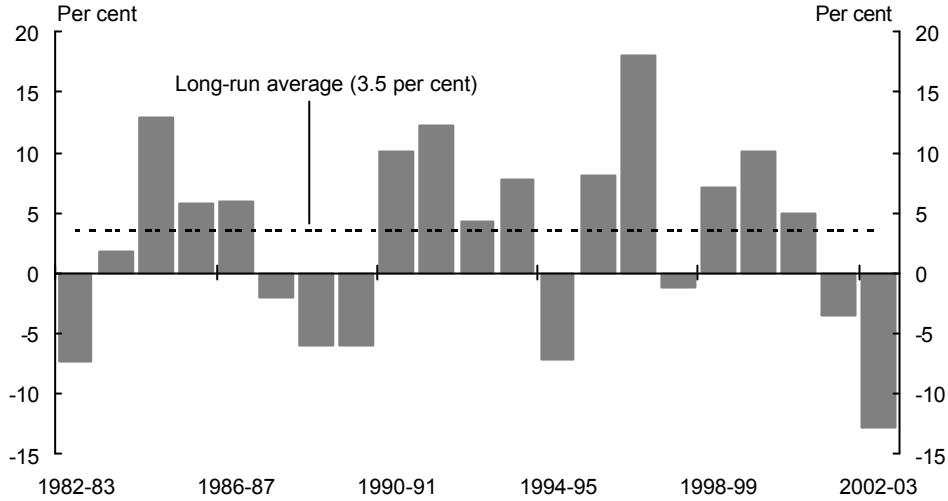
In the 2002-03 Budget, exports were expected to rebound in 2002-03, although to below long-term trend growth rates, as world growth started to pick-up. Solid farm exports were also expected on the assumption of a return to average seasonal conditions. In MYEFO, the 2002-03 Budget export forecasts were revised down reflecting continued global weakness and the expected impact of the drought.

Export volumes fell by 0.7 per cent in 2002-03, a much weaker outcome than the forecasts in the 2002-03 Budget and MYEFO of 6 per cent and 2 per cent growth respectively. The weaker export outcome reflected a combination of the continued global weakness, the drought, an appreciation in the Australian dollar, and the temporary impact of SARS and the war in Iraq.

Weak MTP growth and a strengthening exchange rate restricted growth in exports of elaborately transformed manufactures (ETMs) to below trend levels in 2002-03. Growth in exports of ETMs was 3.7 per cent in 2002-03, compared with decade annual average growth of around 9 per cent.

As a result of the drought rural exports fell by 12.8 per cent in 2002-03, in year-average terms, the largest decline on record (Chart 5 and Box 3).

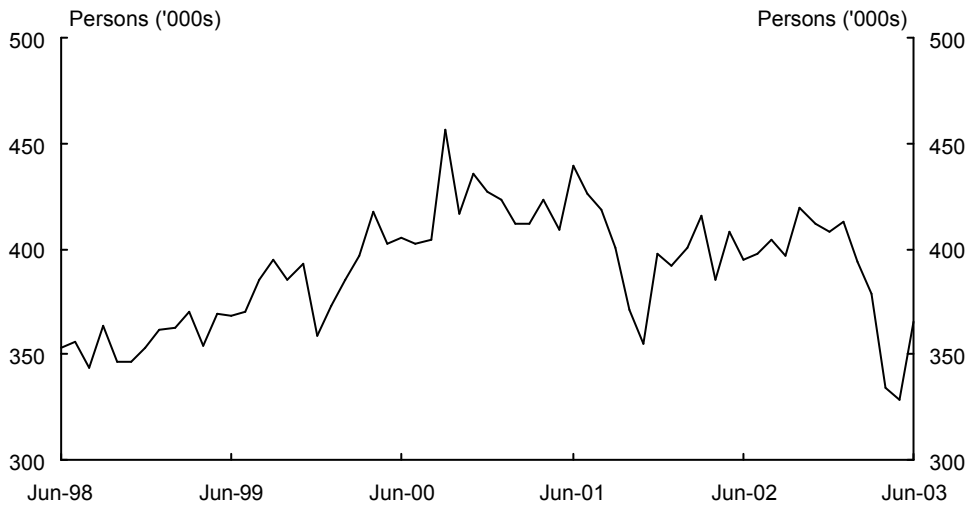
**Chart 5: Rural export growth
(year average)**



Source: ABS Cat. No. 5302.0.

Service exports declined by 2.4 per cent in 2002-03. Tourism was particularly affected by the health and security concerns associated with the SARS epidemic, the Bali bombings and the war in Iraq. Short-term overseas arrivals declined 7.5 per cent over the year to June 2003, with much of the fall occurring in early 2003 (Chart 6).

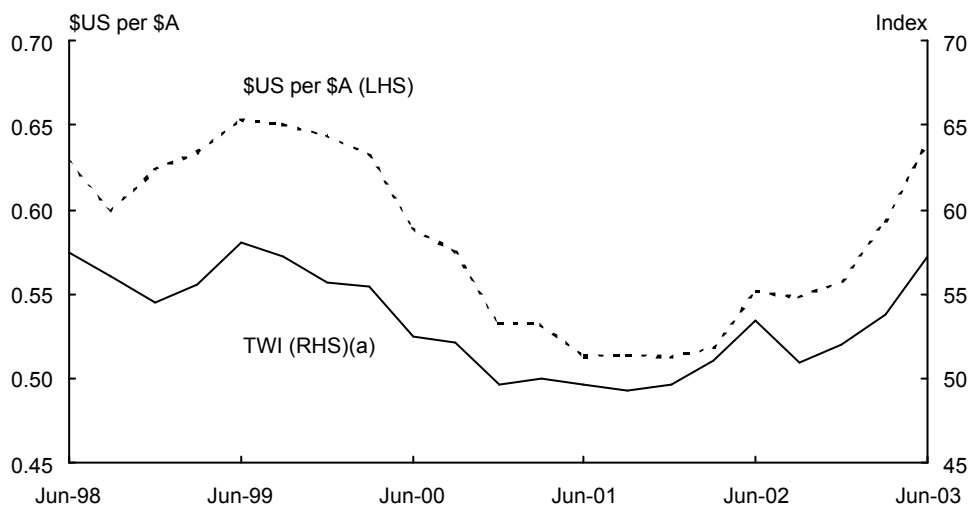
Chart 6: Short-term visitor arrivals



Source: ABS Cat. No. 3401.0.

Adverse external conditions were also reflected in weaker export prices in 2002-03, exacerbated by the appreciation of the Australian dollar exchange rate. Export prices fell by 2.6 per cent.

Chart 7: Exchange rates

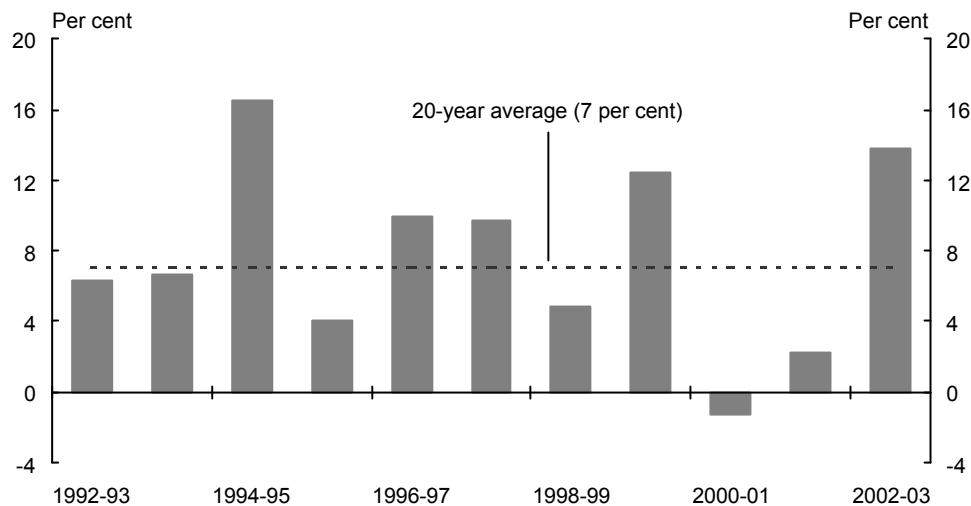


(a) TWI May 1970 = 100.
Source: ABS Cat. No. 5302.0.

Import volumes grew strongly in 2002-03, with a substantial 13.8 per cent year-average increase (Chart 8). This was broadly in line with the 2002-03 Budget and MYEFO forecasts.

The strong growth in imports reflected strong domestic demand, particularly import-intensive business investment, and a partial substitution of imports for domestically produced goods and services as the Australian dollar rose. The aviation industry's upgrading of its fleet of civil aircraft also contributed to the strong import growth.

**Chart 8: Import growth
(year average)**



Source: ABS Cat. No. 5302.0.

Import prices fell by 4.7 per cent in 2002-03 in year-average terms, largely driven by the rise in the Australian dollar. The decline was partially offset by an increase of around 10 per cent in year-average terms for the price of fuels and lubricants, which was largely driven by a rise in crude oil prices.

The terms of trade rose by 2.2 per cent in 2002-03, below the 2002-03 Budget forecast but in line with the MYEFO forecast. The increase in the terms of trade in recent years contrasts with the decline that has historically been experienced during the course of global economic downturns.

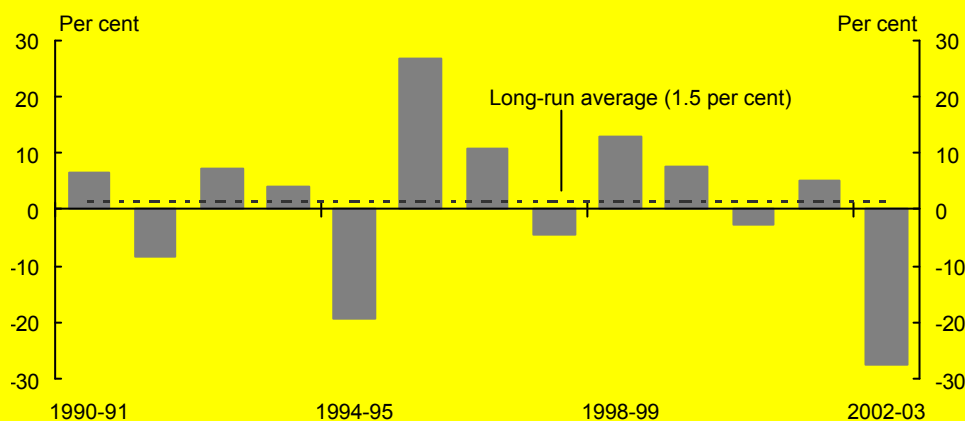
The CAD widened from 3.1 per cent in 2001-02 to 5.6 per cent of GDP in 2002-03 due to a deterioration in Australia's trade balance. This compared with a forecast of 4 per cent of GDP at Budget and 4½ per cent at MYEFO. The net income deficit, which reflects the servicing of Australia's net foreign liabilities, increased slightly to 3 per cent of GDP. The proportion of exports required to pay the interest on net foreign debt, the debt servicing ratio, declined further in 2002-03, to be 8.3 per cent in the June quarter 2003.

Box 3: The impact of the drought

The farm sector has historically accounted for around 3.5 per cent of Australian GDP, but has contributed more than one-fifth of total exports. During the course of 2002-03, severe rain deficiencies across much of Australia had a substantial adverse impact on most aspects of farm activity.

Farm production declined by around 28 per cent in 2002-03 (Chart A), subtracting around 1 percentage point from overall GDP growth. This reduced agriculture's share of GDP from 3.6 per cent in 2001-02, to around 2.5 per cent in 2002-03 — an historical low.

**Chart A: Farm GDP growth
(year average)**

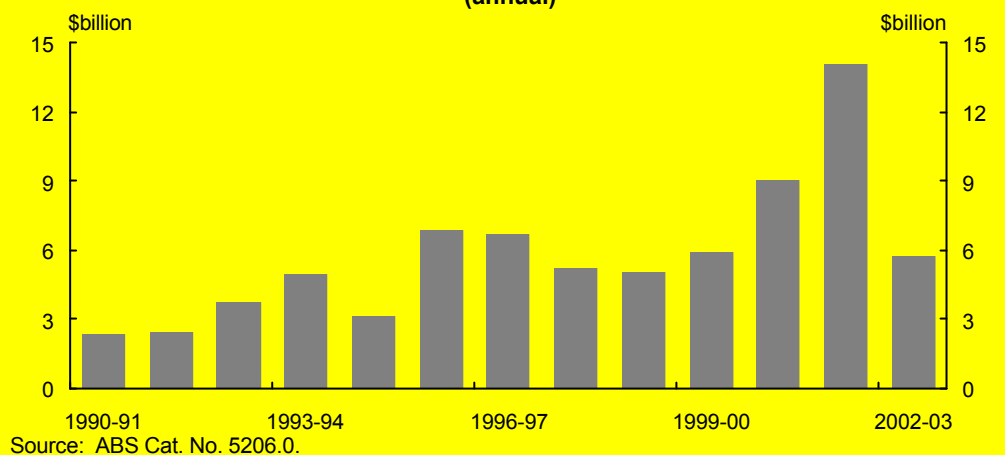


The decline in farm production was driven by a decline of around 60 per cent in the production of cereals and grains.

Rural exports declined by around 13 per cent in year-average terms in 2002-03, subtracting around 2.5 percentage points from total export growth. Cereal and grain exports declined by over 30 per cent in year-average terms.

Farm incomes declined sharply over 2002-03, down around 60 per cent in year-average terms (Chart B). The drought and the appreciation in the Australian dollar over the course of the year contributed significantly to the decline.

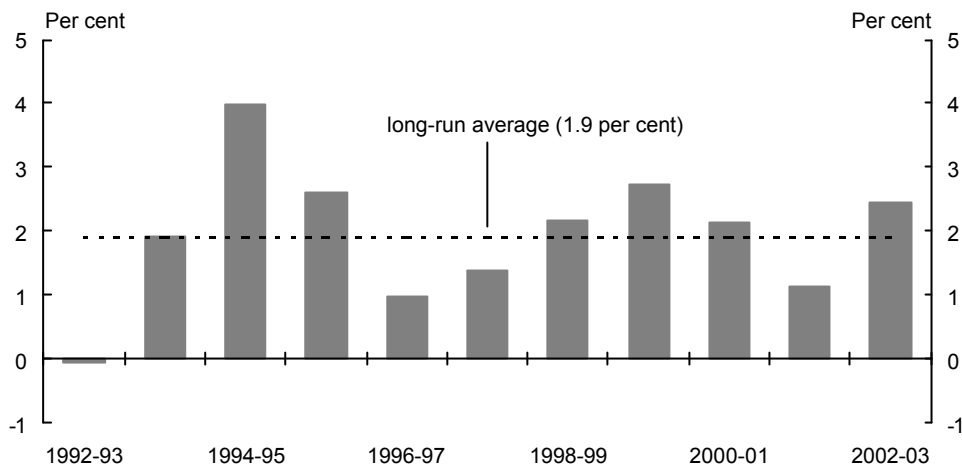
Agricultural employment declined sharply, to be around 60 000 persons lower in year-average terms in 2002-03. This followed a peak in farm employment in 2001-02, after very favourable conditions in recent years. Investment in farm machinery in 2002-03 was relatively stable, as farmers prepared for an end to the drought.

Box 3: The impact of the drought (continued)**Chart B: Agricultural income (annual)****Labour market**

In year-average terms, employment increased by 2.5 per cent or 226 500 persons in 2002-03, following growth of 1.1 per cent in 2001-02 (Chart 9). The increase in employment was underpinned by solid growth in both full-time and part-time employment, consistent with the solid outcome for non-farm GDP growth and moderate wages growth.

The strong growth in employment in 2002-03 was above the 2002-03 Budget and MYEFO forecasts of employment growth of 1¾ per cent. The higher-than-expected outcome reflected very strong employment growth in the middle part of the year.

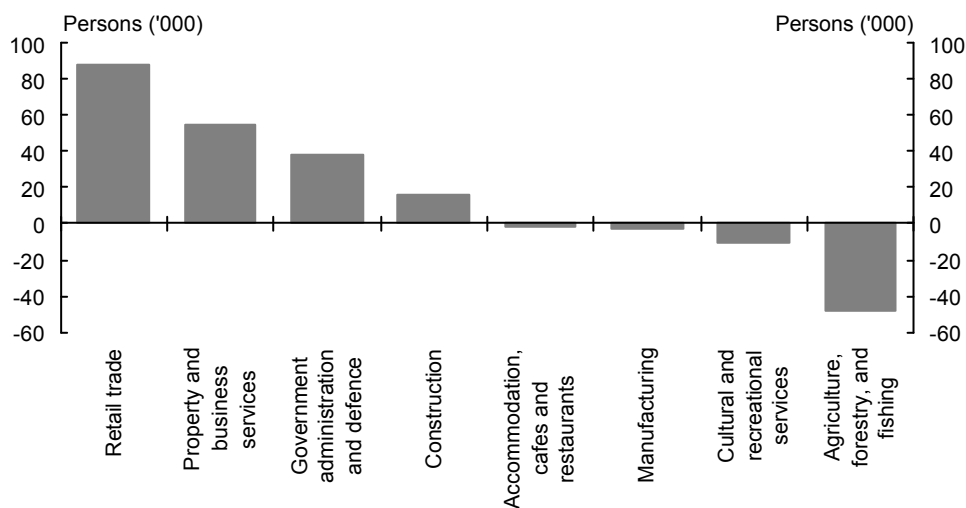
Chart 9: Employment growth (year average)



Source: ABS Cat. No. 6202.0.

Through the year to June 2003, employment growth was strongest in the retail trade, property and business services, government and construction sectors (Chart 10). In contrast, employment in agriculture declined significantly in 2002-03 due to the drought.

Chart 10: Employment growth in selected industries (level change, through the year to June 2003)



Source: ABS Electronic Publication No. 6291.0.55.001.

The unemployment rate declined from 6.3 per cent in the June quarter 2002 to 6.1 per cent in the June quarter 2003, in line with the 2002-03 Budget and MYEFO forecasts.

Wages and prices

Wages growth remained well contained in 2002-03.

The National Accounts measure of wages — average non-farm compensation of employees (AENA) — increased by 3.4 per cent in year-average terms in 2002-03. Other measures pointed to more solid wage outcomes over the past year. The Wage Cost Index (WCI) increased by 3.6 per cent in through-the-year terms in 2002-03, up from 3.1 per cent in 2001-02, while average weekly ordinary-time earnings of full-time adults (AWOTE) increased by 6.3 per cent in 2002-03, up from 5.2 per cent in 2001-02. Business surveys, including the National Australia Bank's measure of total labour costs, also pointed to a moderate increase in wages growth in 2002-03.

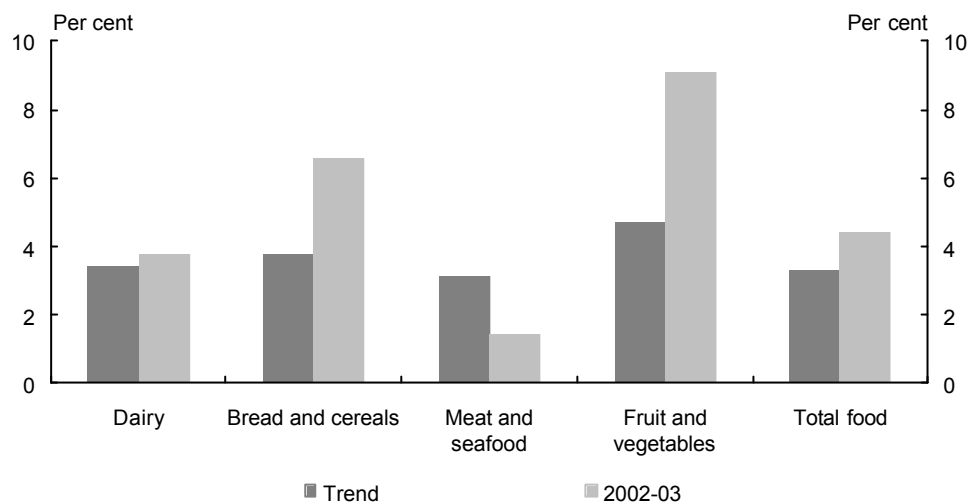
At the industry level, the education sector recorded the fastest rate of increase in the WCI in 2002-03, with growth of at 4.4 per cent in year-average terms. The average weekly earnings measures show that solid wage increases were also recorded in the manufacturing, construction, and health and community services industries.

Inflation remained moderate in 2002-03. The headline CPI increased by 3.1 per cent in year-average terms and by 2.7 per cent in through-the-year terms in 2002-03. This outcome was slightly above the 2002-03 Budget and MYEFO forecasts.

Increases in housing and food prices were major contributors to year-average inflation in 2002-03, each contributing 0.7 percentage points. The increase in the price of housing, driven by higher house purchase costs, reflected increased material and labour costs associated with strong demand in the housing market, in addition to higher insurance costs.

The drought is estimated to have contributed around $\frac{1}{4}$ of a percentage point to inflation in 2002-03, through higher food prices. This estimate primarily reflects higher-than-usual price increases for fruit and vegetables and bread and cereal products, partly offset by lower-than-usual prices for meat and seafood (Chart 11).

**Chart 11: Drought impact on food prices
(growth in selected food sub-groups^(a) ^(b))**



(a) Year end growth rates.

(b) Where trend is defined as the annual average increase in the sub-group over the past decade.

Source: ABS Cat No. 6401.0.

Notwithstanding the impact of the drought and the strength in the housing market on individual components of the CPI, general price pressures in the economy remained in check. While wages growth picked up in 2002-03, in line with the strong labour market, overall labour costs remained contained. Further, imported inflation remained subdued, reflecting weak global conditions, the ongoing fall in the prices of imported information and communication technology goods, and the appreciation of the exchange rate.

Consistent with moderate growth in the medium-term drivers of inflation, headline inflation was within the target band at June 2003.

The Reserve Bank left the official cash rate unchanged at 4.75 per cent over the course of 2002-03. This reflected the subdued inflation outlook and a balancing of domestic factors, including relatively solid growth, against the backdrop of a weak and uncertain international economic environment. Australian 10-year bond yields fell from above 6 per cent at the beginning of July 2002 to just over 5 per cent at end-June 2003, while Australian equity prices, as measured by the ASX 200 index, fell by around 6 per cent during the course of 2002-03.

In 2002-03, the Commonwealth recorded an underlying cash surplus of around \$7.5 billion (1 per cent of GDP).

Key themes from the Treasury Business Liaison Program — July/August 2003

The following article is a summary of findings from the Treasury Business Liaison Program conducted in July and August 2003.¹ Treasury greatly appreciates the commitment of time and effort made by the Australian businesses and industry associations that participate in this program.²

Overall business conditions in the non-farm sector of the economy remained strong in the first half of 2003. However, the external sector, which was affected by the drought, weak world growth and the SARS epidemic, remained weak. Contacts were generally optimistic about the outlook for 2003-04, with emerging signs that the drought is breaking and that the SARS epidemic and the war in Iraq had only a limited and transitory effect on economic activity.

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- 1 A detailed explanation of the Treasury Business Liaison Program is provided in the Treasury *Economic Roundup Spring 2001*. More recent information is contained in the February 2003 business liaison summary report in the *Economic Roundup Autumn 2003*.
 - 2 Summary reports of Treasury's business liaison reflect the views and opinions of contacts. A summary of business conditions reported by liaison contacts is provided for the information of readers. While Treasury's evaluation of the economic outlook is informed by findings from business liaison, a much wider range of information is utilised to ensure a rigorous assessment of the Australian economy.

Overview

The July/August business liaison round comprised approximately 110 interviews in Sydney, Melbourne, Brisbane, Adelaide, Perth and Canberra and a series of phone interviews.

The round focused on consumer trends, the construction industry and exports. Conditions in the farm sector continued to be monitored. Treasury met with contacts in agriculture, mining and energy, manufacturing, construction, retail, transport, tourism and accommodation, finance and other services.

In the main, contacts reported solid business performance over the past year. However, contacts in the rural sector and related industries, highlighted the negative impact of the drought on activity. The impact of international security concerns and the SARS epidemic were mixed — with some sectors suffering from reduced international travel while other sectors gained from increased domestic demand.

Most sectors recorded solid sales or production and only moderate pressure on wages and costs. In a number of sectors contacts reported that increased competition was pushing down prices and/or profits.

Contacts generally had a positive outlook for the 2003-04 but highlighted risks around the global economy and the exchange rate.

Retail and manufacturing

Following very strong activity in 2002-03, retail sales were expected to continue to grow in the year ahead, although at a lower pace.

A number of retailers noted that the recent appreciation of the Australian dollar had reduced their input costs, allowing them to recover margins without increasing prices. It was also noted that significant discounting by large retailers was keeping prices down.

Motor vehicle sales and production were reported to be very strong, and heading for another record year in 2003. The industry benefited from strong consumer confidence — driven by higher household wealth, increased access to credit and low interest rates — and the introduction of new models. Businesses were also updating their fleets with newer model vehicles.

More recently, the appreciation of the Australian dollar was a positive for car companies that are net importers in Australia. In addition to improved margins, the

appreciation allowed them to provide improved specifications in cars without raising prices (that is, providing effective price reductions).

Views on the outlook for 2004 were mixed. Some contacts anticipated higher interest rates and saturation of the domestic market, making it difficult to increase sales beyond 900,000 per year. However, other contacts remained bullish on the outlook for the industry.

Manufacturing contacts reported sound performance over the past year and were generally optimistic about the year ahead. However, conditions had been tougher in some sectors, particularly those related to rural industries.

Manufacturing companies linked to the automobile and construction industries continued to perform strongly. However, manufacturers of components for the car industry are facing increased competition from low labour cost countries, forcing them to innovate to remain competitive. The push from parent companies for best global sourcing practices and the appreciation of the Australian dollar have added to these competitive pressures.

Manufacturing companies in the pharmaceutical sector reported solid growth in their businesses with only a limited impact from the suspension of Pan Pharmaceuticals. Looking forward, contacts considered their ability to get new products listed under the Pharmaceutical Benefit Scheme to be important.

Construction

Recent business conditions were favourable for the residential sector. However, while the owner occupied segment of the market remained strong, contacts reported some quietening in the investor segment of the market. Some contacts reported no expected new project commencements for the next 1½ to 2 years. This emerging softening in sales was particularly evident in the high rise and medium-density residential segments, although sales for those with prime location remained strong.

Contacts reported that the market in Sydney remained solid, while Melbourne was 'coming off a bit'. However, forward indicators for Brisbane, such as the number of deposits taken, indicated substantial building activity was likely over the year ahead. According to contacts this strong activity is partly being driven by strong interstate migration flows into Queensland.

Work on alterations and additions remained strong, with some builders booked for up to two years. Some contacts also noted that upward pressure on construction costs was making renovations very expensive.

Key themes from the Treasury Business Liaison Program

Contacts' views on house prices were mixed, with some expecting them to plateau around mid-2004 while others noted a risk of declining prices. The scarcity of land was reported as one of the main factors behind the recent escalation in house prices. Low interest rates, the poor performance of alternative investments and buyers trying to beat further price increases were also seen by contacts as contributing factors.

The non-residential building segment, was seen by contacts as 'holding up', despite being a bit soft in some markets. For example, in Melbourne an increase in office vacancies and a fall in yields were deterring further investment activity. Some contacts expected office construction to peak by the end of 2003.

Business activity in engineering construction continued to be very strong. The outlook for infrastructure projects remained very positive with several large infrastructure projects on the horizon. Major projects in NSW include the Western Sydney Orbital, the Sydney Cross City Tunnel, the Lane Cove Tunnel and the Parramatta Rail Link.

There are also substantial resource projects currently underway; however, the outlook for new resource project commencements was uncertain. In particular, the appreciating Australian dollar and low prices for some commodities, in Australian dollar terms, had led to deferrals or cancellations of a number of resource projects. Some contacts noted that a further appreciation of the Australian dollar could increase pressure on small to medium-sized players in some segments and stem the flow of new projects.

Agriculture

Contacts expected a very strong rebound in wheat and barley crops with strong planting in South Australia and Western Australia. These high planting acreages reflect the need to generate cash and the reduced demand for grazing pastures associated with the low livestock levels.

Western Australia was reported as having its best start in 20 years with rains having commenced a month earlier than usual. In contrast, as of mid-July, parts of New South Wales, Victoria and Queensland were still experiencing dry to poor farming conditions which, combined with the appreciation of the Australian dollar, was affecting rural exports and farm incomes.

Contacts reported in mid-July that the drought through most parts of Queensland continued to have a substantial negative impact on agricultural production, particularly for cotton and the dairy industry. Some contacts also reported that uncertainty surrounding water management was putting expansion plans on hold in

the cotton industry. Although sugar production was not affected by the drought as badly as other commodities, the outlook was uncertain given low world prices and competition from Brazil.

The general view was that livestock numbers were not expected to recover fully until 2005. However, some contacts indicated that solid spring, summer and monsoonal rains could bring the recovery forward into 2004.

The aquaculture export industry was badly affected by the SARS epidemic, which reduced demand from Asia.

Mining

The outlook for mining was mixed, reflecting the improving demand for particular commodities and the impact of the appreciation of the Australian dollar.

According to contacts, demand for coking coal and iron ore — which are used in the steel industry — remains particularly strong. China is the main driver of the strong demand. Japan was also recording increases of 10 per cent per annum in steel production, adding to the strength of demand. Increased competition from Indonesia and China was reflected in a continued downward trend and 'gloomy' outlook for the price for steaming coal.

The market for aluminium was expected to be flat in 2004 but to pick up in 2005, when some contacts expect world growth to have returned to its long-run average.

The appreciation of the Australian dollar, which came on top of relatively low prices, was eroding export margins.

The regulatory treatment of greenhouse emissions remained a key concern for the mining industry, and contacts reported that it will influence investment plans.

Service industries

The year to date has been mixed for the tourism industry, with much of the drop off in international travel being offset by solid demand for domestic travel.

- The strong trading performance for the high end of the accommodation market (five stars) at the start of the year was interrupted between April and June by the SARS epidemic (which reduced overseas tourist arrivals from Asia and Europe). However, business started to pick up again in July.

Key themes from the Treasury Business Liaison Program

- The steady growth in the domestic travel segment meant that budget-type accommodation had continued to perform well.

In response to recent global trends, the industry is restructuring and consolidating, with a number of operators converting structures from hotels to serviced apartments. The outlook for the industry is positive, with forward indicators, such as room bookings, conference bookings and airline bookings, all pointing towards a strong second half of 2003.

The 2003 Rugby World Cup is expected to have a positive impact on businesses, with overseas visitors likely to stay longer and travel more widely than visitors who came for the Olympics.

Contacts in the insurance industry reported that, after a recent period of upward corrections, further price increases should more closely reflect inflation. While in general premiums were levelling out, they were still rising sharply in some segments. Profitability was returning to the industry and the outlook was considered promising.

Some contacts in the finance industry reported that activity in consultancy services had started to pick up, following two years of poor trading performance. Tax services in particular were performing strongly. Contacts also reported signs of an emerging turnaround in investment banking services, following significant consolidation over the last two years.

Employment, wages and prices

Contacts generally reported that employment intentions were expected to remain stable and positive in the near term. Hiring intentions for construction and engineering services remained particularly strong. Employment growth in the health sector was expected to remain solid. Some contacts reported that they are increasing their proportion of part time or casual labour as a means of controlling their labour costs and increasing responsiveness to changes in business conditions.

Most contacts expected wage increases to remain moderate — in line with inflation or slightly above — and to be offset by productivity gains. An increased use of bonus or performance linked payments was mentioned by a number of contacts, as a means of keeping wage costs in line with productivity gains.

The appreciation of the Australian dollar, in addition to strong competition in a number of sectors, helped constrain price pressures across the economy. Going forward, contacts expected price pressures to remain limited. The most notable exception was the construction sector, where contacts expected continuing cost and price pressures.

Treasury submission to the Senate Economics References Committee Inquiry into the Structure and Distributive Effects of the Australian Taxation System

The following article is the Treasury submission to the Senate Economics References Committee Inquiry into the Structure and Distributive Effects of the Australian Tax System. The Committee is currently undertaking a broad ranging inquiry into the taxation system (see terms of reference attached to the Submission) and is due to report by June 2004.

The submission addresses the broad terms of reference of the Inquiry. It covers the underlying principles, purpose and structure of the Australian taxation system, trends in the tax burden on individuals and companies, potential effects of taxation on economic behaviours, particularly workforce participation, and projected long term trends in Commonwealth taxation and spending based on analysis in the *Intergenerational Report 2002-03*.

Introduction

This submission outlines in broad terms the purpose of a taxation system and some general principles that should guide the development of taxation policy. The submission then addresses terms of reference (a) to (e) in turn. The terms of reference are at Attachment A.¹

Taxation is one of the most important powers of government. At Federation, the Australian Constitution explicitly vested the Commonwealth with the power to make laws with respect to 'taxation; but not so as to discriminate between States or parts of States' (s.51(ii.)) — see the discussion under terms of reference (e).

Governments generally have regard to a number of 'tax policy principles' when considering the merits of tax proposals. The principles provide a framework that can help governments improve the wellbeing of the Australian people through the provision of a well functioning taxation system. Determining the appropriate application of tax policy principles, and the trade-offs between them, are policy matters for governments.

Treasury has responsibility for advising the Commonwealth Government on taxation policy formulation and for instructing on the preparation of tax laws to give effect to the Commonwealth Government's tax policy decisions.

Purpose of a taxation system

Funding government

The fundamental purpose of taxation is to finance government spending.

Without taxes, governments could not fund expenditure in areas as diverse as defence, public order and security, education, health, social security (including family support), transport and communication, housing and community amenities, and on many other goods and services. The range of goods and services provided by governments in Australia broadly reflects the historical expectations of the Australian people. Our geography, institutions, politics, economic development and social values are among the factors that have moulded this pattern of government spending priorities over time. Some countries have lower tax rates than Australia but invariably provide a lower level of government goods, services and transfer payments.

1 Treasury has recently published a paper that contains information that is also relevant to the terms of reference: Commonwealth Treasury (2003), 'Preliminary assessment of the impact of The New Tax System', *Economic Roundup, Autumn 2003*.

Australia is one of the few countries in the world at present that fully pays for government spending without recourse to borrowing. The advantages of having a sufficient level of taxation to avoid borrowing include reduced pressure on interest rates, enhanced attractiveness for investors, and reduced future need to raise taxes to pay for interest on the stock of debt. Borrowing can be a form of taxation on future generations.

Other objectives of taxation

The taxation system can be used for other purposes beyond revenue raising. Governments can use taxes to influence social and economic outcomes, resource allocation, consumption patterns, the level and direction of savings, and the relative welfare of different groups. The Australian taxation system has an impact on the distribution of net incomes: it redistributes income through a progressive income tax system, through integration with the social security/welfare system and through the pattern of tax expenditures. As explained in more detail below, tax expenditures are concessions designed to give a targeted benefit to a specific activity or taxpayer and are a possible alternative to a direct payment. The provision of incentives through a tax concession for capital expenditure on landcare is an example of a tax expenditure.

Tax policy principles

It is generally agreed that taxes should be efficient (cause minimum distortions), equitable (fair) and simple (easily understood). A more detailed explanation of the meanings of these three tax principles is found below.

Despite the widespread acceptance of these key tax principles, their full attainment may be hindered where the objectives conflict. For example, equity objectives might entail more complex legislation, which could conflict with simplicity and possibly also efficiency objectives. Careful consideration is required when balancing trade-offs between these objectives, and as noted above, decisions on these trade-offs are policy matters for governments.

There are also issues of a more practical nature. The methodology behind the measurement of efficiency, equity, and simplicity is problematic. Further, the data necessary to inform decisions is often not available on a timely basis or is costly to obtain.²

² A more detailed discussion of the methodological issues surrounding distributional analysis is contained in the discussion under terms of reference (b).

Efficiency

The general principle is that taxes should transfer the required financial resources to government with as little disturbance as possible to the workings of the economy.

Promoting efficiency is aimed at creating a healthier and faster growing economy, with all the attendant benefits that has for employment, investment and the level of income of Australians.

In general terms, as the rate of tax increases, the adverse effects on efficiency become more severe. One way to avoid these effects while retaining the overall level of revenue is to broaden the tax base instead of raising the tax rate. It follows that a more broadly based tax system will tend to lead to less distortion in terms of the relative prices of goods and services, the relative rewards of different types of work, the relative attractions of work and leisure, and the relative returns from different types of investment and saving.

Equity

Equity, or fairness, generally is seen as having two dimensions:

- horizontal equity, which means that people in similar economic circumstances should be treated similarly; and
- vertical equity, which means that people with different means should be treated differently, with those who are better off bearing a greater share of the tax burden.

Horizontal equity

A tax that places significantly different burdens on taxpayers in similar economic circumstances is generally considered to be unfair. However, difficult questions arise in applying this principle. Should the total income of a family, which might include a number of income earners, be considered, or the income of each individual separately? What is the appropriate time period for assessing equity — should it be over a week, a year, or the life cycle of a person? There are no simple answers to these questions — they require the exercise of careful judgement.

Vertical equity

Tax systems across the world vary widely not only in their interpretation of the meaning of 'vertical equity' but also in the way they have been designed to achieve it. Vertical equity is the proposition that those who are better placed financially should bear a greater tax burden than those who have less financial resources.

A key question that needs to be addressed in the pursuit of vertical equity is the degree of progressivity that is necessary in the tax system.³ There is a wide variety of opinion on this issue.

Clearly, the balance of the overall tax system needs to be considered in determining progressivity. Progression in the tax system is usually introduced through direct taxes on income or assets. These taxes allow for adjustments to be made according to capacity to pay. Australia's personal income tax system is progressive. Commodity taxes are less easily adapted to capacity to pay, and attempts to do so through exemptions or different rates may compromise efficiency and/or simplicity. The level of vertical equity should also take into account tax-funded transfer payments from government. In Australia, many of these transfer payments, such as pensions, unemployment and sickness benefits, are carefully targeted towards those who have less financial resources.

Simplicity

A simple tax system should provide clarity, consistency and stability. While all taxes impose compliance costs on taxpayers, an effort should be made to minimise them. Greater complexity tends to impose higher compliance costs on the community and higher administrative costs on tax authorities, both in terms of monetary costs and the time and effort spent complying with the tax system.

Clarity means that taxation provisions should be sufficiently clear for taxpayers to understand the tax implications of their actions. Taxation policy should be internally consistent as well as being consistent with broader economic policy. Stability requires the direction of policy to be well articulated and understood, so that taxpayers have confidence that the broad direction of policy will be maintained.

Other considerations

Efficiency, equity, and simplicity are the traditional and fundamental criteria for tax systems. However, there are other issues that can be relevant when evaluating a tax or tax system. These include the extent to which the design of the system contributes to voluntary compliance, achieves an appropriate level of tax expenditures, aligns the tax and income support systems, and is consistent with the current fiscal strategy.

Another important element to consider is the distinction between the legal incidence of a tax (who has responsibility for remitting the tax) and the economic incidence (who

³ Progressive taxes are those where the proportion, and not just the amount, of taxes increases for higher tax brackets, that is, the average tax rate rises as income increases. Fiscal incidence and the progressivity of Australia's tax system is discussed in more detail under terms of reference (b).

effectively bears the financial cost of the tax). For instance, while a tax may be imposed at say, the business level, ultimately some or all of that tax may be paid by another class of taxpayer, such as consumers. In particular, this issue of incidence can make judgements on equity issues more difficult.

No particular priority ranking is attached to any of these general policy principles. Each criterion is relevant when assessing a tax system as a whole, or a new policy proposal, or any particular element of the tax system. However, it is the responsibility of governments to determine how to balance these principles in any particular case.

Overview of the structure of the Australian taxation system

The purpose of this section is to provide an overview of the Australian tax system — encompassing Commonwealth, State and local government taxes. This overview provides the context for the Committee's specific terms of reference.

National accrual tax revenue breakdown by level of government

In 2001-02, the total taxation revenue accruing⁴ to Australian governments (Commonwealth, State and local) was \$216.9 billion⁵ (30.4 per cent of GDP) and of this \$149.8 billion was Commonwealth taxation revenue (21.0 per cent of GDP). An additional \$27.4 billion in goods and services tax (GST) revenue (3.8 per cent of GDP) was collected by the Commonwealth on behalf of the States and Territories (States).⁶

Commonwealth Government taxes

Table 1 shows that the major components of Commonwealth taxation revenue in 2001-02 were taxes on income (79.4 per cent of total taxation revenue), indirect taxes

4 For a commentary on the statistical conventions used, see Australian Bureau of Statistics (2000), Information Paper: *Accruals-based Government Finance Statistics, 13 March 2000*, Catalogue Number 5517.0.

5 Australian Bureau of Statistics (2003), *Taxation Revenue, Australia, 2001-02*, Catalogue Number 5506.0. This amount excludes taxes paid between governments, while the amounts in Tables 1 and 2 include taxes paid between governments.

6 The Commonwealth revenue measures included in this submission differ from the Australian Bureau of Statistics' Government Finance Statistics measures by treating GST collections by the Australian Taxation Office as State tax revenue rather than Commonwealth tax revenue paid to the States as grants. This approach reflects the clear policy intent of the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, which is that the GST is a State tax collected by the Commonwealth in an agency capacity. The Commonwealth has no discretion over the expenditure of GST collections, as all tax receipts are passed to the States. However, because the GST is levied by the Commonwealth for constitutional reasons, the Australian Bureau of Statistics regards it as Commonwealth revenue.

(17.1 per cent of total taxation revenue), fringe benefits tax (FBT) and other taxes (3.5 per cent of total taxation revenue). Income tax from individuals and companies was the major source of income tax revenue, and excises made up most of the Commonwealth indirect tax revenue.

Table 1: Commonwealth Government tax revenue (accrual basis), 2001-02

	2001-02 \$m	Per cent of tax revenue %
Income tax		
Individuals and other withholding(a)		
Gross income tax withholding (b)	79,822	53.3
Gross other individuals	17,237	11.5
<i>less: Refunds</i>	10,637	7.1
Total individuals and other withholding	86,422	57.7
Companies	27,133	18.1
Superannuation funds		
Contributions and earnings	3,341	2.2
Superannuation surcharge	830	0.6
Total superannuation funds	4,171	2.8
Petroleum resource rent tax	1,306	0.9
Total income tax	119,032	79.4
Indirect tax		
Excise duty		
Petroleum products and other fuel products	12,793	8.5
Other excise	6,837	4.6
Total excise duty	19,630	13.1
Customs duty	5,214	3.5
Other indirect taxes(c)	791	0.5
Total indirect tax	25,634	17.1
Fringe benefits tax(d)	3,675	2.5
Other taxes	1,506	1.0
Total tax revenue	149,848	100.0

(a) Includes Medicare levy revenue of \$4,970 million.

(b) Includes Pay As You Go (Withholding) and other withholding. Other withholding includes amounts withheld for failure to quote a Tax File Number or an Australian Business Number, interest, dividends and royalty payments to non-residents, and payments to aboriginal groups for the use of land for mineral exploration and mining.

(c) Includes the wine equalisation tax, luxury car tax, and the final wholesale sales tax liability.

(d) Consistent with Government Finance Statistics (GFS) reporting standards, excludes fringe benefits tax collected from Commonwealth government agencies (\$360 million in 2001-02).

Source: Commonwealth of Australia (2002), *Final Budget Outcome 2001-02*.

State and local government taxes

Table 2 shows the key components of State and local government taxes (on an accruals basis) in 2001-02.

Total State and local government tax revenue was \$67.4 billion in 2001-02. The largest source of State and local government tax revenue was the GST, totalling \$27.4 billion in 2001-02, or 40.6 per cent of total State and local government tax revenue. The next most significant revenue source was property taxes, which accounted for \$19.2 billion or around 28.5 per cent of total taxes, followed by payroll taxes at \$9.7 billion or around 14.3 per cent of total tax revenue.

Table 2: State and local government tax revenue (accrual basis), 2001-02

	2001-02 \$m	Per cent of tax revenue %
Employers payroll tax	9,665	14.3
Property tax		
Taxes on immovable property		
Land taxes	2,172	3.2
Municipal rates	6,804	10.1
Other	534	0.8
Taxes on financial and capital transactions		
Financial institutions transactions taxes	972	1.4
Government borrowing guarantee levies	185	0.3
Stamp duties on conveyances	7,302	10.8
Other stamp duties	1,213	1.8
Total property tax	19,182	28.5
Taxes on the provision of goods and services (non-GST)		
Excises and levies		
Agricultural production taxes	3	0.0
Levies on statutory corporations	2	0.0
Taxes on gambling		
Taxes on government lotteries	556	0.8
Taxes on private lotteries	314	0.5
Taxes on gambling machines	2,229	3.3
Casino taxes	283	0.4
Race betting taxes	311	0.5
Taxes on gambling n.e.c.	14	0.0
Taxes on insurance	2,836	4.2
Total tax on the provision of goods and services (non-GST)	6,548	9.7
Goods and services tax(a)	27,389	40.6
Tax on use of goods and performance of activities		
Motor vehicle taxes	4,291	6.4
Franchise taxes	13	0.0
Other	303	0.4
Total tax on use of goods and performance of activities	4,607	6.8
Total tax revenue	67,391	100.0

(a) See footnote 6.

Source: Australian Bureau of Statistics (2003), *Taxation Revenue, Australia, 2001-02*, Catalogue Number 5506.0.

Responses to the terms of reference

(a) The level, extent and distribution of the current tax burden on individuals and businesses

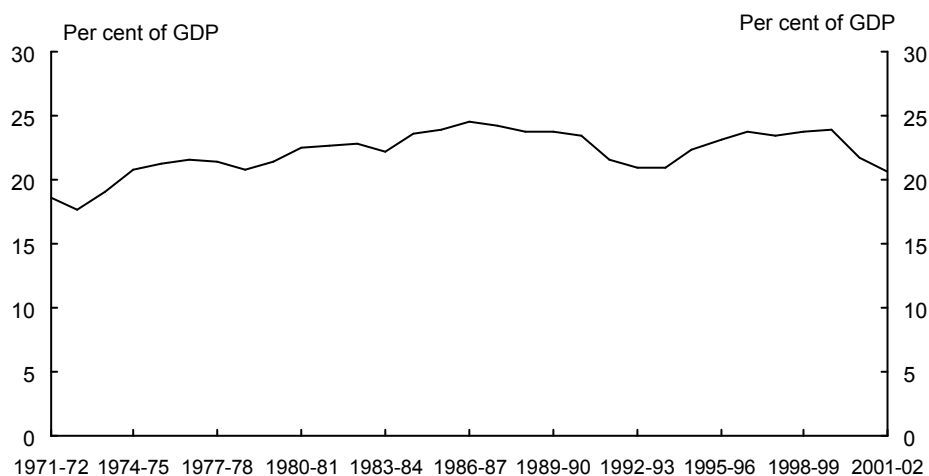
The purpose of this section is to describe the components of the tax burden on individuals and companies as well as provide information on the level and extent of these taxes over time. Comparisons over time require the use of cash rather than accrual revenue estimates because the Commonwealth only introduced accrual accounting from the 1999-2000 Budget. The analysis below covers taxes from all levels of Government: Commonwealth, State and local.

Further detail is accessible in Australian Bureau of Statistics (ABS) statistical collections on taxation⁷, Commonwealth Budget Papers, and taxation statistics published by the Australian Taxation Office (ATO).

Commonwealth Government taxes (cash)

Commonwealth taxation receipts have averaged 22.3 per cent of GDP over the last 30 years and were 20.7 per cent of GDP in 2001-02⁸.

Chart 1: Commonwealth tax revenue (cash)



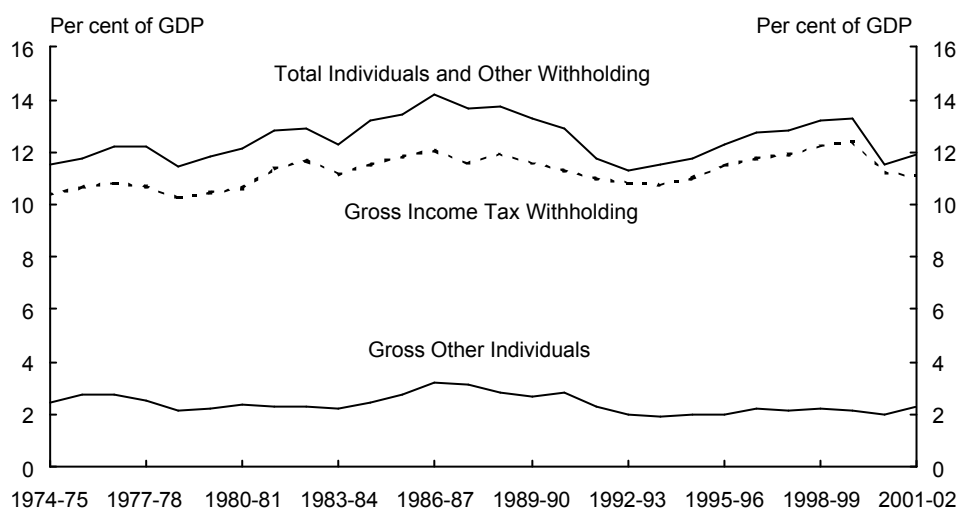
Source: Commonwealth of Australia Budget papers, various years; Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product*, Catalogue Number 5206.0, various years.

⁷ Australian Bureau of Statistics (2003), *Taxation Revenue, Australia, 2001-02*, Catalogue Number 5506.0.

⁸ This figure is on a cash basis, while the figure in the Overview section is on an accruals basis.

Income tax levied on individuals has declined from an average of 12.4 per cent of GDP during the 1990s to 11.9 per cent in 2001-02 reflecting significant personal income tax cuts. Personal income tax revenue from unincorporated small businesses in the 'other individuals' category remained relatively stable during the period (see Chart 2).

Chart 2: Income taxation of individuals (cash)^(a)

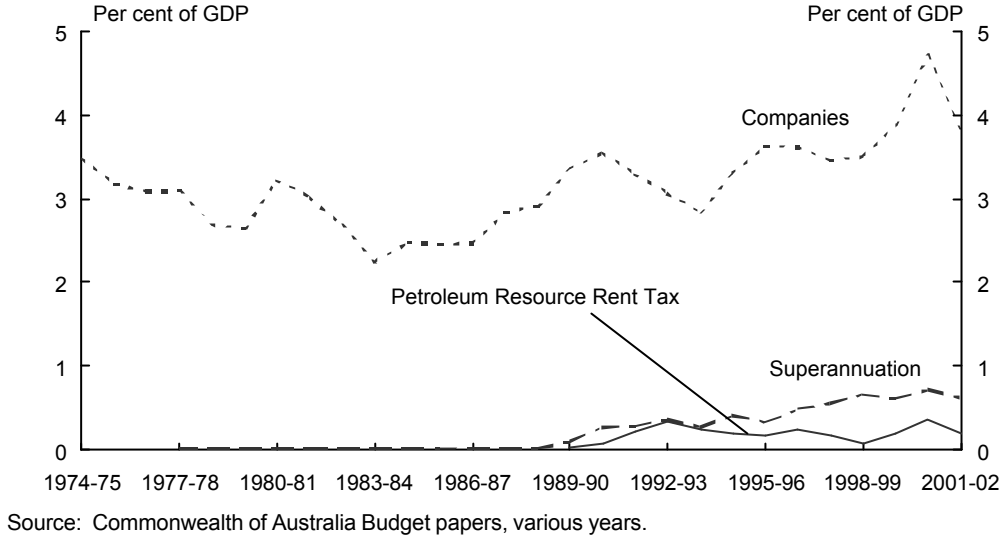


(a) The Gross Income Tax Withholding category includes all taxes withheld from payments under the Pay As You Go (PAYG) system and other withholding. The bulk of this revenue arises from tax withheld from wages and salaries. Other withholding includes amounts withheld for failure to quote a Tax File Number or an Australian Business Number, interest, dividends and royalty payments to non-residents and payments to aboriginal groups for the use of land for mineral exploration and mining. The level of Total Individuals and other withholding is reduced by the payments of individual income tax refunds. The Gross Other Individuals category includes personal income tax levied on the unincorporated sector (small business, primary producers and investors), salaries and wages (when PAYG withholding credits are insufficient to meet the tax liability assessment) and capital gains.

Source: Commonwealth of Australia Budget papers, various years.

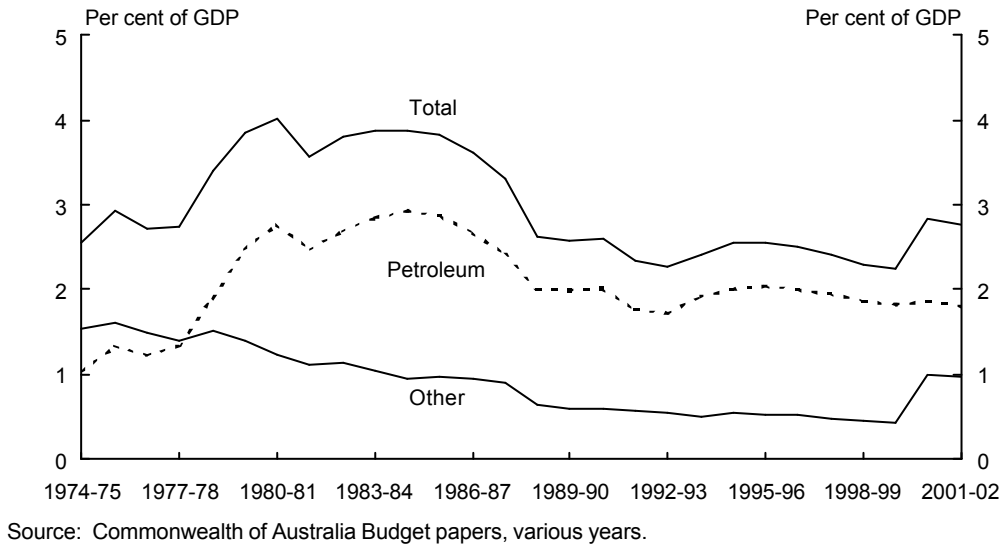
Company income tax revenue has increased as a share of GDP from 2.4 per cent in the mid-1980s to 3.8 per cent in 2001-02 (see Chart 3). This increase during the period reflects strong profit growth and significant broadening of the company tax base, offset to some extent by reductions in the company tax rate. Company tax revenue rose as a share of GDP in 1999-00 and in 2000-01 due to the introduction of the Pay As You Go instalment system which resulted in a bring forward of company tax payments in those years. This effect reflected transitional arrangements and has now been largely unwound.

Chart 3: Income taxation of corporations (cash)



There has been a reduction in excise revenue as a percentage of GDP since the mid-1980s (see Chart 4). Total excise revenue has declined from 3.8 per cent of GDP in the mid-1980s to 2.8 per cent of GDP in 2001-02.

Chart 4: Excise duties (cash)

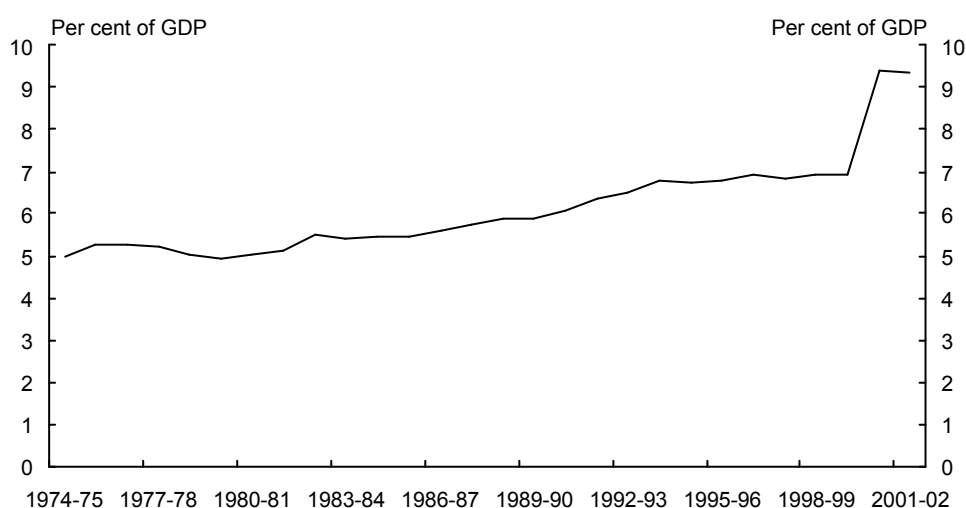


State and local government taxes (cash)

Historical trends in State and local government taxes as a proportion of GDP are shown in Chart 5. The major change in State and local government taxes in the last thirty years has been the introduction of the GST from 2000-01, which is collected by the Commonwealth and paid in full to the States. Total State and local government tax revenue increased from 5.0 per cent of GDP in 1974-75 to around 9.4 per cent of GDP in 2001-02.⁹ Apart from the GST, this increase in State and local taxation is largely attributable to revenue growth in taxes on property, namely from taxes on capital and financial transactions, and from growth in taxes on franchises.¹⁰ The growth in revenue from capital and financial transactions reflects, in part, the Commonwealth's decision to transfer the debits tax base to the States from 1 January 1991.

Commonwealth and State financial relations are addressed in discussion of terms of reference (e).

Chart 5: State and local government total tax revenue (cash)^(a)



(a) See footnote 6.

Source: Australian Bureau of Statistics.

9 As noted in the discussion under terms of reference (e), from 2000-01, Commonwealth-State financial relations have been governed by the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, which among other things, provides GST revenue to the States in exchange for the abolition of certain State taxes and Financial Assistance Grants. The Commonwealth provides the States with additional financial assistance to ensure that the States are no worse off under this new system.

10 As discussed in the section responding to terms of reference (e), State taxes on franchises were replaced by Commonwealth revenue replacement payments, and were treated as State taxes in the ABS accounting framework. These revenue replacement payments were abolished in 2000-01 as part of the reforms to Commonwealth-State financial relations.

(b) The impact of (a) on taxpayers' families

Methodological issues in distributional tax analysis

It is difficult to assess fully the impact on individuals and families of the level, extent and distribution of the current tax burden.

It is clear that the personal income tax system is progressive. Table 3 shows that in the 2000-01 income year, taxpayers in the top quintile, based on taxable income, paid 58.0 per cent of the total personal income tax paid while they received 43.6 per cent of the total taxable income received by taxpayers. Conversely, taxpayers in the bottom quintile, who received 6.3 per cent of taxpayers' total taxable income, paid only 2.0 per cent of total personal income tax paid.

Table 3: Share of personal income tax paid by taxpayers, by quintile, by taxable income, 2000-01

Quintile of taxpayer, by taxable income	Share of total taxable income of taxpayers (per cent)	Share of total tax paid (per cent)	Average tax rate (per cent)
1	6.3	2.0	7.7
2	11.6	6.5	13.6
3	16.3	12.9	19.1
4	22.2	20.6	22.4
5	43.6	58.0	32.2
All quintiles	100.0	100.0	24.2

Source: Preliminary ATO estimates.

With the introduction of *The New Tax System*, the average rate of personal income tax paid by taxpayers on their taxable income has decreased from 25.0 per cent for the 1999-2000 income year to 24.2 per cent for 2000-01. At the same time, the Government increased the first tax threshold from \$5,400 to \$6,000 and extended the tax rebate for senior Australians, reducing the number of taxpayers by around 300,000.

The distributional impact of indirect taxes, company tax and State and local government taxes on individuals and families is much more difficult to quantify.

There is also a high degree of interaction between Australia's tax and income support systems, which means that an analysis of the distributional effects of the tax system would need to take into account the effects of both the tax and benefit systems. Many social security payments are subject to special tax treatment, some being tax exempt while others are associated with tax offsets or rebates. Some payments such as Family Tax Benefit are delivered as either a fortnightly payment from Centrelink or an annual payment via the tax system. Many Australians also receive non-cash benefits through a range of concession cards and government provided services, including health and education services.

Data limitations also make it difficult to measure accurately the full impact of the tax and benefit system, or fiscal incidence on families and individuals.

Household expenditure survey and ABS fiscal incidence estimates

The ABS publishes a study of fiscal incidence following each *Household Expenditure Survey* (HES), the most recent being for 1998-99.¹¹ The *Fiscal Incidence Study* looks at the effect that regular government cash payments ('direct benefits') and subsidies for health, education, housing and welfare ('indirect benefits') have on household income distribution. The study also examines the effect that personal income tax ('direct taxes') and 'selected indirect taxes' on the production, sale, purchase or use of goods and services have on household income distribution.

The study traces the effect of benefits and taxes on income distribution by developing different measures of household income and examining the change in quintile shares of household income as more benefits and taxes are added. The different types of household income are:

- private income which is income from work and investments;
- total gross income which is private income plus direct benefits;
- disposable income which is total gross income less direct tax; and
- final income which is disposable income after indirect taxes and benefits.

Table 4 summarises the ABS findings for 1998-99. The distribution of household income taxes and benefits are shown across quintiles of household gross income, which is the most generally used measure of income by the ABS.

11 Australian Bureau of Statistics (2001), *Government Benefits, Taxes and Household Income, Australia, 1998-99*, Catalogue Number 6537.0. The ABS has advised that data from the next Household Expenditure Survey, to be conducted in 2003-04, should be available in the latter half of 2005.

Table 4: Distribution of household income taxes and benefits by gross income quintile and effect on household income, 1998-99

Share of:	Quintile 1 (per cent)	Quintile 2 (per cent)	Quintile 3 (per cent)	Quintile 4 (per cent)	Quintile 5 (per cent)
Private income	0.4	5.4	15.9	27.5	50.8
Total gross income	3.6	9.4	16.2	25.4	45.4
Total gross income plus indirect benefits	5.7	11.7	17.1	24.6	41.0
Direct tax (personal income tax)	0.2	2.3	11.9	25.4	60.1
Selected indirect taxes	9.7	14.0	18.7	25.0	32.7
Total taxes	3.1	5.9	14.0	25.3	51.6
Disposable income	4.4	11.2	17.3	25.4	41.6
Final income (after indirect taxes and benefits)	6.5	13.6	18.0	24.3	37.6

Source: Australian Bureau of Statistics (2001), *Government Benefits, Taxes and Household Income, Australia, 1998-99*, Catalogue Number 6537.0.

The ABS fiscal incidence estimates indicate that Australia's tax system is progressive, with households in the lowest gross income quintile paying 3.1 per cent of total taxes in 1998-99, while households in the highest quintile paid 51.6 per cent of total taxes. The distributions across gross income quintiles of disposable income and final income are much more evenly distributed than private income indicating that the combined impacts of Australia's tax, cash payments and subsidy systems are progressive.

However, final income per household may still understate the progressivity of the system. Low income households typically have fewer adults and persons. Table 5 shows that the distribution of final income per person is more evenly distributed than the distribution of final income per household.

In assessing these findings it is also useful to note the ABS advice that the income of the lowest income quintiles has been underestimated. The ABS has estimated that proposed corrections to welfare and business income attributed to the lowest income quintiles in the 1998-99 HES would result in 'the mean income of the lowest income quintile being revised upwards by about 11 per cent, and that of the second lowest quintile being revised upwards by about 2 per cent'.¹² Furthermore, the ABS *Fiscal Incidence Study* does not allocate some taxes, such as capital gains tax which is likely to mainly impact on higher income earners. The implication is that a more complete study, incorporating corrections proposed by the ABS and a wider range of taxes, would find greater redistribution.

12 Australian Bureau of Statistics (2002), *Australian Economic Indicators, April 2002*, Catalogue Number 1350.0.

Table 5: Distribution of household residents by gross income quintile and per capita final income, 1998-99

Share of:	Quintile 1 (per cent)	Quintile 2 (per cent)	Quintile 3 (per cent)	Quintile 4 (per cent)	Quintile 5 (per cent)
Persons in households	11.4	17.4	20.5	23.5	27.3
Dependent children in households	5.7	17.1	25.7	25.7	25.7
Final income per person	12.3	16.8	19.0	22.3	29.7

Source: Australian Bureau of Statistics (2001), *Government Benefits, Taxes and Household Income, Australia, 1998-99*, Catalogue Number 6537.0.

The extent of redistribution accomplished through the interaction of the tax and benefit system is also partly demonstrated by the change in the type of household in each quintile over time. While the lowest quintile now comprises largely single or younger people this was not the case 15 years earlier. In 1984-85 the proportion of aged people and sole parents in the lowest quintiles was much higher. Changes to the tax and benefit system that have targeted these groups have coincided with a growing proportion of aged people and sole parents in the second quintile.

Other researchers rely on data from the HES as a basis for their own analysis of fiscal incidence. The HES and the resultant ABS analysis have a number of limitations arising from the survey and its coverage of taxes. The most recent study allocates 53 per cent of total government revenue and 50 per cent of total government expenditure to the household sector.

Other distributional tax analysis results

A study of fiscal incidence in 1996-97 by Professor Ann Harding and Dr Neil Warren concluded that the overall impact of the tax system was progressive. The study also found that the total tax burden is relatively stable across the lifecycle until retirement.¹³

When *The New Tax System* was introduced on 1 July 2000, the tax-free threshold was increased to \$6,000 per annum, and the first marginal tax rate was reduced to 17 cents in the dollar, benefiting many low income earners. A recent study by the National Centre for Social and Economic Modelling (NATSEM) and Professor Neil Warren found that,

the net impact of the taxes and outlays examined is to dramatically reduce national income inequality, with the Gini coefficient¹⁴ more than halving as the definition of income is expanded from equivalent private income to equivalent final income.¹⁵

Treasury recently published its own preliminary assessment of the impact of *The New Tax System* including a population distributional analysis of tax reform, comparing real disposable incomes before tax reform and about one year after tax reforms were introduced. Treasury analysis showed that families with children and working families in lower income brackets saw the greatest proportional increases in their real disposable incomes following tax reform (Table 6).¹⁶

Table 6: Proportional increase in real average weekly disposable income^(a) by family type and quintile, 1999-00 and 2000-01

Quintile	Couple without children	Retired pensioner couple	Couple with children	Self-funded retiree	Retired pensioner single	Single person in the labour force	Sole parent
	%	%	%	%	%	%	%
1	4	7	8	5	7	5	13
2	2	7	8	6	7	0	12
3	1	6	4	5	6	1	11
4	1	6	4	3	6	2	8
5	2	10	2	2	7	3	4

(a) Records with the bottom 10 per cent of disposable income were excluded following ABS practice as the ABS has 'concerns with the fact that the extremely low incomes (close to nil or negative) recorded for some households in this group do not accurately reflect family living standards' (ABS, 2002).

Source: STINMOD and Treasury calculations.

International comparison

Comparison of the tax burden and redistributive effects of tax and benefits systems across countries is problematic. In most OECD countries employees and employers contribute significantly to the financing of the social security system. Social security contributions are generally distinguished from income tax, but are used to fund income support payments similar in nature to those that are provided out of general revenue in Australia. Therefore, it is generally more appropriate to compare the Australian personal income tax burden with the combined burden of income tax and employees' social security contributions in other countries.

13 Harding, A., and Warren, N. (1999), *Who pays the tax burden in Australia? Estimates for 1996-97*, Discussion Paper No. 39, National Centre for Social and Economic Modelling (NATSEM), University of Canberra.

14 The Gini co-efficient is a measure of inequality. The lower the Gini co-efficient, the lower the level of inequality.

15 Harding, A., Warren, N., Beer, G., Phillips, B. and Osei, K. (2002), *The Distributional Impact of Selected Commonwealth Outlays and Taxes*, 14 March 2002, Draft Paper prepared for the Review of Commonwealth-State Funding, National Centre for Social and Economic Modelling, University of Canberra, p 2.

16 Commonwealth Treasury (2003), 'Preliminary assessment of the impact of The New Tax System', *Economic Roundup*, Autumn 2003.

An OECD study on income distribution and poverty in 1998 found that 'direct taxes paid by individuals and public transfers substantially reduced income inequality and poverty in all the countries examined' and that poverty appeared to have fallen in Australia and a number of other OECD countries over the period from the mid-1980s to mid-1990s.¹⁷

In 2002-03, the OECD estimates that a single Australian taxpayer on the average production wage faces a tax burden (net of cash transfers) of 23.6 per cent. This is comparable with the OECD estimates of the tax burden (net of cash transfers) faced by a similar taxpayer in the USA (24.3 per cent) and UK (23.3 per cent), and lower than that faced in Canada (25.7 per cent) and France (26.5 per cent).¹⁸

(c) The use and efficacy of various tax and expenditure incentives to influence social and economic conduct, for instance participation in the workforce

Behavioural responses to tax and expenditure incentives

Changes in taxation, including tax expenditures, can be expected to result in changes in taxpayer behaviour. Broadly, imposing a tax on a good or service will raise its price, and generally be expected to reduce its demand or supply. Conversely, a tax expenditure through concessionary tax arrangements can be expected to increase demand or supply. The extent of these impacts depends on issues such as how responsive behaviour is to changes in price, the extent of income effects from those who own the good or service, and also who carries the final incidence of the taxation measure.

As discussed in the introduction, efficient taxes aim to distort economic choices as little as possible. On occasions, however, the market price of goods and services may not adequately reflect both private and social costs. Taxation is one of a suite of tools that can be used to 'correct' the price of market goods to include social external costs. External costs may include pollution, potential community safety risks, or behaviour that imposes burdens on the health system.¹⁹

Care must be exercised in using tax instruments as sometimes the costs of imposing the measure can exceed the costs of initial problem. These compliance costs to society

17 Burniaux, J., Dang, T., Fore, D., Forster, M., d'Ercole, M. and Oxley, H. (1998), *Income distribution and poverty in selected OECD countries*, Economics Department Working Papers No. 189, Organisation for Economic Co-operation and Development (OECD).

18 OECD (2003), *Taxing Wages 2001-2002*.

19 For example, Pigovian taxation allows external costs (for example, pollution) to be 'internalised' (or paid for) by the imposition of a tax on the polluters at a rate that just compensates the community for the pollution in monetary terms.

are not necessarily confined to transaction costs; they can also include potential efficiency losses.

In the same way as taxes can provide a disincentive for certain behaviour, tax expenditures can be used in certain circumstances to motivate desired changes in taxpayer behaviour or to promote social policy objectives. Treasury's *Tax Expenditures Statement* documents the nature and extent of tax expenditures in Australia.²⁰

Efficacy of tax and expenditure measures to influence social and economic conduct
Assessing the efficacy of tax and expenditure measures in achieving behavioural change is a complex task. It involves identifying the original aim of the tax or concessions concerned and then evaluating whether that aim has been achieved, usually on a case-by-case basis. There are difficult issues in determining what would have happened in the absence of the particular policy measure, and establishing the degree of causation between the policy measure and an actual change. Often there is a lack of data to inform the analysis.

Assessments of tax measures may range from a simple determination of whether particular goals set have been met, to an econometric analysis of whether a concession has had a measurable impact on taxpayer behaviour and whether that difference is in the desired direction. The analysis could examine any unexpected side effects of a measure, alternative methods by which the objectives could have been achieved (such as education or improved information flows), and possibly even whether doing nothing would have been the preferred option.

In evaluating the effectiveness of a tax expenditure, consideration should be given to whether alternative policy measures could more effectively meet the objectives. In addition, an evaluation should be made of whether a tax expenditure is the simplest and most efficient method, or whether it would be better to deliver assistance via a direct Budget outlay by a programme delivery agency.

Workforce participation

Labour force participation can be understood as one of the three key drivers of economic growth in Australia (the others being population and productivity).

By international standards, the participation rate in Australia among women generally and the mature aged is low. The structure of the tax and retirement income systems (as well as the income support system and other policies) should take account of their impacts on labour force participation.

²⁰ The *2002 Tax Expenditures Statement* is available at:
<<http://www.treasury.gov.au/documents/505/PDF/TES2002.pdf>>

Economic theory suggests that there are two primary effects that a tax change can have on the decision to participate in the workforce. The first of these is a 'substitution effect'. If there were no changes other than a fall in tax rates, hourly take home pay levels would increase. This change in take home pay rates²¹ would be expected to provide incentives for an increase in participation. At least partially offsetting this impact is an 'income effect'. The fall in tax rates would mean that a worker would not have to work as many hours to earn the same level of income.

One measure of the impact of taxation on income is the concept of the 'effective marginal tax rate' (EMTR). EMTRs measure the percentage of a one dollar increase in income that is lost to income tax and income tests on government payments and services. While high EMTRs are thought to provide a disincentive to earn additional income, it is not generally possible to isolate fully the actual influence of EMTRs on workforce participation.²²

With the introduction of *The New Tax System*, the Government reduced effective marginal tax rates (EMTRs) for low income families. The lowest marginal tax rate was reduced to 17 per cent, and taxpayers that had previously experienced 34 per cent and 43 per cent marginal tax rates had their top tax rate reduced to 30 per cent. Changes in tax thresholds also meant that the vast majority of Australian taxpayers were in the very broad tax bracket from \$20,001 through to \$50,000. At the same time, the income test taper rate on family payments for low income families (Family Tax Benefit (Part A)) was reduced from 50 per cent to 30 per cent, and the income test taper rate on pensions was reduced from 50 per cent to 40 per cent.

Although high EMTRs can still occur as a result of interactions between the tax and social security system, studies have shown that only a small proportion of the population experience them. A recent NATSEM study found that in 2002, since the introduction of *The New Tax System*, only 8 per cent of people faced EMTRs in excess of 60 per cent, and only 1 per cent faced EMTRs in excess of 80 per cent. NATSEM estimated that in 1997, under the previous tax system 3 per cent of people faced

21 Technically, the tax cut would change the relative price between labour income and alternative uses of time.

22 Recent literature suggests that generally labour supply decisions involve a dynamic assessment, in which individuals take account of both current and future wages in making employment choices, rather than focussing on immediate EMTRs or replacement rates see Chapman, B., Jordan, J., Oliver, K., and Quiggan, J. (2001), *Unemployment traps and age-earnings profiles: estimates for Australia 2000*, Australian Journal of Labour Economics 4(3), pp 174-91.

EMTRs in excess of 80 per cent, including 1 per cent who had EMTRs in excess of 100 per cent.²³

Another key consideration in assessing the tax system and workforce participation is the impact of an increasingly internationally mobile workforce. For some people, there is significant flexibility in determining the country in which they will work. This provides scope for individuals to choose their preferred balance between the level of taxation and the provision of government goods and services. The design of the structure of the Australian tax system needs to take account of the impacts of this globalisation on parts of the workforce.

Other social and economic behaviours

The Government has identified nine high priority whole of government policy issues to be examined in depth in the current year and beyond.²⁴ Several of these affect the social and economic conduct of Australians, namely: balancing work and family life; the demography of Australia; and education.

With regard to work and family life, the Government has established an inter-departmental Taskforce to review the options that might better facilitate choice for families in balancing work and family lives. The Demographics Taskforce will follow up the work undertaken in the *Intergenerational Report*²⁵ in recognising and preparing for population ageing issues. In developing education reforms out of the Review of Higher Education, the Government will be guided by the principles of diversity, quality, equity and sustainability.

It is possible that the Government may choose to use the taxation/social welfare system to deliver possible changes that might emerge from these policy refinement and review processes.

23 Beer, G. (2002), *Work incentives under a New Tax System: the distribution of effective marginal tax rates in 2002*, NATSEM conference paper 12/2002, paper presented to the 2002 Conference of Economists, 30 September — 3 October 2002.

24 For details of the nine areas of government policy focus, see the Hon John Howard MP, Prime Minister, Address to the Committee for Economic Development of Australia 'Strategic Leadership for Australia Policy Directions in a Complex World', 20 November 2002, available at <<http://www.pm.gov.au>>.

25 For a discussion of the findings of the *Intergenerational Report*, see the discussion under terms of reference (d).

- (d) The long term social and economic impact of the current distribution of taxation, government spending and employment including the intergenerational consequences of the tax structure

The Government reported to the Parliament on the long-term fiscal outlook for Australia in its *Intergenerational Report*, released as Budget Paper No. 5 for 2002-03. The projections in this section of the submission are taken from the *Intergenerational Report*.²⁶

The *Intergenerational Report* pointed to demographic changes that will put pressure on government spending in the future, notably the ageing of the 'baby boom' generation and declining fertility rates. By 2042, around 24.5 per cent of Australia's population is expected to be aged over 65, reflecting the ageing of Australia's 'baby boomers', with lower mortality rates than previous generations.

At the same time, the total fertility rate of Australian females has declined. Since the mid-1970s, the total fertility rate has been well below the rate needed for population replacement. The trend towards having fewer children, later in life, is a key influence on Australia's changing population structure. The number of children born to women aged 30 to 39 is increasing, but this does not fully compensate for the decline in the number of children born to women aged 20 to 29. Based on recent trends, the total fertility rate is projected to fall to 1.6 (births per woman) by 2042.

Growth and productivity

GDP projections depend critically on productivity assumptions. The *Intergenerational Report* provided high, base case and low productivity growth scenarios starting in 2006-07.

Table 7 shows projected GDP growth over the next four decades. This table reflects the interaction of changes in productivity assumptions, while maintaining the same population and participation projections. The high productivity scenario uses a productivity growth rate similar to the 1990s (that is, 2.0 per cent per year), the base case scenario assumes the average rate of productivity growth over the last 30 years of 1.75 per cent per year, while the low growth scenario uses a productivity growth rate similar to that experienced in the 1980s (that is, 1.2 per cent per year).

26 Commonwealth of Australia (2002), *Intergenerational Report*, Budget Paper No. 5, 2002-03 available at <<http://www.budget.gov.au/2002-03/html/index.html>>.

Table 7: Average real annual GDP growth rates (per cent) under different productivity growth scenarios

Decades	High Productivity growth in scenario	Base case	Low productivity growth in scenario
2000s	3.2	3.1	2.9
2010s	2.6	2.3	1.8
2020s	2.2	2.0	1.4
2030s	2.1	1.9	1.3

Source: Commonwealth of Australia (2002), *Intergenerational Report*, Budget Paper No. 5, 2002-03.

Real GDP per person, an indicator of the growth in living standards, is projected to be 2.1 per cent this decade and slow to 1.4 per cent by the 2020s, under the base case scenario.

Employment projections

The rate of growth in the labour force is expected to decline, perhaps significantly, in response to population ageing, although the outcome will be influenced by future trends in labour force participation that are difficult to forecast. Unemployment is projected to decline to 5 per cent by 2006-07 and then to remain stable. With the slowdown in labour force growth it will become increasingly important to examine whether there are any distortions in the labour market, and their interaction with government policies, including taxation arrangements, that might affect participation rates.

Government spending projections

Over half of Commonwealth government spending is directed to health and aged care, social safety net payments to individuals and education. This spending is sensitive to demographic changes. The projections in the *Intergenerational Report* show that spending in health and aged care and social safety net payments to individuals are likely to grow relative to GDP. However, education spending as a proportion of GDP is likely to fall as a consequence of the ageing population. Areas of Commonwealth spending that are less demographically sensitive, such as defence and the environment, are assumed to remain constant as a proportion of GDP.

Taxation revenue — intergenerational consequences

Over the last three decades, Commonwealth taxation revenue has remained relatively steady as a proportion of GDP. For the *Intergenerational Report*, Commonwealth taxation revenue was projected to remain constant at 20.8 per cent of GDP from 2005-06 to 2041-42.

Tax revenue is less likely to change as a percentage of GDP due to demographic change than government spending. Personal income tax revenue does not fall as a percentage of GDP as the population ages, because labour force and wages growth

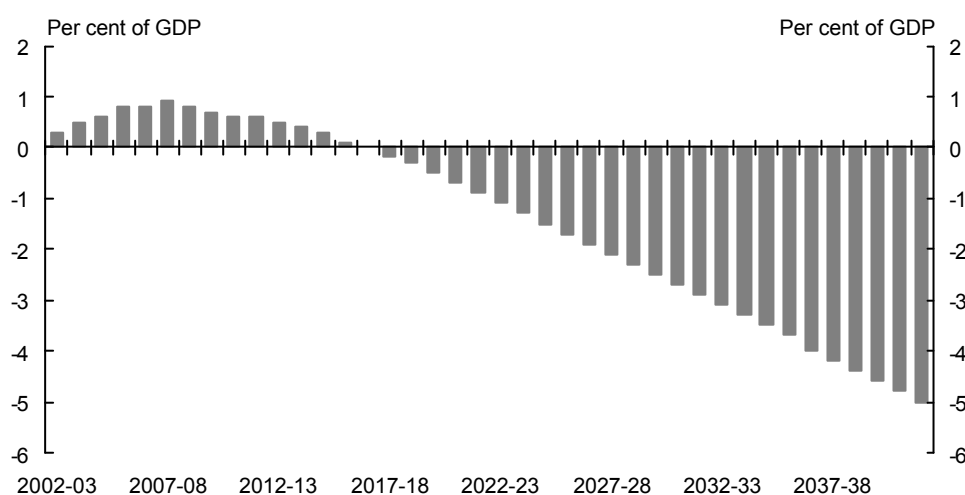
trends affect income tax and GDP growth more or less equally. GST revenue is less at risk from demographic change than other forms of indirect tax due to a broad base that includes many services.

Growing gap between spending and revenue

Chart 6 shows the net fiscal impact of tax revenues remaining relatively constant for the next forty years while government expenditures on health, aged care and income support are predicted to rise significantly as a proportion of GDP.

By 2041-42, the gap between spending and revenue was projected to grow to 5.0 per cent of GDP. Using the *Intergenerational Report* assumptions, to prevent the budget moving into deficit, an extra \$87 billion more would need to be collected from taxpayers by 2042, or governments would need to reduce the projected growth in spending.

Chart 6: Projection of the fiscal pressures in Australia^(a)



(a) Measured as the difference between projected spending and revenue as a percentage of GDP, without adjustment of public debt interest beyond the 2002-03 forward estimate period.

Source: Commonwealth of Australia (2002), *Intergenerational Report*, Budget Paper No. 5, 2002-03.

(e) The respective roles of the Commonwealth and the States in relation to the collection and distribution of tax revenue

Constitutional aspects

The Constitution explicitly vests the Commonwealth with power to raise taxation on the proviso that this power not be used to discriminate against States or parts of States (s.51(ii.)). The Constitution also vests the Commonwealth with exclusive responsibility for customs and excise (s.90) but again this power cannot be used to give preference to one State or part of a State over another (s.99).

The States retain the power to impose taxes, other than customs and excise, on persons, events or things connected with the State.

Collection and distribution of income tax revenue

Since the enactment of uniform tax legislation in 1942 only the Commonwealth has levied income tax. Income taxes — on companies and individuals — account for around 80 per cent of total Commonwealth tax revenue.

Uniform national income taxes provide a fair and reliable tax base and achieve administrative efficiencies in tax collection while simplifying taxpayer compliance.

The Commonwealth made grants totalling \$26.3 billion to State and local governments in 2001-02, mainly in the form of specific purpose payments.²⁷

Collection and distribution of additional taxes on alcohol, tobacco and petroleum

Until 1997, the States levied business franchise fees (taxes) on the sale of certain alcohol, tobacco and petroleum products. On 5 August 1997, a High Court ruling cast into doubt the constitutional validity of all State business franchise fees.²⁸ On 6 August 1997, at the unanimous request of the States, the Commonwealth announced 'safety net' arrangements to protect States' finances. These arrangements provided for the Commonwealth to increase the rates of existing Commonwealth taxes and provide the additional revenue collected under these arrangements to the States (less administrative costs) as revenue replacement payments (RRPs). These RRP's have always been treated as State taxes under Commonwealth accounting.

Commonwealth-State financial relations under *The New Tax System*

Since *The New Tax System* came into effect on 1 July 2000, Commonwealth-State financial relations have operated under the framework of the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the Intergovernmental Agreement) which was endorsed by Heads of Government in June 1999.

A key element of *The New Tax System* is that all revenue from the GST is received by the States to be spent according to their own priorities. GST revenue is distributed between the States according to the principles of horizontal fiscal equalisation. This principle is that 'the States should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the

²⁷ Details of Commonwealth payments to the States are published in Commonwealth of Australia (2002), *Final Budget Outcome 2001-02*.

²⁸ *Ha v New South Wales* (1997) 189 CLR 465.

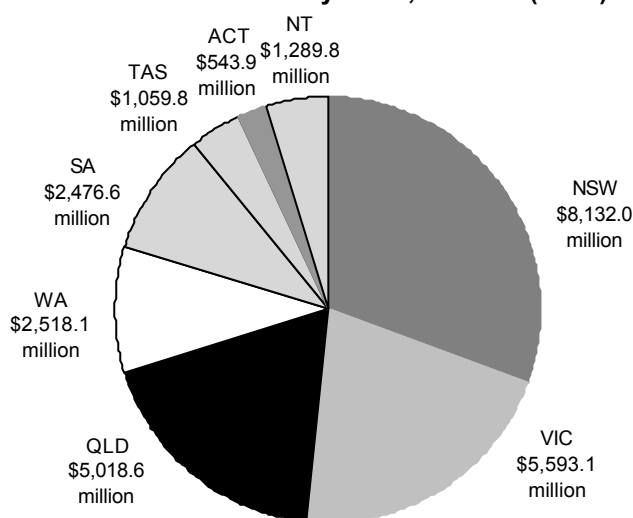
same level of efficiency, each would have the capacity to provide services at the same standard²⁹.

The Intergovernmental Agreement provides for the abolition of a number of less efficient State taxes. Most notably, financial institutions duty and stamp duty on quoted marketable securities were abolished from 1 July 2001, whilst debits tax is to be abolished by 1 July 2005, subject to review by the Ministerial Council which oversees the implementation of the Intergovernmental Agreement (NSW abolished debits tax on 1 January 2002). Under the Intergovernmental Agreement, the States no longer receive financial assistance grants and RRP from the Commonwealth.

The Commonwealth made a commitment to provide assistance to the States in the transitional years to ensure that each individual State would be no worse off than it would have been had *The New Tax System* reforms not been implemented.

The States received \$26.6 billion in GST (cash) revenue in 2001-02.³⁰ Chart 7 illustrates the GST revenue provision to each State in that year.

Chart 7: GST revenue by State, 2001-02 (cash)



Source: Commonwealth of Australia (2002), *Final Budget Outcome 2001-02*.

29 Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1999*, Volume 1, Main Report, p 4.

30 As determined by the Commissioner of Taxation. As noted in the Overview, the accruals measure of GST revenue was \$27.4 billion in 2001-02.

Administration of the GST

The GST is collected by the ATO for the States. Since many Australian businesses operate on a national basis, it is more effective for the GST to be administered by a single national agency rather than by requiring businesses to remit multiple returns to offices of state revenue. The administration of GST by the ATO capitalises on the ATO's extensive national infrastructure.

The States compensate the Commonwealth for the costs of collecting and administering the GST. The Commissioner of Taxation has a Performance Agreement with the States that came into operation on 1 July 2002, the purpose of which is to provide accountability of the ATO to the States, on behalf of whom the GST is collected. Administrative policy for the GST is determined through the Ministerial Council for Commonwealth-State Financial Relations, comprising the Commonwealth Treasurer and each State and Territory Treasurer.

Attachment A: Terms of reference

Senate Economics References Committee The Structure and Distributive Effects of the Australian Taxation System

The Senate has referred the following matter to the above Committee for inquiry and report by June 2004:

The structure and distributive effects of the Australian taxation system with reference to:

- (a) the level, extent and distribution of the current tax burden on individuals and businesses;
- (b) the impact of (a) on taxpayers' families;
- (c) the use and efficacy of various tax and expenditure incentives to influence social and economic conduct, for instance participation in the workforce;
- (d) the long term social and economic impact of the current distribution of taxation, government spending and employment including the intergenerational consequences of the tax structure;
- (e) the respective roles of the Commonwealth and the States in relation to the collection and distribution of taxation revenue; and
- (f) any other relevant issues which may arise in the course of the inquiry.

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East Asian capital flows

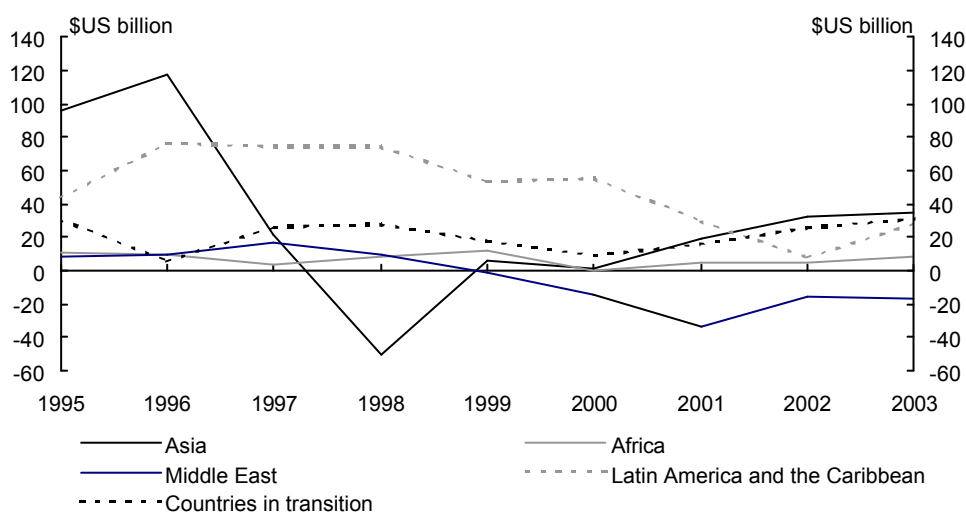
Financial flows to East Asia have changed markedly in size and composition over the last decade. Foreign direct investment now dominates capital inflows with new foreign bank lending and portfolio investment remaining subdued. Foreign direct investment to China has grown rapidly since the early 1990s and competition within East Asia for foreign investment is intensifying. This article considers the factors that have influenced capital flows into East Asia over the past decade, with an emphasis on foreign direct investment.

East Asian capital flows

East Asia's economic development has relied on strong rates of capital accumulation over the past 30 years.¹ Inflows of foreign capital have supplemented the region's large pool of domestic savings to fund investment, especially in Southeast Asia. The East Asian financial crisis brought to the fore the importance of appropriate policies to attract and sustain domestic and international flows of capital.

In the early 1990s, strong rates of economic growth and the liberalisation of investment regimes across much of East Asia spurred strong private capital inflows as foreign investors sought out high rates of return. The 1997-98 East Asian financial crisis saw a dramatic withdrawal of capital from the region as investors and firms fled. Flows have picked up gradually since then, albeit against the backdrop of the global economic downturn in 2001 and the end of the technology bubble (Chart 1).

Chart 1: Net private capital inflows^(a)



(a) The definition of Asia used by the IMF for net capital flows includes developing Pacific Island economies, South Asian and Central Asian developing economies as well as the East Asian economies discussed in this paper.

Source: IMF World Economic Outlook, September 2003.

Still, for many regional economies, inflows of foreign capital remain well below pre-crisis levels. Portfolio investment is showing recent signs of recovery, but lending by foreign banks to the region remains flat, at best. Inflows of foreign direct investment (FDI) to East Asia have intensified in recent years, in large part drawn by China's low labour costs, strong growth and its entry into the World Trade Organisation.

1 In this paper East Asia is Korea, Taiwan, Hong Kong, China, Indonesia, Thailand, Malaysia, Singapore and the Philippines.

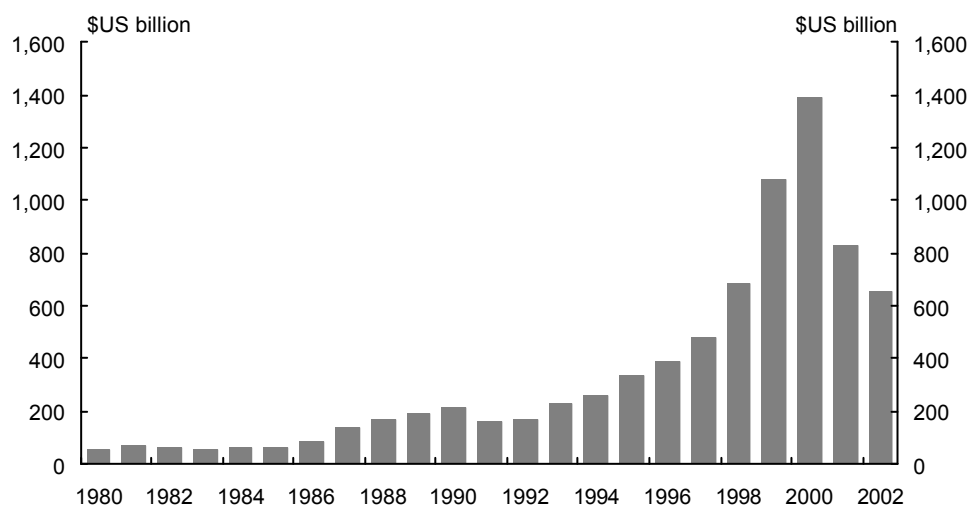
This article examines trends in foreign capital flows, with a primary focus on developments in FDI. It discusses the development of FDI as the key source of capital flow to East Asia and the role that FDI has played and is playing in the development of East Asian economies. China's role as the major regional recipient of global FDI and as an important driver of intra-regional FDI are also considered. The paper also briefly discusses portfolio and bank lending, alternative sources of finance for the region, but which have fallen in relative importance since the East Asian financial crisis.

Foreign direct investment

Foreign direct investment into East Asia increased substantially over the past two decades in response to sustained strong growth, economic development and market liberalisation. By 1993, non-Japan East Asia was receiving over 60 per cent of developing country FDI inflows and over one-fifth of global FDI.

Post-crisis, the sale of distressed banking and corporate assets drove a temporary surge in regional FDI, but excluding China, the region has struggled to attract consistent strong inflows of new FDI since. Global FDI flows tripled between 1997 and 2000, driven by a boom in merger and acquisition activity, mainly between the United States and Europe (Chart 2). Over the same period, FDI to non-Japan East Asia also continued to grow rapidly, although East Asia's share of global flows fell to just under 10 per cent, and its share of developing country FDI fell to around 55 per cent.

Chart 2: Global net inflows of foreign direct investment



Source: United Nations Conference on Trade and Development, World Investment Report 2003.

East Asian capital flows

Over the last two years, global FDI flows have fallen significantly, in line with the slowing global economy and the drying up of merger and acquisition activity across developed countries. FDI to East Asia has also eased, although not to the same degree and remains the dominant form of foreign capital inflow.

The role of FDI in the development of East Asia

Historically, Japan, Korea and Taiwan have not had a strong reliance on FDI, as domestic firms dominated the export sector and governments preferred to rely on strategic alliances and the importation of capital goods as a means of acquiring skills and technology. Over the period 1989-94, FDI contributed 5.6 per cent to fixed investment in Northeast Asia (Japan, Korea, Taiwan and Hong Kong), and 13.3 per cent in ASEAN 5 (Singapore, Malaysia, Indonesia, Thailand and the Philippines). By the late 1990s, this pattern had changed. FDI was contributing around 17 per cent to fixed investment in Northeast Asia, and 19 per cent in the ASEAN 5. Northeast Asian economies have become more open to FDI as service sectors have become more important, and as FDI restrictions were liberalised in the wake of the financial crisis, especially in Korea.

FDI has always played a significant role in the economic development of Southeast Asia, especially Singapore. In 2002, Indonesia's stock of FDI to GDP ratio was 32 per cent, Malaysia's 60 per cent, Thailand's 24 per cent and Singapore's 143 per cent. But inflows to Southeast Asia were disrupted by the financial crisis and inflows have yet to return to their pre-crisis levels. In Indonesia, there has been a net outflow of FDI since 1998 although the rate of disinvestment is easing. FDI flows to Malaysia and the Philippines picked up slightly in 2002, but remain well below pre-crisis levels.

FDI is playing an important role in the economic development of China — China's FDI to GDP ratio was around 35 per cent in 2002 — and FDI inflows continue to be very strong. China offers many of the conditions that investors like, certainty of decision making, high skill levels, a large and strongly growing domestic market, and cheap labour. But at just 11 per cent of fixed investment, FDI flows remain small as a share of overall capital formation.

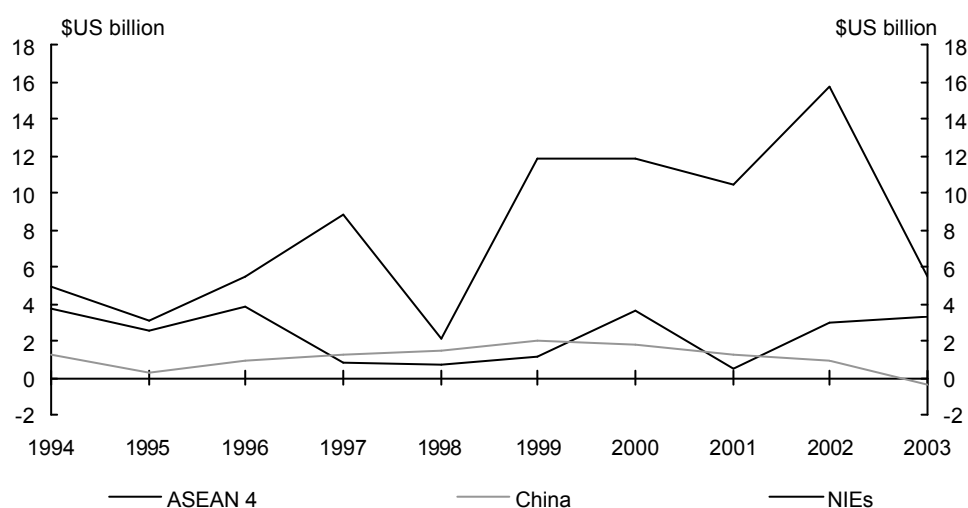
Sources of FDI

The newly industrialised economies (NIEs) of Singapore, Korea, Taiwan and Hong Kong and the ASEAN 4 (Malaysia, Indonesia, Thailand and the Philippines) have tended to source investment from outside the region. On the other hand, investment to China has predominately been from within the region, mainly from Taiwan and Hong Kong.

The US is a major source of FDI for the region. Around 16 per cent of US net FDI went to East Asia in 2002. In the first six months of 2003, US FDI flows into East Asia are below levels recorded over the same period in 2002, with the exception of Malaysia and Taiwan (Chart 3). This reflects the weak US economy, the inherent lumpiness of FDI data, and the impact of SARS on East Asia in the first half of 2003.

In recent years, the US has concentrated its investment in the NIEs, particularly in the IT and financial service sectors. But the US (along with Europe) is also an important investor in ASEAN and, at the same time, the US has not significantly increased its investment within China. Indeed, ASEAN receives more FDI from the United States than does China.

Chart 3: United States net foreign direct investment to East Asia



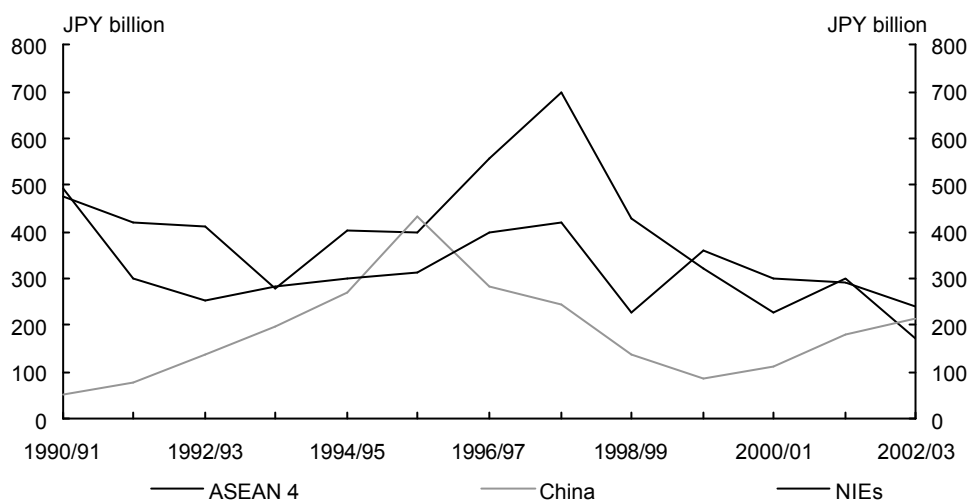
Note: Data for 2003 is for the six months to June 2003, annualised.
Source: United States Bureau of Economic Analysis.

Japan has been a key global source and the largest regional source of FDI and bank lending to East Asia. Rapid growth and industrialisation saw Japanese multinationals seek increased market share offshore and establish manufacturing production chains in the NIEs and Southeast Asia in response to rising production costs at home.

Investment flows slowed in the wake of the Asian financial crisis as financial sector problems in Japan, and the region's structural weaknesses and poor growth led to a rationalisation of Japanese foreign investment and a contraction in Japanese lending abroad.

East Asian capital flows

Chart 4: Japanese foreign direct investment to East Asia



Note: FDI flows for Japan are gross values.
Source: Japanese Ministry of Finance.

Data from Japan's Ministry of Finance show that by 2002, around 15 per cent of Japan's FDI went to the rest of East Asia — around the same as Japan's investment to Latin America. The manufacturing sector accounts for around two-thirds of Japan's direct investment in East Asia, part of the 'hollowing out' of Japanese manufacturing.

Around one-third of Japan's FDI to the region is directed to China — primarily aimed at the production of goods for export to Japan and third country markets. However, Japanese manufacturers are increasingly investing in China with a view to servicing and developing their market share in the Chinese domestic market.

Compared with China, Southeast Asia appears to be attracting increasingly less FDI from Japan, even though Japan's flows to China are currently lower than in the mid 1990s (Chart 4). This reflects Japanese firms shifting their low-cost production bases away from Southeast Asia, especially Malaysia and Indonesia, to China. However, Southeast Asia's transport equipment and electrical sectors continue to attract significant Japanese investment flows.

Annual surveys of Japanese manufacturers foreign investment intentions undertaken by the Ministry of Economy, Trade and Industry suggest that while China is the preferred destination for new investment, Japanese multinationals will continue to be involved Southeast Asia, given their established supplier networks, strategic alliances and sunk investment. Japan has a considerable stock of investment in ASEAN — more than three times that of China.

At the same time Korea, Hong Kong and Taiwan appear to be losing out to China — Japanese FDI flows to these countries have been on a downward trend since the late 1990s (Chart 4).

Intra-regional investment

Trade and investment flows are creating a virtuous cycle in the region. While inflows from major developed economies, especially the US and Japan, continue to be important for the region, the expansion of trade linkages and the development of regional trading arrangements are increasing intra-regional investment flows.

While Japan is still the main intra-regional source of FDI, Taiwan, Hong Kong and Korea are important sources of FDI to China and the ASEAN economies as they continue to relocate their labour-intensive manufacturing production to these lower cost economies. Similar to Japan, these economies are moving to establish new production bases in China across a wide array of higher value-added manufacturing sectors.

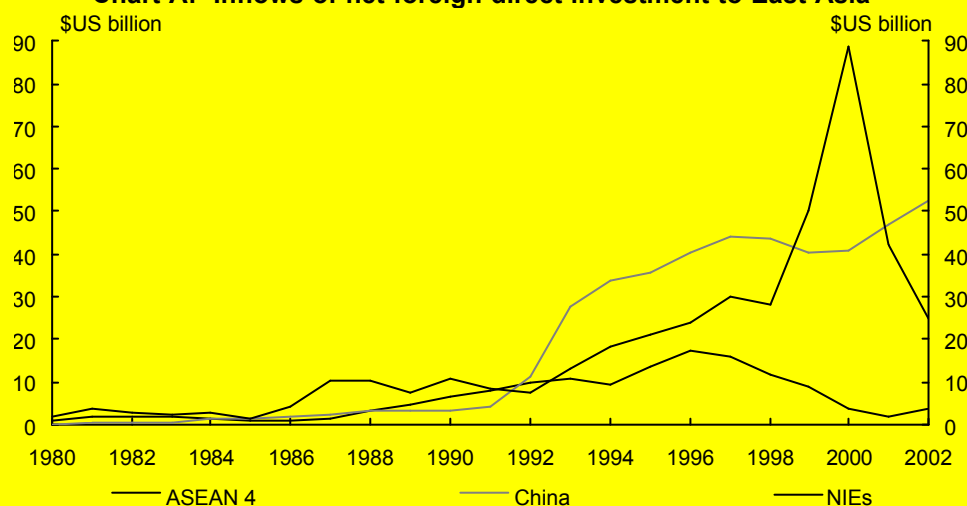
Intra-ASEAN FDI is also expanding, growing from 7 per cent of GDP in 1999 to 17 per cent of GDP in 2002, and should continue to grow as integration of trade and investment flows develop further.

Box 1: China's role in the region

China is the largest developing country recipient of FDI and since 1992 has received more global FDI inflows than the ASEAN 4 economies combined, much of it from other Northeast Asian economies.

In 2002, China was the largest global recipient of FDI, overtaking the US. China received 33 per cent of global developing country inflows in 2002 and accounted for 60 per cent of FDI inflows to East Asia. Furthermore, FDI to China increased slightly, even as the weak global economy saw global flows fall (Chart A).

Chart A: Inflows of net foreign direct investment to East Asia^(a)



(a) Inflows to the NIEs in 2000 were exaggerated by a doubling of inflows to Hong Kong on account of a single large acquisition in telecommunications valued at \$US24 billion.

Source: United Nations Conference on Trade and Development, World Investment Report 2003.

The stock of FDI in China is now around \$US450 billion (almost 40 per cent of GDP), and has grown by over \$US40 billion per year since 1996. But the magnitude of inflows to China may be overstated. The surge in FDI from the early 1990s may be due, in part, to 'round-tripping' as Chinese funds were channelled through overseas markets back to the mainland to access government incentives that were only available to 'foreign' investors. The World Bank notes that around 25 per cent of China's FDI inflow may be due to round-tripping.

Box 1: China's role in the region (continued)

Demonstrating the importance of foreign investment, and its export orientation to the Chinese economy, foreign-funded enterprises account for around 55 per cent of China's exports. The share of total Chinese production attributed to foreign-funded enterprises was 34 per cent in 2002, compared with 2 per cent in 1990.

China's development as a source of capital

At the same time, China is emerging as a source of investment. Recent data from the United Nation's Conference on Trade and Development (UNCTAD) show that China's role as an investor has been growing slowly but steadily since the start of the 1990s, overtaking the ASEAN 4 in 1995 as a source of FDI. China is now one of the top FDI exporters among developing countries — from a two year average of \$US2.5 in 1991-92, China's FDI outflows have grown to almost \$US5 billion in 2001-02.

Australia is also benefiting from China's outward investment. As at June 2002, China was the thirteenth largest investor in Australia with a stock of investment worth \$A2.9 billion, up from \$A1.2 billion in 1997. Most of China's Australian investments are in the resource and property sectors.

Portfolio investment

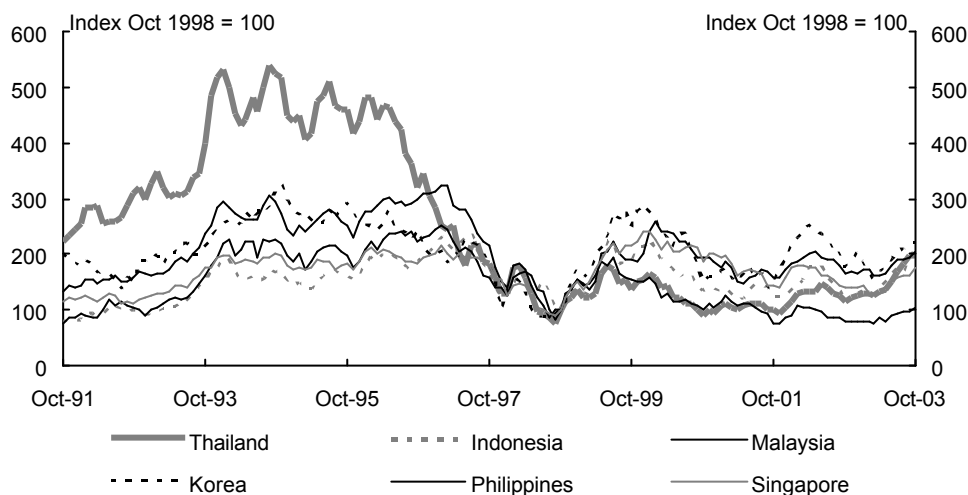
East Asian equity prices almost doubled between 1991 and 1996, before falling substantially during the 1997-98 East Asian financial crisis. The fall in equity prices reflected the large-scale withdrawal of international and domestic investors. This was especially apparent in Thailand where equity prices fell almost 80 per cent between 1996 and 1998 (Chart 5). Regional equity markets have shown little sustained strength in the six years since the crisis, with most hovering around their pre-crisis level. However, more recently, equity markets have been improving in line with improved regional growth prospects and stronger global markets.

Since the start of 2003, equity markets in the developing economies of Southeast Asia have grown more strongly than the more industrialised economies of Korea, Singapore, Hong Kong and Taiwan. This reflects stronger economic growth since mid-2002 in Southeast Asia, the effects of the SARS epidemic on Singapore, Hong Kong and Taiwan in the first half of 2003, and corporate-sector difficulties and poor GDP growth in Korea.

East Asian capital flows

The surge in portfolio investment into Thailand and Indonesia has been particularly strong, growing by 50 to 60 per cent since the start of the year. While portfolio flows into these economies are being fuelled by a turnaround in sentiment, the strong growth was off a low base.

Chart 5: East Asian equity markets

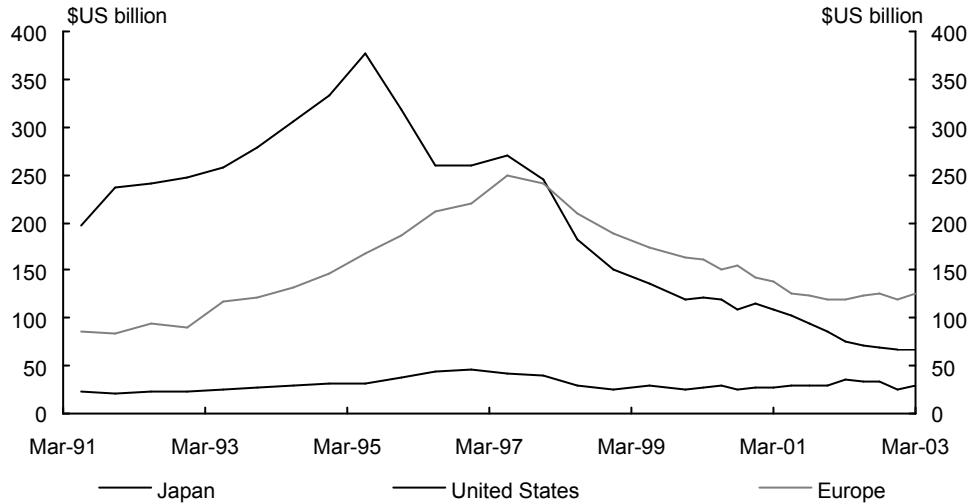


Source: Datastream.

Bank lending

Foreign bank lending to East Asia has fallen considerably in the years following the financial crisis, with the continued withdrawal of Japanese banks from the region especially significant (Chart 6). The decline in foreign willingness to lend to East Asia has not been restricted to lenders from any particular region. More recently, lending from Japanese banks has stabilised at low levels while lending from US and European banks has remained flat.

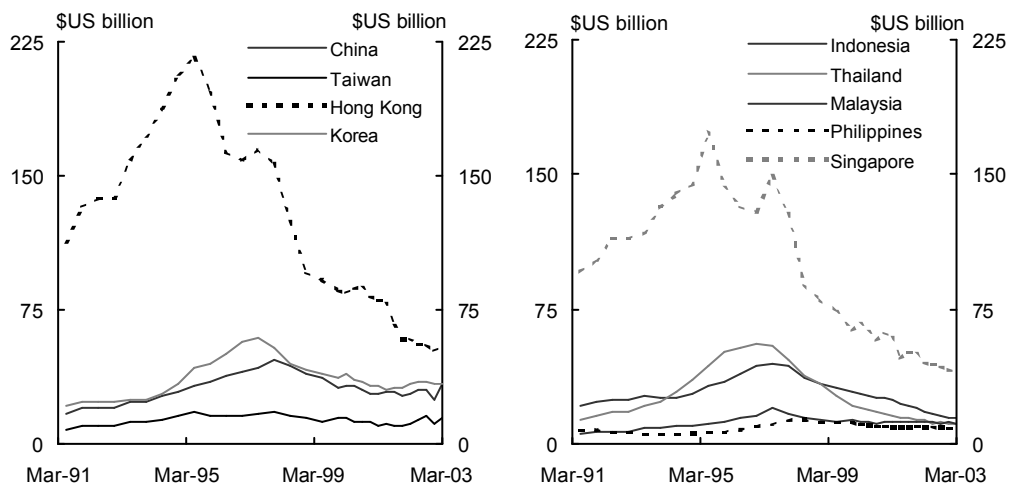
Chart 6: Sources of consolidated claims by foreign banks on East Asia



Note: Europe includes: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden and The United Kingdom.
 Source: Bank for International Settlements: Consolidated International Banking Statistics.

A large portion of the fall in foreign bank lending to East Asia reflects falls in lending to the major East Asian financial centres of Hong Kong and Singapore by Japanese banks (Chart 7). The large fall in lending by Japanese banks that started in 1995 reflected wide-spread problems in the Japanese financial sector. Initially, the decline in Japanese lending to East Asia was partially offset by increased lending from Europe. However, the East Asian financial crisis in 1997-98 saw lending fall from Europe.

Chart 7: Claims by foreign banks on East Asian economies



Source: Bank for International Settlements: Consolidated International Banking Statistics.

Concluding comments

The increased integration of regional production means that most East Asian economies will continue to attract and benefit from inter and intra-regional investment flows. Intense competition for funds is also likely to lead governments to adopt more liberal investment regimes.

Foreign direct investment will remain the main source of foreign capital for East Asia, and current discussions on regional trade agreements aimed at reducing barriers to investment should help this process. But to address the ongoing requirements for capital, reforms that promote sustainable capital inflows as well as the development of domestic capital markets are needed. These will help ensure domestic funds are allocated efficiently while limiting economies' vulnerability to future fluctuations in capital flows. In this regard, measures to develop and deepen regional capital markets (e.g. the recently proposed regional bond market) are welcome developments that will aid in this process by enabling East Asia to better channel regional savings.

Domestic reforms — particularly the strengthening of financial systems and corporate governance frameworks to maintain investor confidence and encourage domestic savings to flow towards efficient investment — remain on-going objectives for governments in the region. A stable political environment and sound macroeconomic policies are also an important prerequisite for attracting investment flows. For Southeast Asia, conditions that support physical and personal security will also be key factors in determining their longer-term attractiveness to investment and sustained strong rates of GDP growth.

Australia and the international financial architecture — 60 years on

This paper was presented by Dr Ken Henry, Secretary to the Treasury¹ as the Sir Leslie Melville Lecture on 16 July 2003. The paper explores the tensions surrounding Australia's decision to join the International Monetary Fund (IMF), discusses changes in the world economy since the 1940s and the new tensions that have emerged for the IMF and its various members. The paper reflects upon the future direction of the IMF and the broader international financial architecture, including the role that Australia might play.

1 This paper has been prepared with the considerable assistance of a number of people in the Treasury, most notably Adam McKissack, Martin Parkinson, Alice Peterson and Karen Taylor. If the paper is to be cited, these names should appear as co-authors.

Introduction

My lecture today is given in memory of Sir Leslie Melville. Sir Leslie had a long and distinguished career in Australian public policy, economics and education, and his legacy lives on in many of our present institutions.

Sir Leslie held many influential positions during his career but today I wish to focus on one aspect of his career — his role as head of the Australian delegation to the Bretton Woods conference in 1944 and later as Australia's representative at both the IMF and World Bank. Specifically, I would like to use the opportunity of this memorial lecture to reflect upon the system Sir Leslie helped bring about and its relevance to the modern world economy, almost 60 years on from the Bretton Woods conference.

After giving some background on Australia's decision to join the IMF, and the tensions surrounding that decision, I will discuss changes in the world economy since the 1940s and how these have created new challenges for the Fund. I will conclude with some remarks about the future direction of the IMF, the broader international financial architecture, and Australia's role in the development of that architecture.

Origins of the IMF and Australia's decision to join

The IMF was established at the Bretton Woods conference in 1944 to promote international financial stability in the post World War II reconstruction period. The Fund's purpose, as set out in its Articles of Agreement, is to promote international monetary cooperation, financial stability and world economic growth.

At the time the IMF was established the experience of the 1930s was fresh in many minds. Competitive devaluations of the 1920s and 1930s — often described as 'beggar-thy-neighbour' policies — were seen as a key source of instability in the international financial system. A key part of the answer to this problem, as conceived by the architects of the Bretton Woods system, was to create a system of pegged exchange rates.

The Fund's primary function, then, was to support the maintenance of exchange rate parities, including by lending to members facing short-term balance of payments disequilibria. The Fund essentially acted as an international credit union. Members contributed to a pool of reserves from which countries facing balance of payments deficits could borrow to maintain their pegged exchange rates.²

² See Boughton (2000).

The IMF model followed closely the proposal put forward by the US Treasury official Harry White.³ Britain had supported the more ambitious model proposed by Keynes. Keynes' concept of an international clearing union would have involved the establishment of an international central bank, fulfilling a lender of last resort role through the provision of virtually unlimited liquidity to countries facing short-term imbalances. Harry White's credit union model was less ambitious, particularly in terms of the amount of liquidity it would promise.

Sir Leslie and the Australian team were attracted to the international clearing union model put forward by Keynes.⁴ But Australia had bigger ambitions for the new Fund. Sir Leslie sought, among other things, agreement to having the Fund charged with the policy objective of full employment.⁵ The rationale was that buoyant levels of demand in the world economy would assist small, open, economies like Australia to achieve full employment without encountering constraints on the balance of payments.⁶ Sir Leslie was not successful. Australia was alone in pushing this objective and the Bretton Woods architects considered the inclusion of a full employment objective to impose too much of a constraint on the policies of the major economies.⁷

Sir Leslie was also concerned with the degree of inflexibility in exchange rate adjustments under the White plan, compared with the Keynes plan.⁸ In addition, Australia thought the White plan was too limited regarding the size of the Fund, as it meant that Australia's drawing rights would be quite small. Others shared this view.⁹

Frustrated with the model proposed (and in some quarters, distrustful of the nature of the institution) Australia did not join the IMF when it was established in 1944.

Melville was clearly embarrassed by this decision.¹⁰ Twenty nine countries were founding members of the Fund and Australia and Russia were the only major players not to sign up to the Bretton Woods agreement.¹¹

3 Boughton (2002).

4 Cornish (1999), p 139.

5 Cornish (2002), p 473.

6 Cornish (2002).

7 Moggridge (1980), p 251 and Dyster and Meredith (1993), 185.

8 Cornish (1993), p 449.

9 Horsefield (1969), p 98.

10 Cornish (2002), p 474.

11 El Salvador, Nicaragua, Panama, Denmark (which did not have a government at the time of signing), Haiti, Liberia, New Zealand and Venezuela were the other countries not to sign. Source: Horsefield (1969).

The IMF was a topic of lively debate within the Australian Cabinet in the early years. Dr Evatt, along with other ministers, was vehemently opposed to the IMF.¹² There was a view that the Fund would be run by international financiers — the group held responsible for the depression in the 1930s. Evatt and others believed that the IMF would be dominated by the big American banks who would not be at all sympathetic to the social problems facing member countries. Eddie Ward, a member of Chifley's ministry, claimed on national radio in March 1946 that the Bretton Woods agreement threatened the 'sovereignty of Australia' and it would 'enthroned a World Dictatorship of private finance, more complete and terrible than any Hitlerite dream'.¹³

Prime Minister Chifley, while wary of 'Wall Street capitalists' and their concentration on 'dollar profits', was willing to set aside these reservations and place his trust in the 'brighter and more humanitarian' outlook on world affairs held by the US State Department.¹⁴ He pushed his colleagues to ratify the Bretton Woods Agreement.¹⁵ Australia eventually became a member of the IMF in 1947.

While debate about the merits of the Bretton Woods system continues to the present day, it appears likely that the system contributed to the relatively benign economic conditions that prevailed in the 1950s and 1960s. Australia benefited indirectly from the Fund's contribution to this environment and prospered. Australia also relied directly on the Fund a number of times during this period, with the largest drawing being that made under a US\$175m Stand-By Arrangement in 1961.¹⁶

Developments since 1944

The international financial system has seen many changes since the 1940s — most notably, abandonment of the original Bretton Woods system of pegged exchange rates in the early 1970s and the emergence of capital account crises in the 1990s.¹⁷

12 Cornish (1993), p 449 and Day (2001), p 445.

13 Day (2001), p 444.

14 Day (2001), p 444.

15 Cornish (1993), p 449.

16 Australia's largest ever drawing on the Fund was an SDR 332.5m loan in 1977 to meet the terms of the International Sugar Agreement. The loan was made under the IMF's former Buffer Stock Financing Facility — a facility designed to assist commodity exporters in stabilising commodity prices through the purchase of buffer stocks.

17 This section draws heavily on the material in Parkinson and McKissack (2003).

While no consensus exists on the reasons for the breakdown, between 1968 and 1971, of the system of pegged exchange rates, some factors are commonly put forward. Among these are the breaking of the link between the US dollar and the monetary gold stock. The Vietnam War and the growth in world output and liquidity strained the convertibility of the US dollar into gold. Increasing capital mobility also put strains on the system by facilitating speculation against fixed parities. Finally, price instability in the US meant that the system of fixed exchange rates increasingly ran the risk of providing a transmission mechanism for higher world inflation, in turn placing pressure on parities.

The breakdown of the system of pegged exchange rates was an important turning point for the Fund. It changed the nature of Fund assistance and, perhaps more importantly, the types of countries that drew on its assistance. But more on this later.

An important recent development has been the rapid expansion of private capital flows between countries and the closer integration of global capital markets. While potentially beneficial for the growth of recipient countries, these developments have not always been benign.

The last decade has seen a string of crises in emerging markets — in Mexico in 1995, Asia in 1997 and 1998, Russia in 1998, Brazil in 1998 and 2002, Argentina in 2001-02, and Turkey in 1999 and 2000-01.

It is clear from these crises that the nature of the problem has changed considerably since 1944. First, there is the increasing scale of private capital flows. Large amounts of mobile private capital have increased the risk of sharp market reactions in the face of emerging economic imbalances. The loss of confidence in previously favoured assets, indeed entire countries, can be quite sudden, resulting in dramatic reversals in capital flows with disorderly and damaging economic adjustment.

The new development here is not that private capital flows can be destabilising. This much has been clear since the 'tulipomania' of the 1630s in Holland, and was further graphically illustrated in the extraordinary fluctuations in the share prices of the South Sea Company and its imitators in the early 1700s.¹⁸ The novelty of the recent period is in its scale: the fact of private suppliers of capital taking a position on an entire country, or even, as in the Asian financial crisis of 1997-98, a group of countries.

Second, and more recently, crises have been triggered increasingly by, and have exposed, serious structural policy weaknesses, particularly in financial sectors.

18 For a particularly readable account of these and other privately initiated bubbles, see Galbraith (1990).

While it would be overly simplistic to seek to draw a strict dichotomy between financial crises and 'traditional' balance of payments crises, it is clear that the strains on domestic financial systems posed by the increasing scale of capital flows have introduced a new element into modern crises.¹⁹

The changing nature of the underlying problem has led to changes in the role of the IMF. The Fund first established a formal surveillance role in the late 1970s via an amendment to its Articles of Agreement. This role has evolved, from one of examining the macroeconomic stabilisation policies of member countries to examining areas of structural reform, particularly prudential and regulatory policy in the financial sector. There has been an increasing emphasis also on early detection of vulnerabilities, leading to a focus on issues such as the size, maturity and currency composition of external debt. The widened scope of individual country monitoring has been complemented by an emphasis on multilateral and regional surveillance to identify interactions and linkages that might facilitate the spread of crises.

The scope of conditionality — the conditions applied to IMF loans — has likewise increased in complexity.

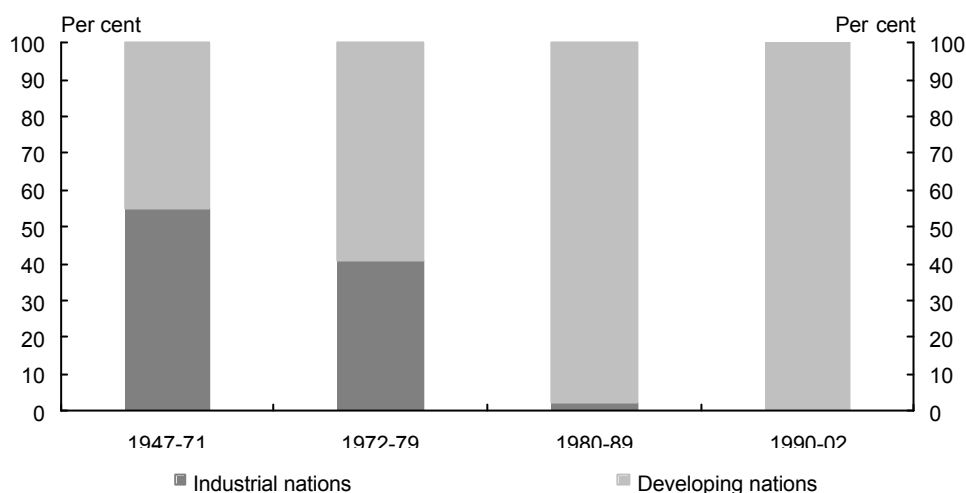
This changing role of the Fund has not been unquestioned. The recent period has seen considerable debate about the effectiveness of the Fund's policies in terms of crisis prevention and crisis resolution. Treasury has spoken on these issues in other fora.²⁰ The important point to note is that there is increasing tension between those who want the IMF to be more vocal and forthright and those who argue it goes too far already in pushing policy adjustments on its members.

The emergence of these tensions has coincided — though it is far from a coincidence — with a pronounced trend in the direction of Fund assistance. In the early period of the IMF's history, those countries with the greatest influence over IMF policies were also major users of the Fund, consistent with its 'credit union' role. Chart 1 shows that during the 1950s and 1960s the industrialised economies drew heavily on Fund resources. They were the key players under the Bretton Woods system of exchange rate parities. Their use of Fund resources tapered off during the 1970s following the breakdown of the Bretton Woods system. From the 1980s onwards, IMF assistance has been directed almost exclusively towards emerging markets.

19 See Parkinson, Garton and Dickson (2002).

20 See Parkinson and McKissack (2003).

Chart 1: Relative use of IMF resources: industrialised vs developing countries

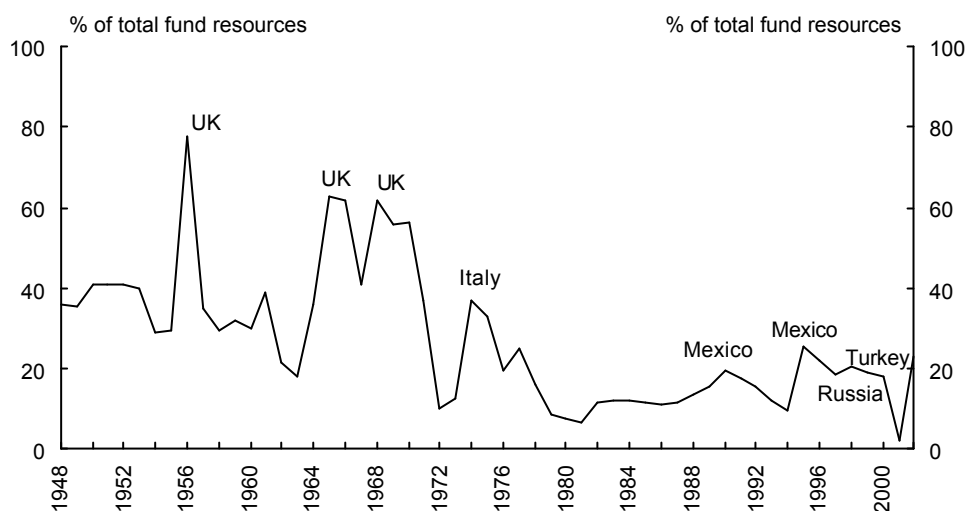


Source: International Monetary Fund, International Financial Statistics online.

Chart 2 looks at the data in a different way, examining the peaks in the use of IMF resources over time (in terms of the share of total lending) of the Fund's largest users in a particular year. The largest peaks in the early years were attributable to the UK (with its largest drawing occurring around the time of the Suez Crisis in 1956). A peak is attributable to Italy in 1975 following fallout from the first oil price shock. However, all of the subsequent peaks are attributable to emerging markets — Mexico in the early to mid 1990s and Turkey and Russia more recently.

The new, emerging markets, group of users of Fund resources has relatively little influence over Fund policies. Indeed, it is arguable that their influence has declined. Somewhat paradoxically, the reason for this is to be found outside of the Fund, in the emergence of other multilateral fora with more concentrated decision making power — including with respect to the power to determine Fund policies.

Chart 2: Largest users of Fund resources



Source: International Monetary Fund, International Statistics online.

In 1973, a short time after the breakdown of the Bretton Woods pegged exchange rate system, the United States Treasury Secretary invited the British, French and German finance ministers to Washington for an informal discussion regarding the international monetary system. Japan joined subsequent discussions.

This group, which came to be known as the 'group of five' or 'G-5', expanded to become the G-7 in 1975 with the participation of Canada and Italy. With the inclusion of the Russian Federation in recent times the group is sometimes referred to as the G-8. While remaining a largely informal policy forum, the G-7 (or G-8) now meets regularly and appears to have supplanted the IMF's policy coordination role for the major economies. It seems increasingly also to see its role as including providing direction and guidance to the IMF and other international institutions.

The diminishing reliance by the major economies on IMF support cannot simply be explained on the basis that these economies no longer need external finance. The fact is that many do. Rather, there would seem to be two explanations. The first is that private financing has replaced official financing in many cases. In fact, many would see the need for Fund resources now being symptomatic of a lack of access to private capital markets. The second reason is that where official external financing has been preferred, sources other than the IMF have been used. A prime example occurred in September 1992 when the pound sterling was suspended from the European Exchange Rate Mechanism (ERM) following a wave of selling of the pound on foreign exchange markets. The UK had borrowed under the ERM's Very Short Term Financing Facility (VSTF), which became available as the pound reached the bottom limit in the ERM.

Other countries, such as Italy and France also used the VSTF. Ironically, these non-IMF funds were accessed to support pegged exchange rates.

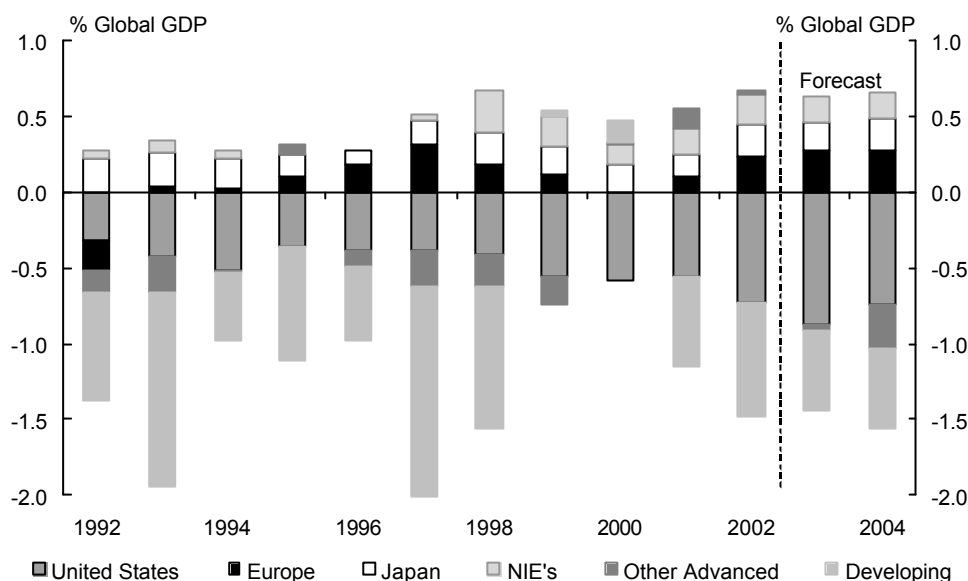
Where does this leave the IMF? One plausible view is that the major economies have come to see the Fund as having a role, primarily, in countering, or reducing the risk of, instability in emerging markets. Indeed, we may well ask whether the major economies have not come to see the Fund's principal role to be to make the world a safer place for internationally mobile capital — a role to be played out through the conditionality attached to Fund programs and surveillance. This is a role that sits rather well with the Fund's foundation objectives of financial stability and world growth.

But one might want to question the presumption supporting this view — which is that the primary source of global financial instability is, and will continue to be, in the emerging markets. This perspective might have been understandable when the major economies saw themselves as capital exporters to emerging markets. But it is a particularly odd perspective today.

If the world were to be divided into six economic regions — the United States, Europe, Japan, other advanced economies, the newly industrialising economies and the developing world — the principal regional attractor of international capital would appear to be the first (see Chart 3). The United States is attracting more capital than the whole of the developing world. Moreover, given the size of the United States' current account deficit, this is likely to be the case for many years. As far as the immediate to medium-term prospects for international financial stability are concerned there is at least as much riding on the quality of United States economic policy as there is the macroeconomic and structural policies of the emerging markets.²¹

21 This is not to argue that the latter are not important. Indeed, they are fundamentally important to economic development in those markets.

Chart 3: Global savings-investment imbalances²²



So there is some irony in the fact of the major economies having stopped using the IMF as a source of advice. The reason they have done so is presumably that they have stopped using the Fund as a source of external finance. Why listen to what the bank manager thinks of you if you have no need to apply for a loan? Not surprisingly, the Fund has not brought about necessary corporate and financial restructuring in Japan. Persistent constraints to product and labour market flexibility in Europe remain. And the Fund has done little to convince the United States (or anyone else for that matter) of the risks associated with its singular current account position. These failures could have serious implications for international financial stability.

But there is a further irony. The lack of impact of Fund advice in the major economies undermines its credibility everywhere else and adds to the tension between developed economies and emerging markets. The latter, who see much of the past volatility in capital markets as having originated from the major economies, question why they should follow Fund advice if the major economies will not.

Partly in response to these sorts of tensions, in 1999 the G-7 formed a new forum called the G-20 to involve a broader spectrum of nations in deliberations about international finance and development issues. The G-20 is comprised of the G-8 countries, Australia

²² I am indebted to Steve Morling and other colleagues in the Treasury for this chart.

and the main emerging market economies (Turkey, Saudi Arabia, South Africa, China, Korea, Indonesia, India, Mexico, Argentina and Brazil).

A further trend involves the establishment of specialised institutions that complement the role of the IMF. Included amongst these is the Financial Stability Forum (FSF), established by the G-7 to promote discussion amongst members on appropriate regulatory and prudential practices. The Financial Action Task Force on Money Laundering (FATF) is another forum established by the G-7, created in response to mounting concern over money laundering and the threat it poses to the banking system and to financial institutions. The work of the FSF and FATF complements, and is complemented by, the work of the various international standard setting bodies.

Challenges

Australia has always valued its membership of the multilateral institutions as a means of helping shape the international rules of the game in a way that it cannot do unilaterally. Our membership of the IMF and other international institutions provides an opportunity to help cultivate a benign international environment within which Australia can prosper. It also provides a vehicle to promote the interests of the region in which we reside and on which our future prosperity depends.²³

To date, our influence in affecting the shape of international finance has rested on two pillars. First, an ability to 'punch above our weight' in multilateral fora. And second, an ability to use our special bilateral relationships with each of the major players, and especially the United States, to encourage them to provide effective leadership in those multilateral fora. I cannot see the Australian Government diminishing the importance of these pillars of influence. But the case for using the multilateral processes rests not only on these pillars. It rests, more importantly, on the continuing relevance and effectiveness of those multilateral processes.

The future relevance and effectiveness of the IMF (and the other international institutions) is very much a national interest issue for Australia.

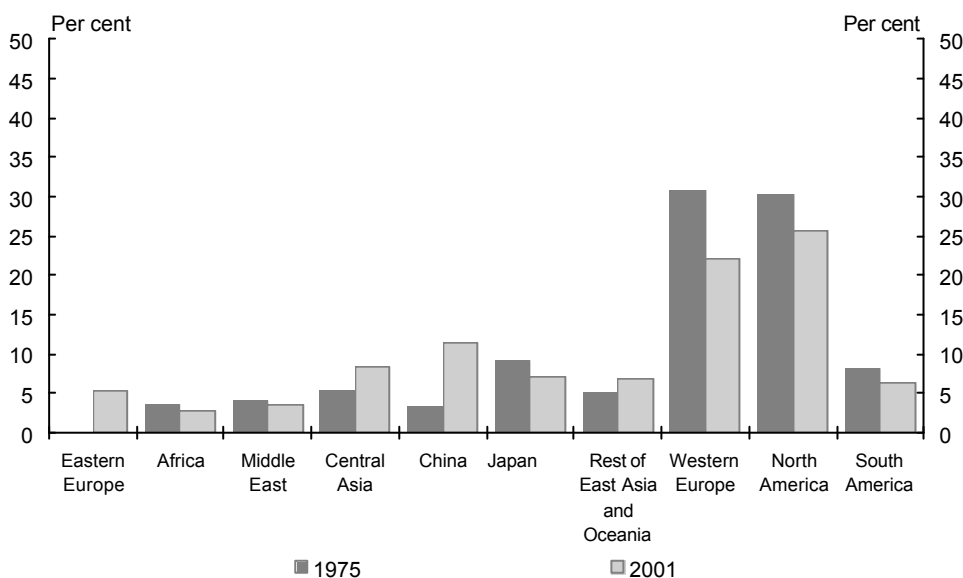
The IMF, and the international community more broadly, face many challenges in addressing the economic problems of the modern era. Not least among those challenges are the significant tensions between those countries pushing for IMF advice to be more effective and those questioning Fund legitimacy.

²³ See Costello (2002) for further discussion of Australia's role in the region.

What is missing is a strong sense of ownership of IMF policies by all member governments. Critical to achieving ownership is representation reflective of relative economic weight.

Chart 4 shows regions' shares of IMF member GDP (in Purchasing Power Parity (PPP) terms²⁴) in 1975 and 2001. China is the big news story here, having seen the largest rise in share, from around 3 per cent of the world economy in 1975 to around 11 per cent in 2001. In 1975 China had a smaller economy than Africa, but by 2001 had become the second biggest economy in the world, and by a considerable margin.²⁵ The rest of East Asia, Eastern Europe and Central Asia have also increased their shares of the world economy. There has been a relative decline in the share of the Americas (though the United States remains the dominant economy) and Western Europe.

Chart 4: Share of IMF member GDP (PPP)



Source: World Development Indicators online.

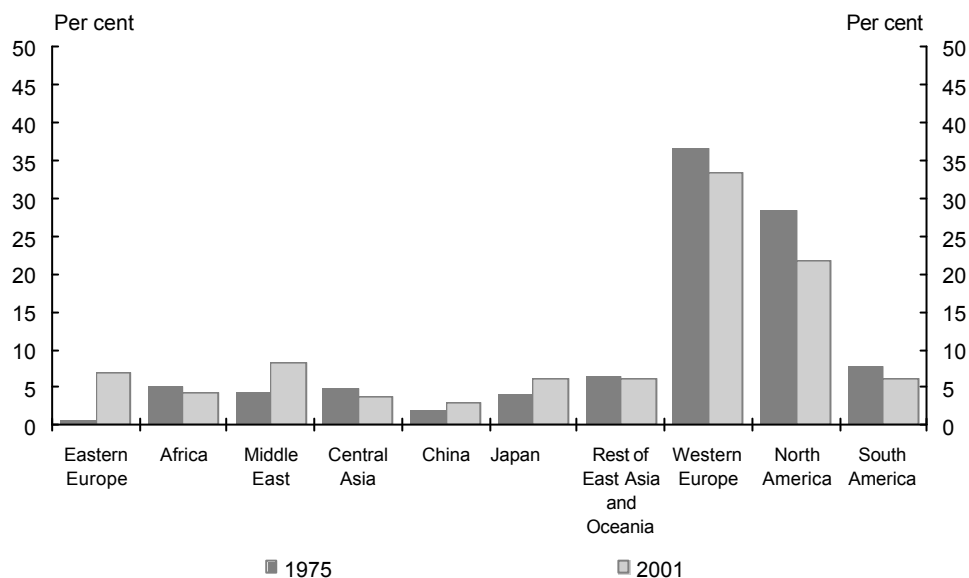
Chart 5 shows changes in IMF quota shares over the same period. These have moved (very) broadly in line with GDP shares; that is, there has been a shift in representation

²⁴ Purchasing Power Parity (PPP) corrects for differences in relative prices. PPP tends to be more stable than exchange rates, which are more sensitive to capital movements and currency speculation. However, PPP uses international market prices, which tend to produce higher GDP figures for large, relatively closed, developing countries.

²⁵ Perhaps as a sign of the rapid rate of progress in China, most commentators continue to believe that Japan holds that position.

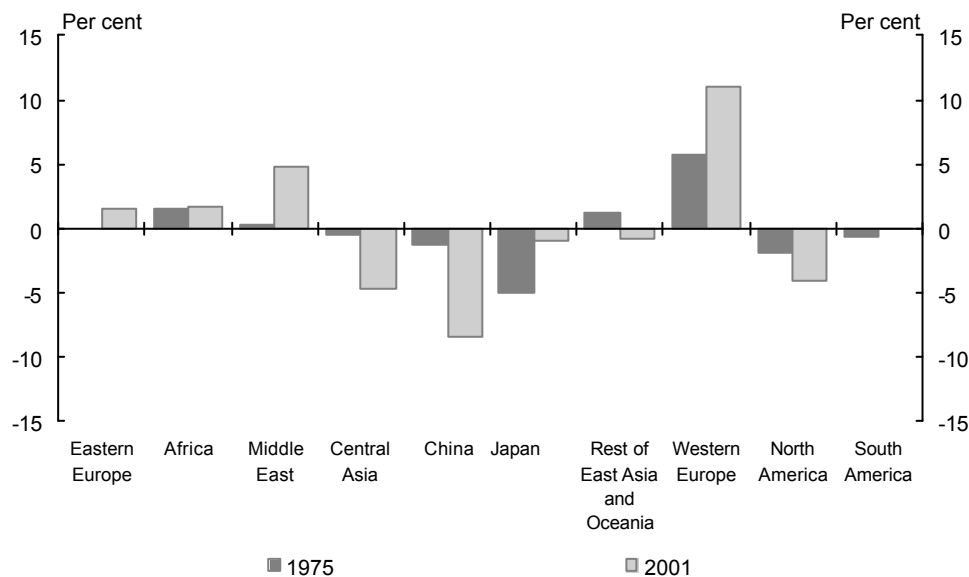
from North America and Europe to some of the Asian economies. But the trend in quota shares has been much less pronounced than in GDP shares.

Chart 5: Share of IMF quota



Source: International Monetary Fund website and Garristen de Vries (1976), p 306-308.

Chart 6: Quota share minus share of IMF member GDP by region



Source: World Development Indicators online, International Monetary Fund website and Garristen de Vries (1976), p 306-308.

Chart 6 brings Charts 4 and 5 together. It measures the differences between quota shares and shares in IMF member GDP — with a negative number implying 'under-representation' and conversely for a positive number. The determination of IMF quotas is a complex issue and Chart 6 admittedly provides an over-simplified picture of whether country quotas are representative or not. I will not explore the intricacies of that debate here. However, Chart 6 reveals a clear trend. The quota shares of China, the rest of East Asia and Central Asia have not kept pace with the rapid growth in these economies. On the other side of the coin, Western Europe is the most over-represented region in comparison to its economic standing, and has become increasingly overweighted since the 1970s.²⁶

These trends have implications for the on-going legitimacy of the Fund. If it continues disproportionately to represent the interests of the Western industrial countries, and not fully recognise the growing economic importance of Asia, its legitimacy, and with that its effectiveness, will decline. The tension will become more pronounced over time. The Korean economy, which was around half the size of the Australian economy in the mid-70s, is now larger and continues to grow at a faster rate. If recent growth trends were to be maintained, the size of the Chinese economy would approach that of the United States in a decade's time.

It should come as no surprise, then, that there has been interest in recent years in the development of regional financial institutions in the Asia-Pacific region. While these may give regional economies a greater sense of ownership of outcomes in international crisis management and fill some of the gaps in the representativeness of the Fund, pressure for their development may reflect a view that the Fund is already losing its relevance in the region.²⁷

Australia has, especially in the past few years, argued the case for reviewing Fund representation arrangements. To correct for the under-representation of Korea at the IMF Executive Board, we have agreed to share with Korea the chair of our constituency at the IMF, with Korea assuming that role next year.

Representation arrangements are important because the backing of national governments is key to ensuring the legitimacy of the Fund. Unless the Fund's membership has collective ownership, the legitimacy of Fund recommendations will always be questioned. But this does not mean that, unless the representation issues

²⁶ Like China, North America has become increasingly underweighted. But the reasons are very different. China's share of world GDP has increased appreciably while its share of IMF quota has barely moved. In contrast, North America's share of world GDP has fallen appreciably but its share of IMF quota has fallen by even more.

²⁷ See Parkinson, Garton, Dickson (2002) for further discussion of this issue.

can be fixed, the Fund should step back from its role of policy adviser. In fact, this role should be reinforced — consistent with the original credit union focus — rather than allowing the Fund to slide into the role of unconditional provider of liquidity (a passive lender of last resort).

National governments, through their representation on the IMF Board, must support the Fund when it gives robust policy advice and should encourage the Fund to make rigorous assessments of requests for resources. This will mean, on occasion, resisting the temptation to use the Fund's resources to effect large bailouts.

Of course, there will always be political pressures on the Board, whatever its composition, to provide assistance to countries in crisis and there is the risk of these immediate political pressures forcing decisions that undermine the implementation of sound policies in the medium term. This is a difficult tension for the Board to address, but it is important that member countries avoid sacrificing Fund credibility in pursuit of short-term goals.²⁸

Consistent with this philosophy, Australia has pushed hard at the IMF Board to ensure that Fund financing is linked to sound policy advice. As a case in point, Australia was one of five chairs at the IMF Board to abstain from supporting a transitional program for Argentina in January of this year. The larger economies were seeking to push through a program to roll-over Argentina's debts in response to short-term political pressures but offered little in the form of policy solutions to Argentina's severe economic difficulties.

Furthermore, it is important not only that the governance of individual institutions such as the IMF is right, but also that the overall financial architecture is right. It would be naive to believe that the major powers will not continue to dominate the international financial institutions. However, it is possible to introduce checks and balances that will help legitimise their activities. For this reason, Australia has engaged actively in the work of the G-20, which brings together a balance of representation from the G-7 economies, emerging markets and smaller industrial countries like ours.

The G-7 has played a valuable 'guidance' role for the Fund to date. However, the G-7 cannot enhance Fund legitimacy since it represents only the interests of the larger developed economies. Quite possibly, guidance from the G-7 has diminished the

²⁸ This issue is discussed further in Parkinson and McKissack (2003).

Fund's legitimacy as its members have been seen to be pursuing their own agenda through the Fund.²⁹

The G-20, on the other hand, could play an important role here. It represents a reasonable cross-section of the IMF's membership, including both developed and emerging market views and capturing the growing influence of the fast-developing economies. It is potentially a powerful tool for facilitating a dialogue between a representative group of member governments, for achieving agreement among key economies on issues of common interest, and for getting emerging concerns of these key economies onto the IMF's radar. This has been shown by the G-20's work in recent years identifying policy lessons for member countries in the areas of globalisation, economic growth and poverty, much of which has the potential to be directly relevant to the activities of the Fund.³⁰ The G-20 is better placed than the G-7 to contribute to Fund legitimacy.

Conclusion

The current generation faces significant challenges in maintaining the relevance of the institutions passed on to us by Sir Leslie Melville's generation. The economic landscape of the early 21st Century is very different from that of the 1940s. The roles of the international financial institutions are being questioned. Alternative sources of advice and support are being sought.

Yet Australia has an important stake in the future of the IMF. As a small, open, economy, the stability of the broader international financial system will always be important to our national prosperity — a point underscored by the financial turmoil in the region in the late 1990s. And the best means we have for influencing the design of that system is the Fund. This is as true today as it was in Melville's time.

But we are well placed to promote the relevance of the institution Sir Leslie helped to build; to ensure that it is credible, that its legitimacy is enhanced and that it becomes even more effective.

Australia is an industrial economy and net creditor at the Fund, yet sits outside the G-7 'club'. Given our geographical position amongst the emerging markets of Asia, and our recognition of their importance to us, we are more attuned to the needs of these economies than are the major developed countries of the North. And the strength of

²⁹ Meltzer (2000).

³⁰ See Henry (2002).

our bilateral relationships with those major northern players provides a vehicle for influencing their exercise of responsible leadership in the multilateral institutions.

As in Sir Leslie Melville's time, there is considerable opportunity for us to use our unique position to promote a better international financial architecture.

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Sources of economic data

The statistical appendix included in previous editions of the Economic Roundup has been discontinued from this edition. The following table provides sources for key economic data. ABS data can be obtained over the internet at <http://www.abs.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 and interest rates	OECD Main Economic Indicators
Consumer price inflation	ABS Cat. No. 6401.0

National accounts

Components of GDP, contributions to change in GDP	ABS Cat. No. 5206.0
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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 and 6302.0
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
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