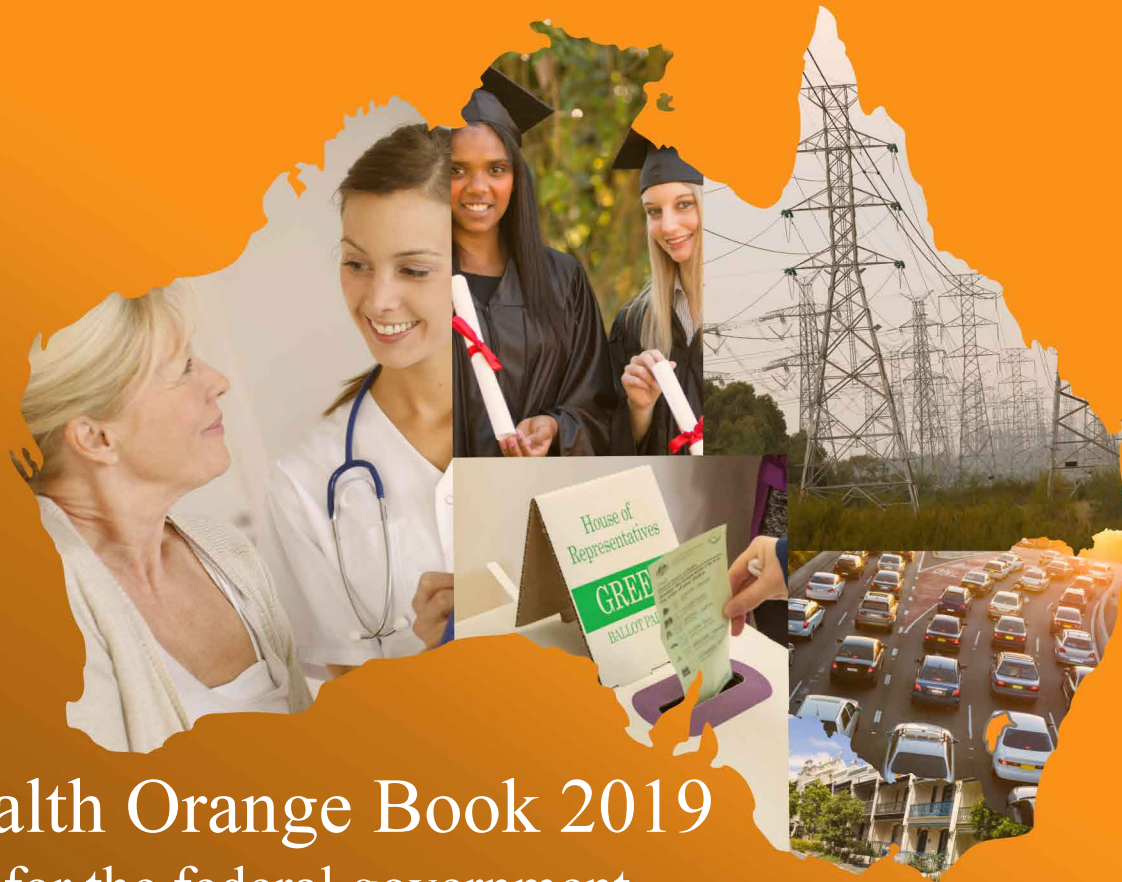


April 2019



Commonwealth Orange Book 2019

Policy priorities for the federal government

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This report was written by John Daley, Stephen Duckett, Peter Goss, Andrew Norton, Marion Terrill, Danielle Wood, Tony Wood and Brendan Coates. All of the current and previous staff of Grattan Institute have made substantial contributions to the materials on which this report is based, and their efforts for this report were coordinated by Carmela Chivers and Will Mackey.

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Overview

A federal election is an opportunity to take stock of how Australia is doing, where it's going, and what governments can do about it. This report sets out priorities for the next Commonwealth Government.

There are many problems. Living standards have stagnated. The Commonwealth Budget may be projected to return to surplus, but this assumes spending restraint governments have not achieved for 50 years.

On many social issues, Australia is not doing especially well compared to its peers, as the International Scorecard in this report shows. Australia's school results are behind. There are fewer dwellings per adult, and housing costs and homelessness are relatively high. Australia's electricity supply is more polluting, less reliable and more expensive than in comparable countries. Trust in government is falling, and too many think government is corrupt and policy making is opaque.

There are some bright spots. Australia's health system is delivering longer lives. Retirement incomes are generally sufficient, except for renters. Government is delivering on health, education and retirement at relatively low cost.

Some of the key policy reforms are primarily problems for state governments, such as planning reforms, transport infrastructure project selection, electricity network costs, public hospital costs, and school teaching. In these areas Commonwealth intervention gains headlines, but often does not improve results.

The Commonwealth is responsible for implementing a clear, credible policy to tackle climate change that will win public support. The Commonwealth needs to respond to rapidly increasing pressures on private health insurance and out-of-pocket costs, and should head towards universal dental care. It should finish the job on school funding.

It should reintroduce the demand-driven higher education system, while controlling costs by increasing repayment of HELP debt. It should abandon the planned increase in the Superannuation Guarantee from 9.5 per cent to 12 per cent, and drive down costs by adopting recommendations for 'best-in-show' default superannuation funds.

Some of our tax arrangements are a big drag on economic growth. Australia needs to reform the combination of personal income tax, means-testing of welfare benefits, and childcare costs and subsidies, which discourage many second-income earners with children from working more. Accelerated depreciation or investment allowances for large companies could attract more investment to Australia.

These changes should be funded (and other tax increases avoided) by reducing the capital gains tax discount, winding back negative gearing, limiting superannuation tax concessions (particularly the zero rate of tax on earnings in retirement), and broadening or increasing the GST.

In a range of other policy areas, we know there are problems, but don't know the answers. The Commonwealth should commission the work to define how to deliver more integrated primary health care, improve the quality of initial teacher education, manage the balance between university and vocational education, and increase the age of access to the Age Pension and superannuation given rising life expectancy.

The politics of reform is never easy. Special interest groups are vocal in protecting their interests. The next Commonwealth Government should improve checks and balances on their influence by making political donations and lobbying more visible, capping election advertising expenditure, and creating a strong integrity commission.

Many countries would be delighted to swap Australia's problems for theirs. But we can do even better. And we must make our own luck.

International Scorecard: how Australia rates

Performance metric		Australia	Canada	Germany	Japan	N'lands	New Zealand	South Korea	Sweden	United Kingdom	United States
Economic development	GNI per capita, 2017 (AUD PPP 2017)	62,752	57,315	66,875	54,270	68,078	48,761	48,388	64,948	54,912	75,945
	Employment rate, 2017 (%)	73	73	75	75	76	77	67	77	74	70
	Youth not in employment, education or training, 2017 (% of 15-29 year-olds)	11.0	12.2	9.3		7.6	11.2		8.0	12.2	13.3
	Income inequality (P90:P10)	4.3	4.1	3.7	5.2	3.4	4.3	4.4	3.3	4.2	6.3
Cities and regions	Metropolitan population (% of total population)	65	61	49	70	46		77	39	55	64
	Metropolitan output (% of national GDP)	65	51	55	75	54		78	49	61	66
Housing	Housing (per 1,000 residents aged 20+)	535	556	624	580	581	545	480	614	569	565
	Median housing costs (% of disposable income)	23.3	19.8	19.7	20.4	23.9		10.0	16.8	22.2	19.5
Energy	Electricity outages (minutes per year)	73	58	13	12	29	138	4	67	24	70
	Electricity carbon intensity (tonnes of CO ₂ e/MWh)	0.76	0.15	0.45	0.54	0.46	0.11	0.52	0.01	0.28	0.43
	Residential electricity price (cents per kWh)	30.8	14.2	44.7	29.4	23.1	26.8	14.2	23.2	26.7	16.8
	Industry gas price (dollars per Gj)	8.9	6.2	10.0	15.3	9.8	6.4	15.8	14.7	9.1	4.9
Health	Life expectancy at birth, total population (years)	82.5	81.9	81.1	84.1	81.6	81.7	82.4	82.4	81.2	78.6
	Health care expenditure (% of GDP)	9.1	10.4	11.3	10.7	10.1	9.0	7.6	10.9	9.6	17.2
	Out-of-pocket costs (% of household consumption expenditure)	3.0	2.7	2.6	2.5	2.6	2.2	5.7	3.8	2.3	2.8
School education	PISA maths, 2015 (PISA score points)	494	516	506	532	512	495	524	494	492	470
	Gap between top and bottom SES quartiles in PISA science, 2015 (years)	3.1	2.4	3.5	2.7	3.2	3.4	2.6	3.1	2.8	3.0
	Spend per student (% of GDP/capita)	22.7	23.5	22.6	25.0	22.1	24.8	33.2	23.0	26.4	21.9
Higher education	Attainment of a bachelor degree or above, age 25-34, 2017 (%)	40	36	31	40	45	41	48	36	44	37
	Part-time enrolment rate in post-secondary education (%)	42	18	13	8	17	44		46	25	38
	Tuition fees charged by universities to domestic students (USD PPP 2015)	5,526	4,969	0	8,411	2,409	4,506	8,419	0	11,797	4,216
Retirement incomes	Retirement income: low-middle income earners (% of pre-retirement earnings)	95	95	66	79	105	101	64	62	84	97
	Operating expenses of private pension funds (% of total investment)	0.78	0.37	0.21		0.12	0.56			0.21	0.35
	Total projected spending on pensions 2055 or latest year available (% of GDP)	3.7	6.9	12.6	9.5	7.9	7.2	6.3	7.4	8.3	5.9
Budget policy	Central government fiscal balance, 2016 (% of GDP)	-1.2	-0.4	0.4	-4.6	-1.1	1.3	-0.8	1.6	-2.6	-3.7
	Central government debt, 2017 (% of GDP)	32	39	46	195	63	42		37	113	89
	Independent forecasts or assessment of forecasts? (Yes/no)	No	Yes	Yes		Yes		Yes	Yes	Yes	Yes
Integrity reforms	Edelman Trust Barometer 2019 (% of people who select a positive response)	42	53	40	39	54		48	46	42	40
	Corruption Perceptions Index 2018 (100 = very clean; 0 = highly corrupt)	77	81	80	73	82	87	57	85	80	71
	Transparency of government policy making (1 = worst; 7 = best)	5.2	5.7	5.5	5.6	5.9	6.3	3.6	5.5	5.6	5.6

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Recommendations

Economic development

Efficiency of taxation

- In order to reduce (or not raise) general income taxes and corporate taxes:
 - Reduce the capital gains tax discount to 25 per cent;
 - Limit negative gearing by quarantining wage and salary income so that passive investment losses can only be written off against other investment income;
 - Increase tax on super earnings in pension phase to 15 per cent, and limit contributions further; and
 - Broaden the GST base and/or increase the GST rate.
- In the longer term, align the tax treatment across different types of savings by reducing taxes on other savings income such as net rental income and bank deposits.
- Lower effective company tax rates by introducing investment allowances or accelerated depreciation on new investment.
- Encourage the states to replace stamp duties with general property taxes.

Labour force participation

- Ask the Productivity Commission to assess combinations of tax, transfer, and childcare support that would reduce welfare traps and encourage higher female labour force participation.

- Ask the Productivity Commission to investigate the economic, social and budgetary costs and benefits of increasing the age of access to the Age Pension and superannuation to 70 years, including the design of a new regime to provide easier access for people aged over 60 whose health has been impaired.

Inequality

- Increase the rate of Newstart to reduce the gap in living standards.

Cities and regions

City and regional growth

- Do not attempt to divert population to regional Australia.
- Work with the states to plan for the growth of cities.

Regional development projects

- Work with the states to ensure people in regional areas have access to a reasonable level of services and infrastructure considering the costs of providing them.
- Streamline regional development programs, and avoid 'doubling up' on development initiatives.
- Evaluate rigorously the costs and benefits of all regional development projects, and their effectiveness after implementation.
- Limit industry assistance to severe economic shocks that threaten individuals in a community with significant and on-going harm; and only support households who would otherwise be in poverty.

Transport

Decision-making processes

- Legislate to prohibit funding state governments for transport infrastructure until a full business case has been prepared, evaluated by Infrastructure Australia, assessed for quality, and tabled in Parliament.
- Require Commonwealth and state governments to introduce stand-alone legislation for transport infrastructure estimated to cost a jurisdiction \$1 billion or more.

Discount rates

- Ask the Parliamentary Budget Office (PBO) to advise each year on the appropriate discount rates regime for transport infrastructure projects, including its assessment of the risk-free rate, the expected market risk premium, the systematic risk of public sector infrastructure projects, and project characteristics that justify a different discount rate.
- Until the PBO assessment is completed, require project proponents to use a discount rate of 3.5 per cent for very low systematic risk projects (typically bus, urban road, and urban passenger rail projects), and 5 per cent for somewhat low systematic risk projects (typically ferry and freight rail projects).

Learning from past projects

- Publish the post-completion report for all transport infrastructure projects funded by the Commonwealth, which details any scope changes and their justification, agreed and actual construction start and finish dates, forecast and actual project costs, reasons for overruns or underruns, and progress against performance indicators; and partner with state governments to use this information to create new benchmarking data.
- Add infrastructure services to the matters that the Productivity Commission assesses in the annual Report on Government Services.

Housing

Housing supply

- Encourage the states to change planning laws and processes to allow more medium-density housing in established suburbs.
- Establish a National Housing Research Council to collect nationally consistent data related to housing supply and demand, including data on the operation of state and local government land-use planning systems, infrastructure charges and migration.

Population policy

- Articulate the appropriate level of migration under both *optimal* and *actual* infrastructure and land-use planning policies.

Foreign investment in residential real estate

- Enforce existing limits on foreigners buying established housing.
- Maintain specific taxes on foreign investors, but do not increase them if it would substantially reduce foreign investment.

Low income housing support

- Increase the maximum rate of Rent Assistance by 40 per cent – an extra \$1,410 a year for singles and \$1,330 for couples, and benchmark it to rents paid by the poorest 40 per cent of renters.
- Expand the stock of social housing, but target it at people at greatest risk of becoming homeless.

What not to do

- Wind back giveaways to first home buyers.
- Avoid incentive schemes for downsizers.

Energy

Emissions

- Introduce an emissions reduction obligation for the electricity sector.
- Adopt the Safeguard Mechanism to create the platform for an economy-wide climate-change policy.

Reliability

- Implement the retailer reliability obligation for the electricity sector.

Costs

- Adopt recent recommendations to improve the efficiency of the wholesale electricity market.
- Don't underwrite new generation.
- Privatised the remaining publicly-owned energy businesses, in concert with relevant states and territories.
- Implement rule changes and ACCC recommendations to deliver effective retail competition.
- Pursue with state governments the effective write-down of overvalued network assets.
- Implement a nationally consistent gas development regime, but do not reserve gas for domestic consumption.

Market governance

- Negotiate a new Australian Energy Market Agreement.
- Develop a comprehensive narrative for the energy transition.

Health

Costs and efficiency

- Encourage the states to improve the efficiency of public hospitals by reducing the National Efficient Price.
- Strengthen the therapeutic group premium policy and expand the number of groups from seven to 18.
- Forge formal agreements with state governments and each Primary Health Network to reduce duplication and improve responsiveness to local needs.
- Introduce market competition and tendering as the way of paying for pathology services.

Quality of care and prevention

- Make information publicly available on rates of complications and questionable care in hospitals.
- Work with the states and territories to provide detailed data to hospitals and clinicians on patient outcomes; and use this data to underpin a new system of hospital accreditation.
- Introduce 'blended' funding for integrated primary care, particularly for people with complex needs, and pay general practices for gathering and supplying better data.
- Initiate the detailed work necessary to update the way general practitioner services are paid for, including rewarding general practitioners more for continuity of care for people with chronic diseases through a scheme of voluntary enrolment.
- Empower and instruct Primary Health Networks to work more closely with their local communities to change some of the factors which contribute to ill health.

- Recover the community costs of obesity, and encourage healthier consumer choices, by imposing a tax on sugary drinks.

Access to health care

- Direct the Productivity Commission to comprehensively review the private health system, including private health insurance.
- Ensure patients can get more information about fees charged by specialists and general practitioners.
- Increase the Commonwealth's share of the growth in hospital outpatient activity from 45 per cent to 55 per cent.
- Commit to a universal primary dental scheme to ensure that no Australian need pay out-of-pocket costs to obtain dental care.
- Strengthen provision of palliative care to give more people a choice about where to die.
- Make better use of pharmacists' skills, by empowering them to provide repeat prescriptions with the agreement of GPs and patients, and to work with GPs to help patients manage chronic conditions.

School education

Commonwealth role

- Avoid new school reform or school improvement initiatives unless:
 - Evidence shows it is a good idea;
 - Government (at any level) can make it happen; and
 - Commonwealth intervention will help, not hinder.

School funding

- Review the Schooling Resource Standard formula, then work with the states to move all schools to a consistent level of funding on a consistent timeframe and in the process:
 - Implement the new income-based model for estimating parents' capacity to contribute;
 - Abolish the Choice and Affordability Fund;
 - Renegotiate the 2018 National School Reform Agreements to prevent state governments from including depreciation, or reclassifying existing regulatory or transport expenditures, as contributions to their share of funding towards the SRS; and
 - Require the National School Resourcing Board to monitor how education systems allocate the funding that is given to them in a lump sum.

National school reform agreements

- Work with the states to deliver the eight newly agreed national school reforms. In doing so:
 - Keep requirements for state government reporting on their education plans to a minimum; and

- Include clear standards on what constitutes 'compliance' with education plan, allowing flexibility where justified.

Initial teacher education

- Make entry into teaching more prestigious by, among other things, pushing for teaching students to have an ATAR of 80 or above.
- Initiate an independent expert review of initial teacher education in 2021 to assess the impact of ongoing reforms and whether additional measures are needed to encourage providers to lift course quality.

Higher education

Demand-driven system

- Restore the demand-driven higher education system.
- Reduce upfront fees in vocational education to make that choice easier for students who may be better off in vocational education.
- Give prospective students more information about their chances of course completion.
- Dis-enrol students who are not engaged with their studies so they don't incur HELP debt.

Costs of HELP

- Reduce the upper thresholds to speed-up repayment.
- Collect HELP debt from deceased estates to reduce doubtful debt.

Retirement incomes

Superannuation Guarantee

- Keep the Superannuation Guarantee at 9.5 per cent, rather than increasing it to 12 per cent by July 2025 as planned.

Superannuation costs

- Adopt the Productivity Commission's recommendations for default super accounts including:
 - Create a single 'best in show' shortlist of up to 10 super funds, selected by an independent expert panel, to assign a default fund for people who are new to the workforce.
 - Default people changing jobs into their existing superannuation account.
- Legislate so that young people and those with low balances are not defaulted into life and other insurance.
- Encourage people to close multiple accounts and to exit overpriced superannuation products; and push sub-scale funds to close.

Age Pension

- Withdraw the Age Pension at a rate of \$2.25 per fortnight for each \$1,000 of assets above the 'asset free' area, rather than the current rate of \$3 per fortnight.
- Include in the assets test the value of a home above some threshold, such as \$500,000, and raise the value of assets that do not reduce the Age Pension for homeowners to the same levels that apply to non-homeowners.

Age-based tax breaks

- Wind back the Seniors and Pensioners Tax Offset so that it is available only to pensioners, and so that those who do not qualify for a full Age Pension pay some income tax.
- Impose the Medicare levy on seniors at the level where they are liable to pay some income tax.

Objectives of the retirement incomes system

- Establish an independent inquiry into Australia's retirement income system (including the role of compulsory superannuation and the Age Pension), which establishes a new standard for retirement income adequacy and assesses whether people are likely to meet it.

Budget policy

Budget repair

- Adopt the tax and spending recommendations discussed throughout this report to improve the structural budget position over time.
- Give the Parliamentary Budget Office responsibility for the macro-economic forecasts that underpin the budget.

Budget monitoring

- Set a small number of clear fiscal targets, enshrine them in the Charter of Budget Honesty, and report on progress against these targets in each Commonwealth Budget.
- Work with state governments to jointly confer responsibility on the PBO to prepare a national Intergenerational Report that contains long-term budget projections across all levels of government.

Integrity reforms

Checks and balances on the influence of special interests

- Cap expenditure on political advertising during election campaigns
- Lower the donations disclosure threshold to \$5,000, require political parties to aggregate donations below the threshold, and introduce 'real time' disclosure of donations.
- Publish ministerial diaries.
- Broaden the lobbyist register to include all holders of Parliament House 'orange passes', so that everyone who lobbies regularly is subject to the Lobbying Code of Conduct.

Accountability of public officials

- Introduce a code of conduct for all parliamentarians on conflicts of interest, investigate breaches, and appoint a separate ethics adviser to advise politicians they are in doubt.
- Establish a national integrity commission to investigate corrupt and high-risk misconduct in the public sector, with capacity to receive and investigate tip-offs.

1 Overarching considerations

1.1 Scope

This report aims to help the next Commonwealth Government set priorities for reform. Drawing primarily on work published by Grattan Institute over the past decade, it identifies policy changes for a future Commonwealth Government to improve the lives of Australians.

The report discusses reforms to policy to promote economic growth, tax reform and sustainable budgets, cities, transport, energy, school and higher education, health, and the state of our political institutions and democracy itself. Grattan Institute has focused on these because they make a big difference to the lives of Australians, because analysis can chart a path to better policy, and because outcomes are too often driven by vested interests rather than the public interest. These areas cover about three-quarters of Commonwealth Government spending.¹

The report does not cover a number of Commonwealth Government responsibilities, particularly foreign affairs and trade, most immigration issues, defence and security, law and order, industrial relations, communications, agriculture, many welfare payments, human services, Indigenous affairs, and the environment. These areas matter, but have not been part of Grattan Institute's work to date.

The report focuses on issues the Commonwealth Government can influence directly, rather than those that are essentially state and territory² responsibilities. It selectively identifies areas where the Commonwealth should increase coordination or cooperation with the states, and where additional Commonwealth tied grants to the states would help. These areas include situations where the Commonwealth Budget would substantially benefit from state government reforms.

1. ABS (2018a, table 130).

2. In this report, 'states and territories' is abbreviated to 'states'.

1.2 Measuring what matters

This report also includes an *International Scorecard* of key performance metrics, which compares Australia to a selection of comparator countries for the main policy domains covered in the report (p.4).³ The Scorecard is intended to enable Australians to understand where their country is delivering good outcomes relative to its international peers, and provide pointers to where it could do better.

For each of the key domains, the Scorecard focuses on what we should care about most. The metrics chosen are intended to capture the performance of government services, as well as final outcomes. Most are sourced from publicly available data; we have produced a few of them where no appropriate data was publicly available; the bases for calculation and sources are detailed in Appendix A.

The metrics primarily measure outcomes – the things that make a direct difference to peoples' lives. Inevitably these outcomes have many causes, some of them beyond government control. But they are all things that Commonwealth Government policy can at least influence.

3. The comparator countries chosen for the *International Scorecard* are: Canada, Germany, Japan, the Netherlands, New Zealand, South Korea, Sweden, the United Kingdom, and the United States. These countries were chosen because they have similarly high per-capita incomes to Australia, and, like Australia, they regularly score among the top on international comparisons of wellbeing and governance. Despite all having high living standards, the countries chosen vary substantially on other dimensions such as government spending as a share of GDP, the intensity of market regulation, and the degree of income inequality. For more details see Cowgill (2019).

The Scorecard could have used a more comprehensive set of metrics that would provide a more nuanced and detailed view of outcomes.⁴ But while our shorter list loses detail, it provides an overview on a single page that helps overall priority setting and is more approachable for the general public.

The Scorecard covers policy domains discussed in the remainder of the report. It does not attempt to cover domains that Grattan has not studied to date (Section 1.1). Metrics about vocational education and training, defence, public order and safety, Indigenous affairs, the environment and agriculture all matter, but they should be identified by those more familiar with these areas than we are.

1.3 The role of government

The 2019 federal election is occurring at a time of growing scepticism about the benefits of competition and free markets, and louder calls for more government intervention.

Over the past three decades, Commonwealth and state governments embarked on a substantial privatisation and de-regulation agenda. Formerly government-owned industries have been privatised and deregulated, including banks, airlines, telecommunications, railways, ports, public transport, electricity and water assets.⁵ Meanwhile other microeconomic reforms have extended competition in previously sheltered industries such as agricultural production, retail trade, and some professional services.

4. For example, the Productivity Commission's *Report on Government Services* (Productivity Commission (2018a)), which runs to 3,360 pages over 19 chapters and 7 volumes.
5. For example, see: Productivity Commission (2005) and National Commission of Audit (2014, pp. 220–21).

The push towards deregulation and privatisation has, in many cases, delivered better services and lower prices for consumers.⁶ Competitive markets provide incentives for firms to innovate, operate efficiently, and offer competitive prices.⁷ Privatisation can also drive efficiency, keeping prices low. For example, government-owned electricity poles and wires businesses in New South Wales, Queensland and Tasmania 'gold plated' their networks between 2005 and 2014, spending around \$20 billion more than was justified by growing network usage. By contrast, there is little evidence of such over-expenditure by privatised networks in Victoria and South Australia.⁸

But there has also been a string of high-profile problems with this reform agenda, including vocational education and training,⁹ retail electricity,¹⁰ airport privatisation,¹¹ and hospital privatisation.¹² Privatisation has sometimes been followed by ineffective regulation, resulting in higher prices and poor service. Privatisation itself created well-resourced and highly motivated interests that lobby against better regulation.

So now there is a backlash against deregulation and privatisation. Governments are again becoming more actively involved in markets. For example, both sides of politics have argued for more government intervention in the Australian energy market, including calls from the Coalition to re-nationalise parts of the energy grid.¹³

6. For example, Productivity Commission (2005, p. xvii) estimates that implementation of the National Competition Policy and other microeconomic reforms boosted Australian output by 2.5 per cent.
7. King (2014).
8. T. Wood et al. (2018a, p. 3).
9. Senate Education and Employment References Committee (2015).
10. T. Wood et al. (2017).
11. Minifie (2017).
12. For example, the Victorian Government exercised 'step-in rights' under its contract with the private operators of the Latrobe Regional Hospital (Productivity Commission (2014, Box 1)). See also English (2005).
13. T. Wood (2018).

But when intervening in markets, governments should always be careful of the (often hidden) costs. Regulation itself is not free: staffing and funding regulators involves costs, as does complying with regulation. Regulation can often have unintended consequences, such as raising the costs of goods and services.¹⁴ Increasing complexity and regulation can stifle innovation, increase the costs of doing business, and make it easier for interest groups to capture public policy.¹⁵

1.4 Federalism

The Commonwealth and the states share responsibility for many policy areas covered in this report – particularly in health, education, transport and energy. Lines of responsibility are often blurred, leading to the ‘blame game’ between different levels of government.

Many argue that a better division of responsibility between the Commonwealth and the states would improve political outcomes (because accountability is clearer) and efficiency (by reducing overlaps, and clarifying administrative responsibility).¹⁶ But views diverge on whether it is better to centralise, decentralise, or retain the current arrangements.¹⁷

Overall this report demonstrates that federalism is only a minor barrier to better government. The report tries to identify high-level reform priorities for the Commonwealth Government, often working with and through the states. Not one requires wholesale changes to Australia’s federation.

14. Banks (2003, pp. 6–7).

15. Teles (2013).

16. See: Williams (2017) and Maher (2013).

17. Daley et al. (2012b, p. 28). For example, the principle of subsidiarity states that responsibility for regulation and service delivery should be devolved to the lowest level of government practicable; for many services, that means state governments (Twomey and G. Withers (2007, p. 4)).

1.5 A framework for setting policy priorities

Within the policy areas highlighted, the Commonwealth Government typically tries to enable Australians to live fulfilled lives by increasing economic growth, providing valuable services, and promoting fairness, while ensuring a sustainable budget. Inevitably, these aims require trade-offs. The remainder of this section sets out these objectives in more detail.

1.5.1 Economic growth

The size of the economy is a measure of the resources available to the community. Although an imperfect proxy for measuring prosperity, it is usually closer to reality than the alternatives. Of course, individual choice, human connection, health, artistic expression and an unpolluted environment are all part of a valuable life, even if they are not measured as economic activity. But usually they are easier to sustain with the resources of a larger economy.¹⁸

Economic growth has been slowing around the developed world. In Australia, growth has slowed as the mining boom winds down. National per capita incomes have flat-lined for the past six years¹⁹ and wages growth has been slow.²⁰ Most importantly, the prospects for faster economic growth are dim. Many believe that growth will be lower for longer, in Australia and around the world.²¹

Public anxiety about Australia’s future economic prospects is rising. Economic optimism peaked in 2013 – when incomes per capita peaked at the top of the mining boom. As of 2016, fewer Australians expect

18. Daley et al. (2012a, p. 5).

19. ABS (2018b, Table 1).

20. Lowe (2018).

21. Minifie et al. (2017, p. 8).

their financial situation to improve over the next twelve months than at any time since 2001.²²

The pace of economic reform has slowed in Australia. There have been fewer economy-wide reforms over the past two decades than in the 1980s and 1990s (Figure 2.4 on page 31), perhaps because there was less impetus for reform while the mining boom buoyed the economy. It may also be that many of the reforms of the deregulatory agenda articulated in the 1980s have been completed, and policy thinkers need to articulate a new agenda, more focused on issues such as city shape and the delivery of human services, often largely funded by government.²³

Many economic drivers are beyond the control of Australian governments altogether – not least, the performance of the global economy. But there are many economic levers that the Commonwealth Government does control including tax, trade and competition policy, as well as welfare and childcare reforms that could drive greater workforce participation, especially among women and older Australians (Chapter 2).

Even if governments successfully enacted all of the major reforms identified in Grattan Institute's 2012 report, *Game Changers*, these reforms would only boost incomes by up to 6 per cent over a decade.²⁴ Incomes in Australia would remain well behind those in the US, although they would catch up to those of Australia's other peers. But it would be unprecedented if any government successfully prosecuted many of these reforms within a single term in office. Other opportunities, while still worthwhile, seem much smaller, or there is less evidence for them, or they will take much longer than 10 years to pay off.

22. D. Wood et al. (2018b, Figure 4.2).

23. See Productivity Commission (2017a).

24. Daley et al. (2012a, p. 13).

Governments would therefore be wise not to create 'Great Expectations'²⁵ that their potential reform agendas cannot fulfil. As a highly developed economy, Australia's economic growth is limited above all by the pace of global innovation, which Australian governments can do little to influence. Yet while there are limits to how much governments can influence economic growth, there are plenty of worthwhile reforms they could pursue.

Reform of the tax mix and increasing the workforce participation rates of women and older people are some of the largest opportunities to boost economic growth within 10 years. There is strong evidence for the policy changes that would make a difference in these areas. But there has only been creeping progress on these reforms.

The Commonwealth Government can improve the functioning of Australia's cities (Chapter 3), by committing to processes that make it more likely that investments in transport infrastructure will have benefits that outweigh the costs, as discussed in Chapter 4, and providing incentives for the states to reform planning rules, as discussed in Chapter 5. Reforms to improve the quality of health services (Chapter 7) and school education (Chapter 8), and to improve the efficiency of managing retirement savings (Chapter 10) would also make a big difference to economic growth in the long term.

1.5.2 Provision of services

Governments provide many services that improve lives and lift economic productivity. There is always political pressure to do more.

Improving the quality and efficiency of services, particularly in the two largest areas of health and education, should be close to the top of any government's agenda. Chapter 7, Chapter 9, and Chapter 8 discuss these areas in more detail. There are many aspects of

25. See Tingle (2012).

policy in these areas that the Commonwealth controls directly. And while state governments are responsible for many other aspects, the Commonwealth can provide incentives for the states to support reforms to improve these services.

While governments can *fund* services, often third parties can *provide* them better. The 2015 Harper Review of competition policy advocated commissioning a diversity of service providers where possible.²⁶

While this is a sensible idea in theory, execution is everything. The recent examples of aged care and vocational education and training reinforce previous experiences: taxpayer funding of for-profit entities to provide services at the behest of individual citizens must be carefully managed because they inherently create risks of poor outcomes and opportunities for fraud. The risks of outsourcing to the private sector are much higher for services such as aged care, child protection, and disability care, where ‘customers’ are vulnerable and it is difficult to specify and enforce service quality.²⁷

1.5.3 A sustainable budget

Governments must promote economic growth and provide services while ensuring that budgets add up over the economic cycle. Balanced budgets are better than the alternative: persistent government deficits incur interest payments and limit future borrowings. As a result, they can unfairly shift costs between generations,²⁸ and reduce flexibility in the event of a future economic crisis.²⁹ And a weak Commonwealth Budget also constrains other government priorities discussed in this report, even where the benefits of public spending outweigh the costs.

26. Harper et al. (2015, p. 35).

27. Private-sector operators might be more entrepreneurial, but some of their entrepreneurial spirit will be channelled into finding ways to cut costs and quality while remaining within the strict letter of their contract with government (Hart et al. (1997) and Hart (2003)).

28. Daley et al. (2014).

29. IMF (2018a, p. 22).

The Commonwealth Budget has been in deficit since the Global Financial Crisis. The budget bottom line is forecast to improve in the next two years, but continued revenue growth and formidable spending restraint will be required over the coming years to keep the budget in the black.

And there are substantial medium- and long-term pressures that the government will need to tackle (Chapter 11). Spending in health and education and other vital areas is growing faster than GDP. If spending per person continues to grow faster than inflation, then it is unlikely that other areas can be cut enough to make up the gap. Long-term forecasts under ‘business as usual’ scenarios suggest improvements in the short term but a long-term budget blow-out. Without reforms to repair the budget, the deficit could reach 6 per cent of GDP – and net debt more than 50 per cent of GDP – by 2055.³⁰ To meet the long-term structural budget challenges, the Commonwealth Government will need to both increase taxes *and* reduce spending. Some opportunities to do so are discussed in the following chapters.

1.5.4 Fairness

Fairness is a further objective for government. Of course fairness, like beauty, is in the eye of the beholder. There are at least four relevant conceptions of fairness.

One ideal aims for a more even distribution of resources (particularly income and wealth) among the community. Whether this is an appropriate end for government, and how much should be redistributed, remains contested.

Another ideal of fairness aims to ensure that people with the least resources (often identified as the bottom 20 per cent by income) have enough to pursue lives with meaningful opportunities. This ideal tends

30. Hockey (2015, pp. xiv–xv).

to have broader support across political divides.³¹ It is less concerned with redistribution from high incomes to middle incomes, and more focused on redistribution towards people on low incomes.

A third ideal, fairness between generations, also matters. Under almost any theory of ethics, it is unfair for one generation to adopt policies that leave the next generations worse off at a similar age, especially when they have no say in those policies.³² Australia has increasingly adopted age-based tax, welfare, and other spending policies, accompanied by recurrent budget deficits, that increase the risk that the next Australian generation will be less well-off than its parents. These policies also tend to increase inequality *within* generations over the long term.³³ And they undermine incentives by increasing the value of inheritance relative to individual effort.

Finally, procedural fairness matters. People value being able to make plans under stable rules. Like other conceptions of fairness, however, this value is not absolute. The biggest concerns arise if new rules impose adverse consequences as a result of a past action. Yet this does not mean that every rule affecting investments (such as changes to tax rates) should be grandfathered. There is no adverse consequence as a result of past action if those investments would probably have been made anyway. The rule changes simply mean that individuals benefit *less* from their investments.³⁴ In any case, procedural fairness must be balanced against other considerations: grandfathering unsustainable tax arrangements for all current property owners, for example, tends to benefit one generation over the next.

31. Daley et al. (2013b, p. 21).

32. Daley et al. (2014, p. 10).

33. Ibid. (p. 36).

34. Daley et al. (2016c, p. 12).

1.5.5 Complexity

Managing complexity is another objective of government. Complexity can arise when more choices are available to people. But there are costs of dealing with complexity (in time, effort, or cost of expert advice), and often complexity induces indecision that can be the worst choice of all.³⁵ Some of the additional choices may be bad ones, with real costs.³⁶ And these costs can be especially high for the most disadvantaged members of our community.

For example, competition in electricity retailing hasn't delivered what was promised: lower prices for consumers.³⁷ Lower-price deals are available, but most consumers find the market so complicated that they give up trying to find them. Thus many Australians, including some of the most vulnerable, are paying more than they should.

Complex government rules can have hidden costs.³⁸ Complexity imposes additional costs on individuals, businesses and government administrators. It discourages innovation. More worryingly, complexity makes it easier for vested interests to lobby for rules that benefit them.³⁹ The complexity and detail both obscures the impact to all but insiders, and exhausts the limited resources of those representing the public interest.

For example, superannuation has become a textbook example of 'kludgeocracy'. Complexity, originally driven by the search for fair outcomes, has ultimately provided large benefits to vested interests with the time and resources to push for technical changes and discretionary decisions that serve their interests.⁴⁰

35. Kahneman (2003).

36. Gorecki and J. Kelly (2012).

37. T. Wood et al. (2017, p. 3).

38. Teles (2013).

39. D. Wood et al. (2018c, p. 23).

40. Daley et al. (2015a, p. 70); and Daley (2018).

1.5.6 Prioritisation

Governments need to prioritise. Big reforms are inherently difficult because they take time to design, advocate, legislate and implement. Because there are invariably losers who have vested interests to campaign against reform, governments usually have to expend political capital explaining why the reform is in the public interest.⁴¹ Often the time and focus of senior ministers is the most scarce resource.⁴² Without prioritisation there is a real risk that easy but trivial reforms will succeed, while important but difficult reforms wither.⁴³

As outlined in Grattan's landmark reports, *Game-changers* and *Balancing budgets*, it can be useful to prioritise reforms by thinking about both about the value of each reform, and practical doability.⁴⁴

As outlined above, the value of a reform is a result of the combination of how much it contributes to:

- economic growth;
- services that improve people's lives;
- the budget bottom line;
- fairness, particularly support for those who lack meaningful opportunities; and
- other factors, such as improving the environment.

It may also be relevant that government intervention would reduce economic rents. The economic costs of rent-seeking can be substantial. It can reduce economic activity – the 'size of the pie' – if

41. Daley et al. (2012a, pp. 4–5); and Daley et al. (2013b, p. 15).

42. Daley et al. (2012a, p. 6).

43. Ibid. (p. 6).

44. Daley et al. (2012a, pp. 4–5) and Daley et al. (2013b, p. 15). See also Daley et al. (2018a, pp. 90–92) and Daley et al. (2015a, p. 38).

firms devote their efforts to influencing policy rather than developing better and more innovative products and services.⁴⁵

The doability of a reform improves with:

- confidence in particular solutions given the available evidence
- practical complexities in implementation
- the extent of entrenched public opposition (often a consequence of the first order costs being obvious while the second order benefits are less clear)

From the perspective of the Commonwealth Government, a reform is also more doable if it has direct control over the levers, rather than relying on cooperation from the states. In practice a reform will also be harder if it is opposed by well-resourced highly-motivated interest groups. But this opposition is the precise thing that government energy and focus can overcome.

The combination of value and doability should drive the prioritisation of government resources (Figure 1.1).

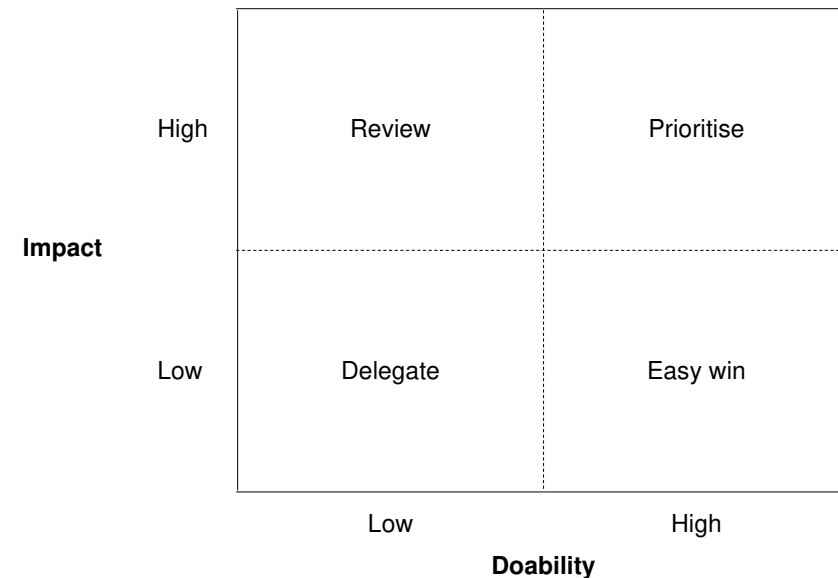
- Reforms that are more valuable and more doable should be **prioritised**. Government should apply resources – public service time, ministerial attention, money, and political capital – to make sure they happen.
- Reforms that are more valuable and less doable should be sent for **review** so that others can gather the evidence, work through the practical problems in implementation, and build public support for worthwhile change.

45. Baumol (1996); Brou and Ruta (2013); Tullock et al. (2002); Lindsey and Teles (2017); and Zingales (2017).

- Reforms that are less valuable but more doable should be seen as **easy wins**. Government should put enough resources into making them happen, and use them to build momentum for other more important reforms.
- Reforms that are less valuable and less doable should be **delegated**. They might be left either to an individual minister or to state governments without the Commonwealth expending its scarce whole-of-government resources. Within an individual portfolio these reforms are worth pursuing relative to the alternatives (otherwise we would not include them in this report as recommendations at all). But a government should focus the energy of its senior ministers on things that matter most.

Using this framework we have ranked all of the recommendations of this report, as shown in Table 1.1 on the next page.

Figure 1.1: Reforms should be prioritised based on their importance and doability



Source: Based on Daley et al. (2012a).

Table 1.1: Priorities

	Prioritise	Easy win	Review	Delegate
Economic development	<ul style="list-style-type: none"> CGT discount and negative gearing Super earnings tax Newstart 	<ul style="list-style-type: none"> Accelerated depreciation 	<ul style="list-style-type: none"> EMTR for 2nd income earners Pension and super age Property taxes 	
Cities and regions				<ul style="list-style-type: none"> Regional project evaluation Regional service levels
Transport	<ul style="list-style-type: none"> Infrastructure decision making Discount rate Past project learnings 			
Housing		<ul style="list-style-type: none"> National Housing Supply Council Foreign real estate ownership Commonwealth rent assist 	<ul style="list-style-type: none"> Planning for housing supply Migration policy 	<ul style="list-style-type: none"> Social housing
Energy	<ul style="list-style-type: none"> Emissions Retailer reliability obligation 		<ul style="list-style-type: none"> Wholesale market reforms Gas taxes 	<ul style="list-style-type: none"> Privatisation network assets Write down of network assets Retail electricity competition
Health	<ul style="list-style-type: none"> Universal dental care 		<ul style="list-style-type: none"> Integrated primary care Private health insurance Out of pocket costs Sugary drink tax 	<ul style="list-style-type: none"> Public hospital pricing Hospital complication data Hospital outpatient funding Pathology costs Pharmacist repeats Palliative care
School education		<ul style="list-style-type: none"> School funding 		<ul style="list-style-type: none"> School reform agreements Initial teacher education
Higher education	<ul style="list-style-type: none"> Demand-driven higher education 	<ul style="list-style-type: none"> Completion information Dis-enrol disengaged students 		<ul style="list-style-type: none"> HELP cost recovery Vocational education fees
Retirement income	<ul style="list-style-type: none"> Default super accounts Age Pension asset test Retirement income system 	<ul style="list-style-type: none"> Age Pension asset taper Default super insurance 	<ul style="list-style-type: none"> Super Guarantee level 	<ul style="list-style-type: none"> Super account switching Age-based tax breaks
Budget				<ul style="list-style-type: none"> Macro-economic forecasts Fiscal targets Intergenerational report
Integrity	<ul style="list-style-type: none"> Political donations Campaign spending Ministerial diaries 	<ul style="list-style-type: none"> Lobbyist register Parliamentarian conflict of interest Integrity commission 		

Our priority table aims to provide a smaller list of the most important reforms that will focus attention. A ministry should put extra resources into pursuing issues that are prioritised from a whole-of-government perspective, while continuing to pursue the others within its purview.

This is not a comprehensive list. It only aims to rank those matters covered by existing Grattan work (Section 1.1). But the methodology may also be useful for determining where other issues should fit on the scale of priorities.

1.6 Guide to this report

The rest of this report considers issues for reform in more detail.

Reforms that would promote **economic growth** and boost Australians' living standards, focusing particularly on a range of tax and welfare reforms, are outlined in Chapter 2.

Two-thirds of Australians live in capital cities, and many believe that the economic divide between **cities and regions** is getting bigger. The differences between them, and what government should do to manage them, is discussed in Chapter 3.

The geographies of cities and regions partly depend on **transport** networks. Reforms to improve the basis on which government funds major transport infrastructure projects are considered in Chapter 4.

Housing affordability is a growing issue, and policy priorities are discussed in Chapter 5.

Our lives, and Australia's economy, depend on the supply of **energy**, which must also respond to climate change. Priorities for energy policy are examined in Chapter 6.

Health is crucial to quality of life and is a large area of government expenditure. Policy reforms to improve health outcomes and access, and to reduce costs are explored in Chapter 7.

In the long term, **education** matters more to economic growth and quality of life than almost anything else. Reforms to **school education** are discussed in Chapter 8, and reforms to **higher education** in Chapter 9.

We expect to spend an increasing number of years retired, so adequate **retirement incomes** are vital. Chapter 10 suggests policies to balance the trade-offs between income before and after retirement, to help help those at risk of poverty, and to minimise the costs of the system.

The **Commonwealth Budget** must deliver all of this but live within its means. The state of the budget and potential reforms to budget institutions are discussed in Chapter 11.

All of this depends on good political institutions to run the day-to-day business of government and to implement reform. **Integrity reforms** so that government works better are recommended in Chapter 12.

2 Economic development

2.1 Where we are

Australia is a prosperous country. Our strong economic growth over decades has increased individuals' material living standards, and enabled our society to invest in many of the non-material assets that improve people's lives. We have high incomes (Table 2.1) and wealth per capita, and a stable economy.⁴⁶ We're ranked 3rd in the world on the UN's Human Development Index, which reflects very high levels of well-being among most Australians.⁴⁷

2.1.1 Incomes

Australians enjoy some of the highest per capita incomes in the world, ranking 11th out of 35 among OECD countries.⁴⁸ Incomes have increased faster than in many comparable countries over the past two decades.

Australia avoided the global malaise in the wake of the Global Financial Crisis (GFC), but incomes have flat-lined since the mining boom peaked in 2012 (Figure 2.1).⁴⁹ Incomes have increased faster in New Zealand and Korea than in Australia in recent years, and other countries – notably the United Kingdom and the United States – are also starting to grow faster than Australia.⁵⁰

There is a risk that economic growth will now be lower for longer, in Australia and around the world.⁵¹ Wages growth has been slow

Table 2.1: International scorecard for economic development

	GNI per capita, 2017	Employment rate, 2017	Youth not in employment, education or training, 2017	Income inequality
	AUD PPP 2017	%	% of 15-29 year-olds	P90:P10
Australia	62,752	73	11.0	4.3
Canada	57,315	73	12.2	4.1
Germany	66,875	75	9.3	3.7
Japan	54,270	75		5.2
Netherlands	68,078	76	7.6	3.4
New Zealand	48,761	77	11.2	4.3
South Korea	48,388	67		4.4
Sweden	64,948	77	8.0	3.3
United Kingdom	54,912	74	12.2	4.2
United States	75,945	70	13.3	6.3

Notes: See Appendix A for notes and sources.

46. Lowe (2018).

47. UN (2018).

48. OECD (2019a). Gross national income per capita, converted to US dollars at PPP.

49. See also: ABS (2018c) and ABS (2019a).

50. OECD (2018a).

51. Minifie et al. (2017, p. 7).

in Australia,⁵² as it has been across most of the OECD,⁵³ despite improvements in the employment rate in most countries.⁵⁴ Recent low wage growth in Australia appears to be only partly explained by spare capacity in the labour market, low inflation and the decline in the terms of trade from its 2011 peak.⁵⁵ Technological change, globalisation, the increased power of ‘superstar firms’, more devolved wage bargaining, reduced union power, underemployment, and slow productivity growth have all been proffered as explanations for wage stagnation,⁵⁶ but there is little expert consensus on what policy makers should do to improve current trends.⁵⁷

2.1.2 Inequality

Income inequality is not particularly high in Australia. The income gap between a household at the 10th percentile and a household at the 90th percentile is smaller than in the US, and a little higher than the UK and Canada (Table 2.1). The level of income inequality in Australia is about average for the OECD (Figure 2.2).⁵⁸

Income inequality has not got much worse in Australia over the past two decades.⁵⁹ Household incomes have grown at about the same rate

52. Salaries increased by 2.3 per cent in the year to September 2018 (ABS (2018d)), far below the 3-to-4 per cent growth that was the norm for Australian workers during the early 2000s (Lowe (2018)).

53. OECD (2018b).

54. OECD (2018c).

55. Bishop and Cassidy (2017).

56. Bishop and Cassidy (2017); Borland (2016); Hutchens and Jericho (2018); Isaac (2018); A. Stewart and Hardy (2018); Taylor and Tyers (2017); Weir (2018); Bishop and Chan (2019); and Eeckhout (2019).

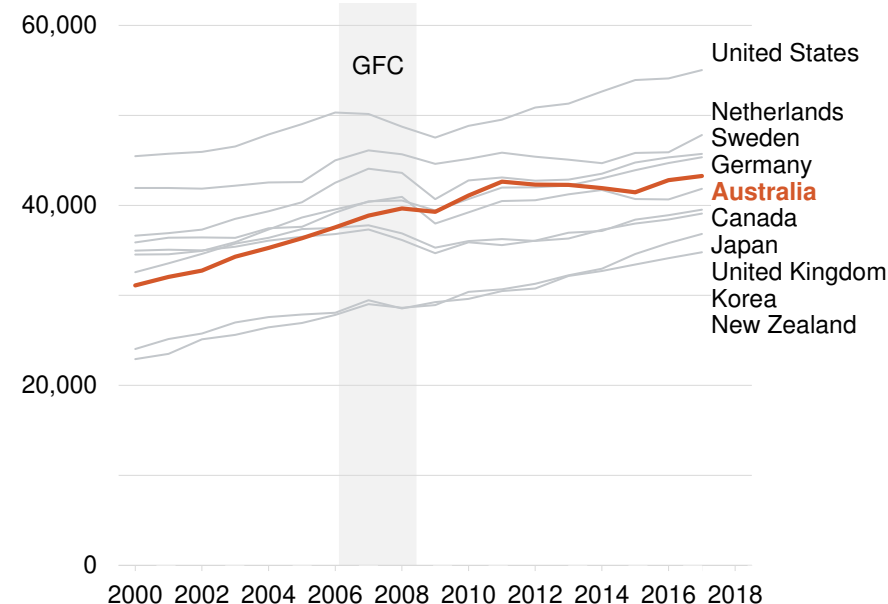
57. Although some claim that the problem is increasing returns to capital rather than labour, recent analysis shows that this is largely a result of notionally increasing ‘returns’ on owner-occupied housing as prices increase (Ellis (2019), Kirchner (2019) and La Cava (2018)).

58. OECD (2019b).

59. Productivity Commission (2018b); and Wilkins (2015).

Figure 2.1: Australian incomes have flatlined in recent years

Gross national income per capita, purchasing power parity adjusted

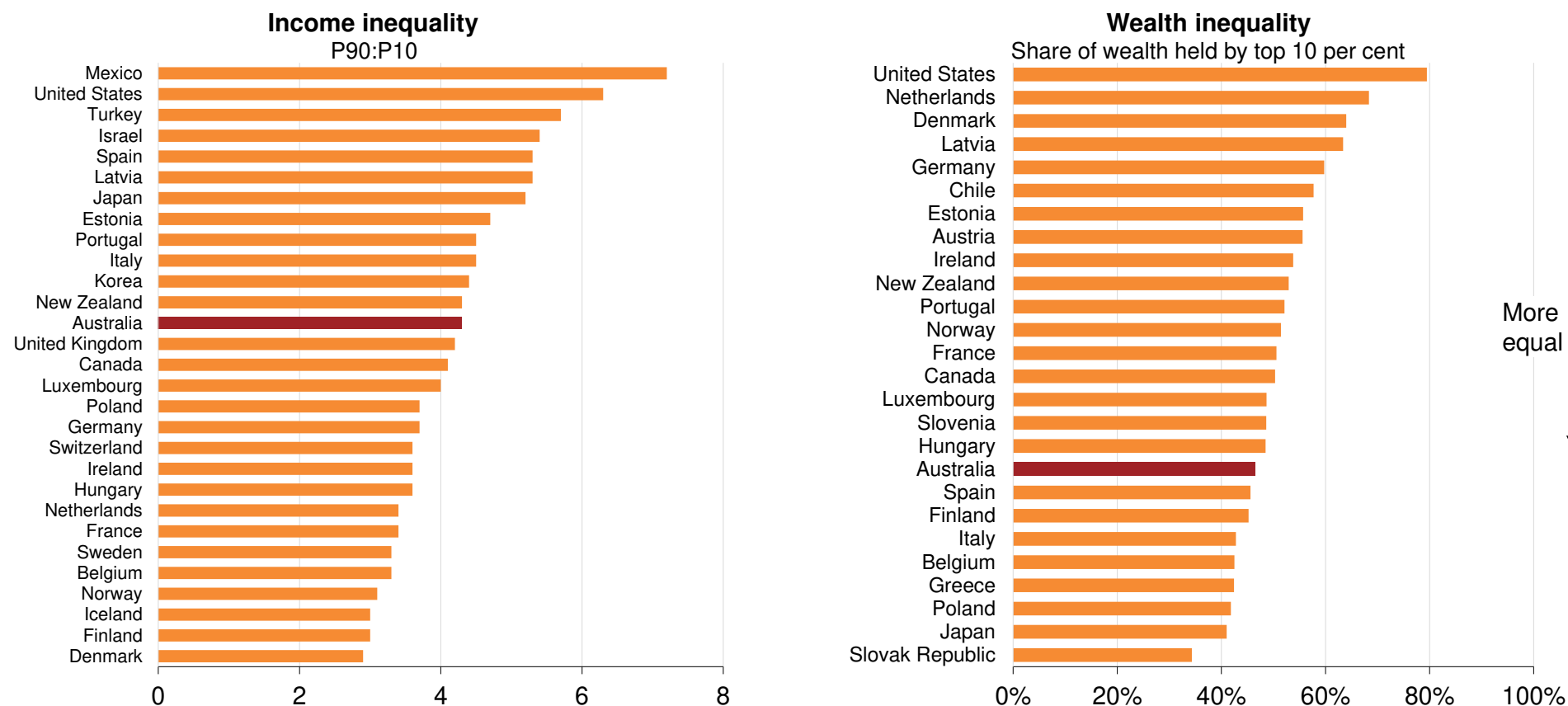


Notes: Constant PPPs, constant prices, OECD base year. Income data for Korea is an OECD estimate.

Source: Derived from OECD (2018a).

Figure 2.2: Income and wealth inequality aren't particularly high in Australia

Income and wealth inequality, selected OECD countries, latest year available



Notes: Income is defined as household disposable income in a particular year. Latest year for income inequality: 2013: Poland, Turkey; 2014: Denmark, France, Netherlands, Hungary, Ireland, New Zealand, Italy, Portugal, Japan, Israel; 2015: Norway, Switzerland, Luxembourg, Canada, Australia, Spain, United States; 2016: Finland, Iceland, Belgium, Sweden, Germany, United Kingdom, Korea, Estonia, Latvia, Mexico. Latest year for wealth inequality: 2012: Canada, Spain; 2013: Estonia, Finland, Ireland, Portugal; 2014: Australia, Austria, Belgium, Chile, France, Germany, Greece, Hungary, Italy, Japan, Latvia, Luxembourg, New Zealand, Norway, Poland, Slovak Republic, Slovenia; 2015: Denmark, Netherlands, United States. The concept of wealth used in the OECD Guidelines refers to 'ownership of economic capital'. It excludes other types of capital (such as human capital, social capital and collectively held assets) that, while important for individuals and communities, are not material assets over which people can exercise ownership rights.

Sources: OECD (2019b) and OECD.Stat (2018).

across the income distribution.⁶⁰ But disposable incomes after housing costs have grown more unevenly, because housing has become much less affordable for low-income earners.

Rising house prices have also worsened wealth inequality over the past two decades, as home-ownership has increasingly benefited the already well-off (Figure 2.3).⁶¹ Inequality between younger and older Australians has increased as a result, since the big winners from the sharp rise in house prices in Sydney and Melbourne over the past few years are older people who were lucky enough to buy a house before the boom.⁶²

2.1.3 Workforce participation

Although the employment rate in Australia is relatively high by overall OECD standards,⁶³ it is lower than in comparable countries (Table 2.1). Participation rates for women and older people are also lower in Australia than in similar countries.⁶⁴ Australian women are substantially more likely to be in part-time employment than men,⁶⁵ and motherhood

60. However, the top 10 per cent of households experienced faster income growth than the rest, and the top 1 per cent earn an increasing share of Australia's total income (Productivity Commission (2018b, pp. 44, 49)).

61. Despite the widening gap, wealth inequality is still low in Australia by international standards (Figure 2.2).

62. Today's households headed by 65-74-year-olds are almost \$500,000 richer on average than households of that age 12 years ago. Households headed by 45-54-year-olds are \$400,000 richer. But this economic progress has not extended to Australia's young. Households headed by 25-34-year-olds are only \$40,000 richer than households of that age 12 years ago (even though they spend less) (Daley and D. Wood (2017a)).

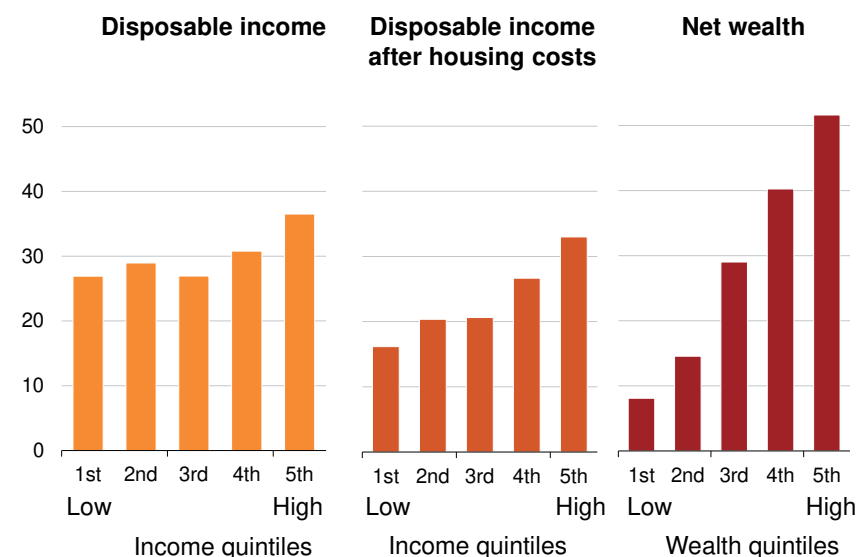
63. The OECD average was 68 per cent in 2017 (OECD (2019c)).

64. OECD (2018d).

65. 45 per cent of women and 16 per cent of men are working part-time. Australia has one of the highest rates of female part-time employment in the OECD (M. Stewart (2018)).

Figure 2.3: Housing costs and prices are the main driver of increasing inequality

Change in real equivalised household disposable income and wealth, 2003-04 to 2015-16



Notes: Housing costs include rents for renters and repayments on loans for owners with mortgages. Growth in income excluding housing costs calculated by subtracting growth in housing costs from growth in disposable income. Income quintiles are calculated using household disposable income, equivalised by family size. Bottom two income percentiles are removed due to low reliability. 2003-04 equivalised household disposable income data from ABS (2016).

Source: Daley et al. (2018a, Figure 1.4).

has a large impact on labour force participation rates among Australian women by international standards.⁶⁶

Some trends are in the right direction: workforce participation among women and older people is generally increasing. More Australian women are working than ever.⁶⁷ More than 70 per cent of women aged 15-64 are working,⁶⁸ and the rate has increased steadily since the mid-1980s.⁶⁹ Older Australians, too, are more likely to be in work. About one in eight Australians aged 65 or older are in the labour force – double the share in 2000.⁷⁰ Young Australians are less likely to be disengaged from the workforce or not in education than young people in the US, the UK, or Canada (Table 2.1).

And despite public concern, there is little evidence that automation is putting people out of work (Box 1) – indeed, employment rates are close to record levels.

However, underemployment is a growing problem for young Australians. One in five people aged 15-24 have fewer hours of work than they would like. This is the highest rate of underemployment among young

66. Australian mothers aged 25-54 are 15 percentage points less likely to be in work than women the same age who don't have children. The difference in Australia is larger than in the US, Canada, and the Netherlands (but not the UK). The average difference across the OECD is about 10 percentage points (OECD (Figure 1.18 2018e)).

67. ABS (2018e).

68. Compared to 83 per cent of working-age men (OECD (2018d)).

69. The participation rate for men, meanwhile, has flat-lined (Jericho (2018a)).

70. OECD (2018d). These changes were probably the result of improved health, education levels, and having partners who are also working longer (Daley et al. (2012a, p. 51)). Recent increases in the age at which people qualify for an Age Pension and tax-free superannuation benefits are also contributing factors.

Box 1: Don't panic: The robots aren't coming to take your job

People have long worried that technology improvements will increase unemployment. In 1978, historians were predicting that a quarter of the Australian workforce would be out of work by 1988.^a Keynes, famously, thought innovation would allow workers to enjoy 15-hour work weeks.^b Not much has changed: commentators today also worry that robots – or automation of work more generally – will put people out of a job.^c

But there's no need to fear: there is no evidence of the death of work.^d The number of hours worked per Australian of working age has *increased* since the 1970s and is close to its all-time high.^e Nor are jobs turning over any faster. The share of people who have worked in the same role for more than ten years has gone *up* since 2008.^f

As economist Jeff Borland points out, there are good reasons *not* to worry about the impact of technology on work: while technological change may cause job losses, it also increases the amount of work available.^g Rather than worrying about mass unemployment, governments should focus on ensuring that displaced workers can make a smooth transition into a new role,^h and that the benefits of technology improvements are shared evenly.ⁱ

a. Borland (2017).

b. Elliot (2008).

c. Caisley (2017); and S. Johnson (2019).

d. Borland and Coelli (2017).

e. Ibid. (p. 383).

f. Borland and Coelli (2017); and Borland (2017).

g. Borland (2017); see also Chester (2018).

h. Including by providing adequate retraining (Chester (ibid., p. 10)) and unemployment assistance (see Section 2.2.3 on page 38).

i. Ibid.

people in 40 years.⁷¹ Young people – especially young women – are underemployed much more often than people aged 25 or older.⁷²

2.1.4 The fruits of economic policy reform

These relatively prosperous outcomes are the fruits of careful economic planning and courageous policy decisions from both sides of politics. But the pace of economic reform has slowed over the past two decades (Figure 2.4).⁷³

The next federal government, no matter its political colour, should enact economic reforms and do what it can to safeguard prosperity. Reducing inefficiencies in the tax and transfer system, supporting competition in markets, and improving workforce participation among women and older people would make the biggest difference to the economic outcomes of all Australians.⁷⁴ But policy makers should also acknowledge the limits to government: improvements are usually gradual and small from year to year.⁷⁵

The rest of this chapter provides a roadmap for the policies that would promote economic growth in Australia.

71. ABS (2018f) and Dhillon and Cassidy (2018). A portion of the rise is because more young people are going to university and taking up part-time work (people who work part-time are more likely to want to work more hours, compared to people in full-time work). But underemployment has increased among young people, even after taking account of rates of part-time employment (Jericho (2018b); and Grattan analysis of ABS (2018f, Table 22)).

72. Jericho (2018a); and ABS (2018f).

73. Daley et al. (2016c).

74. Other reforms, such as addressing climate change (Section 6.2 on page 81), will be vital to ensure our economic growth is sustainable.

75. Daley et al. (2012a).

2.2 What we should do

The next federal government should focus on tax reform. The objectives should be to:

- reduce income tax and modify welfare and childcare means tests to remove barriers and increase incentives for women and older people to participate in the workforce; and
- introduce an accelerated depreciation scheme for new investment.

To pay for these tax changes, to reduce budget deficits, and to avoid other tax increases if spending increases, government should:

- reduce the capital gains tax (CGT) discount and limit negative gearing;
- tighten superannuation tax concessions, particularly earnings in pension phase (or as a second-best alternative, reduce cash refunds for franking credits); and
- broaden the GST base and/or increase the rate.

Grattan work has shown that improving participation would be a ‘game changer’ for Australia’s economy and the government budget.⁷⁶

Australia’s competition policy should focus on improving business regulation and reining in natural monopolies. Industry and innovation policy should be kept to a ‘light touch’.

Where possible, the Commonwealth should also encourage states and territories to replace stamp duties with land tax, and reform land-use planning rules to allow more housing to be built in the inner and middle rings of our major cities.

76. Ibid.

Figure 2.4: Australia has made fewer tough economic choices this past decade, and reversed many
Major policy changes by policy area and government

	Hawke/Keating 1983–1996			Howard 1996–2007			Rudd/Gillard 2008–2013	A/T/M 2013–2019	
Trade and currency	Float A\$	International students	Tariff reductions					FTAs	End auto assistance
Macro/budget policy			RBA inflation targets	Balanced budget commitment			PBO		
Labour markets	Accord	Enterprise Bargaining		Workplace Relations Act	Skilled migration	Work Choices	Fair Work	Age pension access 67	Age pension access 70
Competition policy		Hilmer review		National Competition Policy			Demand-driven higher ed		
Privatisation	GBE reform	CBA sale	Elec Water	Airline IPO	Telstra sale (1,2 & 3)			Medibank sale	
Regulation	Foreign bank entry	Telco dereg.			Bank capital reform		National Reform Agenda		
Tax	Capital Gains Tax	Dividend imputation	Super-annuation	GST	Personal income tax cuts	Company tax cut	Carbon pricing	Super tax	Company tax
Federalism	Medicare				Federal/state financial reform		Federal/state health reform	NDIS	School funding

Notes: Reforms that were not passed, or that were subsequently substantially wound back or repealed, are shown shaded out. 'Airline IPO' is the sale and IPO of Qantas in 1993 and 1995.
Sources: Access Economics (2019) and The Economist (2011); Grattan analysis.

If the Government chooses to support state infrastructure projects, it should invest in projects that will support national economic growth (Chapter 4), rather than political outcomes.

2.2.1 Improve the efficiency of Commonwealth taxation

All taxes drag on economic growth, but some do so more than others. The Australian tax base is a patchwork of more and less efficient taxes.

Income taxes create disincentives to work, particularly when the interaction of taxes, means-testing of welfare benefits, and childcare costs and subsidies create very high effective marginal tax rates (EMTRs). The highest EMTRs in Australia are faced not by high-income earners, but by middle-income earners, particularly women with children (see Section 2.2.2 on page 36).

Corporate taxes create larger economic distortions, whereas land taxes are much more efficient. Broad-based consumption taxes – such as the GST – are more efficient because they are difficult to avoid, and they interfere less with incentives to work, save and invest.

To fund reducing (or at least not raising) income and corporate taxes, government should reduce the CGT discount, limit negative gearing deductions, tighten superannuation tax concessions, and broaden or increase the GST.⁷⁷

Improving the efficiency of Australia's tax base could materially increase economic growth. Policy makers should also consider how any tax change redistributes resources.

77. In theory, personal income tax can be as efficient as a consumption tax (McCaffery (2006, p. 458)). But in practice, consumption taxes may discourage working less than income taxes because their impact on spending power is less obvious (Blumkin et al. (2012) and Sausgruber and Tyran (2005)).

Reduce the CGT discount and limit negative gearing

The interaction of a 50 per cent CGT discount with negative gearing distorts investment decisions, makes housing markets more volatile, and reduces home-ownership. Like most tax concessions, these tax breaks largely benefit the wealthy.

The CGT discount is designed to preserve incentives to save and invest. But policy has overzealously protected incentives to save, at the expense of competing considerations. The economic benefits of lower taxes on savings are small: people with high incomes save almost the same amount regardless of the tax rate.⁷⁸ If taxes on savings are lower, then other taxes must be higher, and other taxes typically impose greater economic costs.

Reducing taxes on investment via a 50 per cent CGT discount distorts investment decisions. It encourages investors to focus more on investments with capital growth rather than annual income. The CGT discount also undermines income tax integrity by creating opportunities for artificial transactions to reduce income tax.⁷⁹

There are concerns of principle that if nominal capital gains are taxed then inflation can erode part of an investor's wealth.⁸⁰ But if the purpose of the CGT discount is to avoid taxing nominal gains from inflation, it has overcompensated most investors given actual returns and inflation over the past 20 years.⁸¹

78. Most studies have found that tax incentives for retirement savings have little effect on the *total* amount saved (Daley et al. (2016b, p. 15)). Savers do tend to switch into whichever investment vehicle pays the least tax, but this switching does not increase overall investment or economic growth.

79. Ibid. (pp. 15–17).

80. Daley et al. (Ibid., p. 10). The original design of the capital gains tax reflected this philosophy by indexing the original price of an asset to CPI. It is arguable that taxing nominal capital gains is a form of wealth tax, the value of which is increasingly debated: see Daley et al. (2016b, pp. 11–12, 18) and OECD (2018f).

81. Daley et al. (2016b, p. 10).

Reducing the capital gains discount to 25 per cent would provide a better balance between these competing considerations and would raise about \$4 billion a year.⁸²

Negative gearing allows people who borrow to invest to use losses to reduce tax on wages and salaries. In Australia negative gearing goes beyond broadly accepted principles for offsetting losses against gains. It diverts capital from more productive investments without greatly increasing housing supply. Like the CGT discount, negative gearing primarily benefits people on high incomes. Australia should follow international practice, and not deduct losses from passive investments from labour income. The change would raise \$2.1 billion a year in the short term, falling to \$1.5 billion as losses start to be written-off against positive investment income.⁸³

Other proposals, such as restricting negative gearing to new properties or limiting the dollar value of deductions, would improve the current regime, but would also leave too many problems in place and introduce unnecessary distortions.⁸⁴

These changes to CGT and negative gearing would improve housing affordability – a little. We estimate prices would be up to 2 per cent lower than otherwise.⁸⁵ Rents wouldn't change much, nor would the rate of new development. With tight constraints on supply of land suitable for urban housing, most of the impact would be felt via lower land prices. The changes would not cause housing markets to collapse: the effect on prices would be small compared to factors such as interest rates and supply of land.⁸⁶

82. Estimates as at March 2019, using 2015-16 tax statistics. See also Daley et al. (2016b).

83. Estimates as at March 2019, using 2015-16 tax statistics. See also Daley et al. (Ibid.).

84. Ibid. (pp. 42–44).

85. Ibid. (p. 32).

86. Ibid. (pp. 31–35).

Arguably the impacts of reforms to the CGT and negative gearing on the housing market would be even smaller today, because so many investors are sitting on the sidelines after changes to macro-prudential rules and recent house price falls.⁸⁷

Phasing in change would reduce price shocks and make the reforms easier to sell. It is better than grandfathering current holdings, which would increase complexity, limit the additional tax collected for many years, and be unfair to new investors, especially younger ones.

Tighten superannuation tax concessions

Superannuation tax concessions continue to provide benefits unrelated to the purpose of superannuation, to substitute or supplement the Age Pension. These tax breaks should be tightened further, which would raise substantial revenue but have limited economic impacts. Ending cash refunds for franking credits would be a second-best policy, but better than current arrangements (Section 10.2.4 on page 132).

Broaden the GST base and/or increase the GST rate

A well-designed package to reform the GST could be progressive, and could increase budgetary options, while dragging on economic growth less than the alternatives.

Australia collects less in consumption taxes than similar countries, and our GST tax base is narrow by international standards.⁸⁸

A revenue-neutral tax reform package that reduces income taxes and increases GST (either by broadening the GST base to include

87. New finance commitments for investment purposes have fallen sharply in the past year (ABS (2019b)).

88. Daley et al. (2015b, pp. 4–7). It is not clear that there is an inherently optimal balance between direct taxes (such as income tax) and indirect taxes (such as the GST).

currently excluded items such as fresh food, health and education, or by increasing the rate) would modestly increase incentives to work and invest.⁸⁹ An increase in consumption taxes also acts as a lump-sum tax on accumulated wealth, and so collects more from households that are living off their savings. However, Treasury modelling suggests that once a compensation package (including higher welfare payments) is factored in, the economic payoff would be relatively modest – probably no more than a 0.3 per cent one-off boost to incomes.⁹⁰

If a GST increase partly funds tax changes to encourage investment – such as an accelerated depreciation scheme – then the net economic payoff may be higher.

Alternatively the government could retain some of the additional GST revenue to improve the budget bottom line. Collecting more through the GST is preferable to most other means of raising revenue, although it would still reduce economic activity.

A GST reform package can be designed to be progressive, so that people on lower incomes are on average better off, while people on higher incomes pay more tax in total.

Previous Grattan work has outlined a package to increase the GST to 15 per cent, modestly cut income taxes (particularly for low brackets) and boost welfare payments. This would leave most Australians on the lowest 20 per cent of incomes better off, while government would have about \$11 billion (40 per cent of the revenue raised) to improve

89. Consumption taxes are efficient for several reasons – they are relatively difficult to avoid, create fewer distortions in decisions to work (because they are less salient), distort savings decisions less (because they treat current and future consumption equivalently), and cost relatively little to collect: see Daley et al. (2015b, p. 6).

90. Treasury presented its own modelling plus those of two private-sector modelling firms. Estimates of the longer-term GDP effects of a revenue-neutral package that increased the GST, reduced income taxes and increased welfare payments varied: Treasury (no gain); Independent Economics (0.18 per cent gain); and KPMG (0.3 per cent gain) (Treasury (2016)).

the bottom line of Commonwealth and state governments, or cut other taxes. Ultimately, it will be necessary to broker a deal on additional GST revenues that is acceptable to both the Commonwealth and states. At best, the Commonwealth might expect to retain around \$6 billion for its own purposes, with the remainder available to the states and territories.⁹¹

Introduce an accelerated depreciation regime for new investment when the budget allows

If the tax changes outlined above create the budgetary space, Australia should introduce an accelerated depreciation regime to encourage new investment.

Corporate taxes drag on the economy because they discourage investment. Australia now has one of the highest *headline* corporate tax rates in the OECD,⁹² although Australia's *effective* corporate tax rate is not as high because of its unusual dividend imputation system.⁹³ This system returns to shareholders about a third to a half of the revenue raised,⁹⁴ but creates other economic distortions.⁹⁵

In theory, lower company taxes lead to more investment, and therefore higher incomes in the long term. But in practice, they mainly increase after-tax returns to foreign investors, because Australia's dividend imputation regime means that the corporate tax rate matters much less to domestic investors.

While a cut to the headline company tax rate would boost Australia's economic output, it would do less to increase the per capita incomes

91. Daley et al. (2015b, pp. 13–27).

92. Our headline corporate tax rate is 30 per cent. Small businesses (with a turnover of less than \$25 million) pay 27.5 per cent (ATO (2018a)).

93. Estimates suggest that Australia's true corporate tax rate – taking account of dividend imputation – is less than 20 per cent (Davis (2012)).

94. OECD (2019c) and M. Stewart (2019).

95. D. Wood and Coates (2018, pp. 12–13).

of Australians.⁹⁶ Much of the benefit of the tax cuts would accrue as increased payments to foreign investors, some of which would be substantial windfall gains on existing investments. The Commonwealth Budget would take an immediate hit, reducing per capita incomes in Australia in the short term. The benefits to Australian incomes would emerge only gradually, as companies choose to invest more.

For example, cutting the company tax rate to 25 per cent this year would reduce gross national income (GNI) by about 0.25 per cent (\$4 billion). As investors respond to a higher rate of return and the capital stock grows, GNI would begin to increase. Based on Treasury models of the cost and economic impact of a company tax cut, GNI would become positive after six years, but the full benefit wouldn't be felt for many years.⁹⁷

The Commonwealth Government recently passed legislation to cut the company tax rate for businesses with a turnover of up to \$50 million to 25 per cent by 2021-22,⁹⁸ while proposals for a similar cut for larger businesses have been abandoned.⁹⁹

Other tax changes could offer similar benefits to a general corporate tax cut, but at lower long-term cost to the budget and the incomes of Australian residents.¹⁰⁰ Tax changes that apply only to new investments

– such as accelerated depreciation or an investment allowance – would boost foreign investment at lower cost than a company tax cut.¹⁰¹

Accelerated depreciation regimes allow firms to write-off new capital investments faster. Bringing forward depreciation reduces the real cost of investing for firms, particularly in long-lived assets such as plant and equipment. In effect, government provides an interest-free loan to the company for new assets.

An investment allowance enables firms to claim a tax deduction for a proportion of new capital investment and then continue to depreciate 100 per cent of the asset's value over its life. It is effectively an investment subsidy.

Accelerated depreciation is usually a better policy than an investment allowance because it is less complex. It is also more familiar to business: Australia has a history of accelerated depreciation schemes, including the current instant asset write-off for small business.¹⁰² The Coalition recently announced an increase and expansion of the instant asset write-off, from \$25,000 to \$30,000 until June 2020, for businesses with turnover of less than \$50 million a year.¹⁰³ Labor has proposed a permanent accelerated depreciation scheme that would allow all businesses to immediately deduct 20 per cent of an eligible asset worth at least \$20,000.¹⁰⁴

96. D. Wood et al. (2018a, pp. 6–8).

97. Daley and Coates (2016). Other analyses differ on whether the net effect would be positive for Australian residents, and if so when (See: D. Wood et al. (2018a, p. 7)).

98. Treasury Laws Amendment (Lower Taxes for Small and Medium Businesses) Bill 2018.

99. Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017. Different company tax rates for small and larger businesses introduces another set of distortions including a disincentive for companies close to the threshold to grow.

100. D. Wood et al. (2018a, pp. 11–14).

101. Accelerated depreciation or an investment allowance reduce taxes only on *new* investments, unlike a general company tax cut which also increases returns on *existing* investments. This 'free kick' to owners of existing assets from a general company tax cut has a substantial budgetary cost, but minimal positive economic impact: see Minifie et al. (2017, pp. 30–40).

102. The instant asset write-off scheme (introduced in the 2015-16 Budget and since extended) allows businesses with a turnover of less than \$10 million to immediately depreciate 100 per cent of the asset's value for up to \$20,000 in capital spend: ATO (2018b).

103. Treasury (2019a, p. 14).

104. Bowen (2018).

The challenge with an accelerated depreciation scheme is that it costs the budget more in the initial years, although less over time, than a company tax cut that provides a similar-sized boost to investment.¹⁰⁵ For example, the Parliamentary Budget Office estimates that Labor's proposed accelerated depreciation scheme would reduce government revenue by \$1.8 billion in its first year of operation.¹⁰⁶

Encourage the states and territories to replace stamp duties with general property taxes

The clearest productivity increase from tax reform would be to replace stamp duties with general property taxes. The Commonwealth should encourage the states and territories to do so.

Stamp duties are inefficient taxes: they discourage people from moving to housing that better suits their needs. And sometimes they discourage people from moving to better jobs.¹⁰⁷ The economic drag of stamp duties has increased over the past two decades.¹⁰⁸ In contrast, land taxes do not distort decisions about land use, provided they apply in a way that the landowner can't avoid.

Shifting from stamp duties to a broad-based property tax (at \$5 to \$7 for every \$1,000 of unimproved property value) could make Australians up to \$17 billion a year better off, while also making housing more affordable (Chapter 5).¹⁰⁹ The gains would be even larger if this broad-based property tax were expanded to fund the replacement of

other inefficient taxes, such as taxes on insurance and stamp duties on motor vehicle sales.¹¹⁰

While this is a state government responsibility, the Commonwealth should provide incentive payments to the states to make this change, similar to those provided under the Hilmer competition reforms, given that Commonwealth revenues will ultimately benefit from the increased economic growth that the reform would encourage.¹¹¹

2.2.2 Improve workforce participation

Increasing the share of the working-age population that is in work would boost economic growth, and counter the ageing of the population. Grattan research has found that improving workforce participation rates for women and older people would be 'game changers' for Australia's economy.¹¹²

Lift female workforce participation

Removing disincentives for women to take up more paid work is good for economic growth and promotes gender equality. More women are working in Australia (Section 2.1), but there are still significant disincentives to women with children entering the workforce, and working more hours. Having children has a very large impact on labour force participation rates among Australian women by international standards.¹¹³

Childcare is the highest hurdle. Before having children, women are just as likely to work as men. But many drop out of the workforce to look after young children, and some never go back to work. Lack

105. Minifie et al. (2017, p. 39).

106. Bowen (2018).

107. Daley et al. (2018a, pp. 121–122).

108. Average rates of stamp duty have risen substantially in all states, from about 2-to-3 per cent on the median-priced house in each capital city in 1995 to about 4 per cent in 2015, because thresholds have not kept pace with rising house prices (Daley et al. (Figure 7.3 *ibid.*)). Rates of property turnover have declined (Daley et al. (*Ibid.*, p. 122)).

109. *Ibid.* (p. 122).

110. Daley et al. (2018c, p. 84).

111. Daley et al. (2018a, p. 129).

112. Only improving the efficiency of taxes is the same order of magnitude (Daley et al. (2012a)).

113. See Section 2.2.2, and OECD (Figure 1.18 2018e).

of childcare and its cost also affect how many hours women work, and this affects their subsequent career progression. Nearly 40 per cent of women who would like to work more hours say that caring for children is the main reason preventing them from being able to take on more hours in the next four weeks.¹¹⁴ As a result, women earn lower incomes, retire on less,¹¹⁵ and are more likely to be financially insecure than men.

Australia's tax and transfer system reduces the incentives for women to re-enter the workforce after having a child. Women with young children face high effective marginal tax rates (EMTRs),¹¹⁶ because they pay more income tax – and lose more of their welfare and childcare subsidies – when they work more hours and earn more money. Women are usually more affected by these EMTRs, because they tend to be the second-earner in their household.¹¹⁷ These EMTRs are much higher than those that apply to single income-earners on the top marginal tax rate.

The new Child Care Subsidy (CCS) has helped, by reducing EMTRs for many second-income earners.¹¹⁸ But many mothers still face high EMTRs on their earnings. A woman in a low-income household still

loses 85-95 cents of every extra dollar she earns if she increases her work hours from three days to four, or from four days to five.¹¹⁹ Women in middle-income households also face high EMTRs, especially when increasing work hours from four days to five.¹²⁰

The interaction of different taxes and transfers can affect working mothers a lot. In 2017, the combination of changes to the Medicare levy, family tax benefits and student loan repayments imposed effective marginal tax rates of 100 per cent on some women.¹²¹ The Federal Government should reinstate a women's budget statement,¹²² to identify and hopefully avoid such unintended consequences. The statement would also regularly highlight how the combination of tax and welfare settings both hold back economic growth and unfairly impose much higher EMTRs on a significant portion of the population.

Encourage older people to stay in the workforce

Increasing superannuation preservation from age 60 to at least 65 if not 70, and increasing the age of access to the Age Pension from age 67 to 70, would make more difference in the long term than almost any other reform to economic growth,¹²³ budget balances,¹²⁴ and retirement incomes.¹²⁵ Having increased the age of access to superannuation and the Age Pension to reflect substantial increases in life expectancy over the past 30 years, it may be appropriate to index these ages to reflect future increases in life expectancy.¹²⁶

114. 272,000 women wanted to work more hours but were unable to start in the next four weeks in 2016-17 (ABS (2017a, Table 4)). 24 per cent of the 650,000 women who wanted a job or more hours and *were* available to start work in the next four weeks said that their childcare responsibilities were preventing them from looking for more work (ABS (ibid., Table 5)).

115. Coates (2018a).

116. Effective marginal tax rates measure the cost of earning an extra dollar of income due to progressive income tax and the withdrawal of welfare benefits or cash transfers (Ingles and Plunkett (2016)).

117. M. Stewart (2018).

118. The Child Care Subsidy came into effect in July 2018, replacing the Child Care Benefit and Child Care Rebate. The new scheme increased the overall subsidy for childcare by \$3.5 billion over five years, removed an annual cap on the amount paid to most families, and adjusted how the benefit is phased out as a family earns more income (M. Stewart (2018) and Doyle (2018)).

119. M. Stewart (2018, p. 8).

120. Ibid. (p. 10).

121. Murphy (2017).

122. M. Stewart (2016).

123. Daley et al. (2012a, p. 12).

124. Daley et al. (2013b, pp. 29–32); and Productivity Commission (2015a, p. 2).

125. Daley et al. (2018b, p. 74).

126. Daley et al. (2013b, p. 30).

Older people are less likely to work in Australia than in many comparable economies.¹²⁷ The age at which people can access superannuation or the Age Pension affects retirement decisions of at least some workers.¹²⁸

Opposition to raising the pension access age focuses on concerns that people on lower incomes are more likely to retire younger, are less likely to be able to work to age 70, and have shorter life expectancies.¹²⁹ But it would be better to address the needs of this group by applying less stringent tests to people aged over 60 than to younger people when assessing whether they have a disability that impairs their ability to work. And in any case, these arguments do not apply to raising the super preservation age to match the age of access to the Age Pension.

Given the combination of a very large policy impact, but substantial concerns about unfairness, the Productivity Commission should be asked to investigate the economic, budgetary, and social costs and benefits of gradually raising the age of access to the Age Pension and superannuation to 70 years.¹³⁰ The inquiry should consider whether there should be a new regime for easier access to the pension and superannuation for people older than 60 whose health has been so impaired that it is difficult for them to work.¹³¹

2.2.3 Increase Newstart payments

Although income inequality is not particularly high in Australia, some households are entrenched in disadvantage.¹³² Unlike wages and

127. Daley et al. (2012a, p. 50).

128. Ibid. (pp. 53–54).

129. Whiteford (2014); and Chomik (2014).

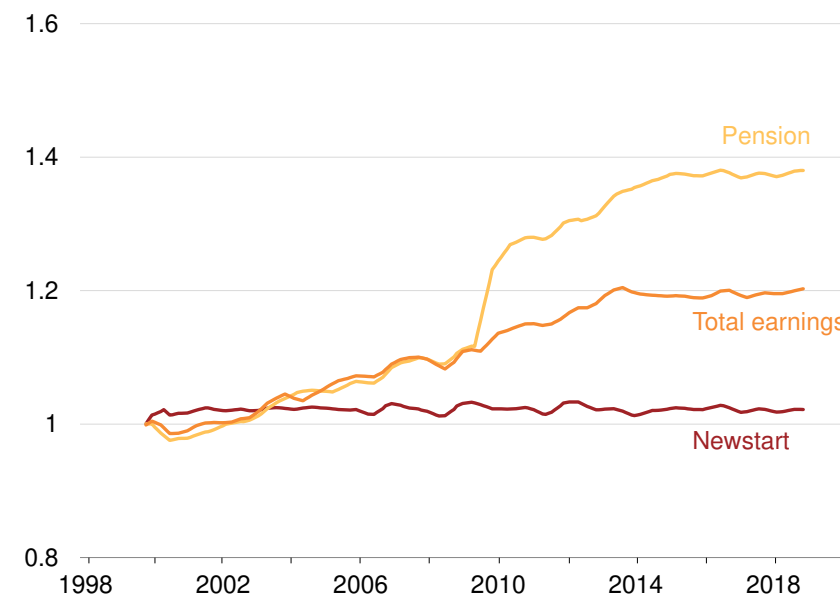
130. Daley et al. (2018b, pp. 102–103).

131. See Daley et al. (Ibid.) for a discussion.

132. Productivity Commission (2018b, Chapter 6).

Figure 2.5: Newstart hasn't increased in over 20 years

Average real total earnings, pension for singles, and Newstart for singles, indexed (smoothed)



Note: Half-yearly moving average shown.

Sources: ABS (2018c) and Department of Social Services (2019a, Table 6).

pensions, Newstart has not increased in real terms in more than 20 years (Figure 2.5).¹³³

While the Age Pension is indexed to wages, Newstart only increases with inflation.¹³⁴ This has 'squeezed' the living standards of people

133. The last time Newstart increased in real terms was more than 24 years ago (ACOSS (2018)).

134. Wages typically increase faster than prices. So the Age Pension has grown more rapidly than Newstart over the past two decades. Several one-off changes have increased the Age Pension even more (Daley et al. (2013a, p. 20)).

living on Newstart relative to the rest of the population (Figure 2.6).¹³⁵ A typical single person on Newstart receives just \$39 a day,¹³⁶ about 18 per cent of average (male) earnings.¹³⁷ Households of working age receiving welfare payments – primarily Newstart – are under much more financial stress than households receiving other welfare payments.¹³⁸

Increasing incomes at the very bottom of the distribution would probably improve economic outcomes¹³⁹ by helping recipients to look for a job.¹⁴⁰ Increasing Newstart would also reduce the number of people with insufficient resources to pursue lives they have reasons to value,¹⁴¹ and reduce inequality.¹⁴²

Consequently, many commentators have argued that Newstart payments are much too low.¹⁴³ A ‘catch up’ increase to Newstart of \$75 a week would have a material impact on the incomes of low-income households,¹⁴⁴ and would bring payments closer to community living standards. Increasing Newstart would do more to reduce poverty rates per budgetary dollar spent than other welfare changes.¹⁴⁵

135. Deloitte (2018, p. ii).

136. People on Newstart may receive up to another \$10 a day in family payments, rent assistance and the energy supplement: ACOSS (2018).

137. ABS (2018c, Table 10C). Newstart was equal to 24 per cent of average male earnings in 1996: Whiteford (2012).

138. Daley et al. (2018b, p. 27); and Daley et al. (2013a, p. 19).

139. Deloitte (2018).

140. The OECD noted concerns that the low level of Newstart ‘raises issues about its effectiveness in providing sufficient support for those experiencing a job loss, or enabling someone to look for a suitable job’: OECD (2010a, pp. 127–28).

141. Reducing absolute levels of poverty that prevent people exercising meaningful choices is broadly regarded as of intrinsic value: Daley et al. (2013a, p. 37).

142. Although the *intrinsic* value of reducing inequality is contested: Daley et al. (Ibid., p. 36).

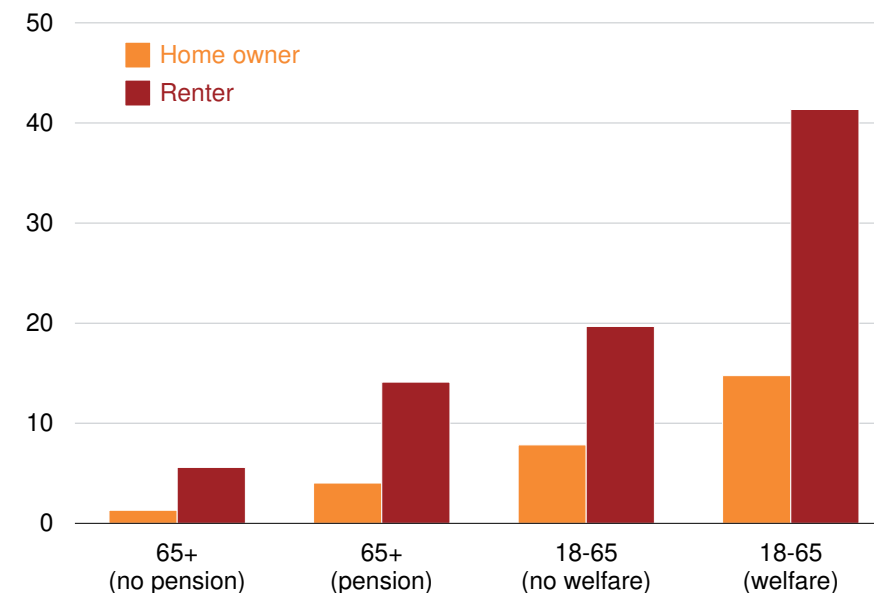
143. ACOSS (2018); Bagshaw (2018a); BCA (2012); BCA (2018); CEDA (2018); Deloitte (2018); Iggulden (2018); and KPMG (2018, p. 14).

144. Deloitte (2018, p. ii).

145. Phillips et al. (2018).

Figure 2.6: Working-age people on welfare are most likely to be in financial stress

Households facing at least one financial stress, 2015-2016, percentage



Notes: ‘Financial stress’ defined as money shortage leading to 1) skipped meals; 2) not heating home; 3) failing to pay gas, electricity or telephone bills on time; or 4) failing to pay registration insurance on time. ‘Pension’ includes everyone over the age of 65 who receives social assistance benefits in cash of more than \$100 per week. ‘Welfare’ includes those who receive more than \$100 per week from a disability support pension, carer payment, unemployment or student allowances, other government pension and allowances.

Source: ABS (2017b).

2.2.4 Promote innovation and competition

By definition, innovation is central to boosting productivity – it is ‘ideas successfully applied’.¹⁴⁶ But innovation doesn’t usually involve invention. Because Australia accounts for only a small share of the global economy, the vast majority of innovations in Australia are invented elsewhere, and then adopted or adapted for local use.¹⁴⁷ Consequently, removing barriers to spreading global innovation to Australia matters much more to economic growth than subsidies for Australian inventions.

Innovation drives productivity, but governments have only limited ability to enhance productivity through innovation. Overall, the biggest spur to innovation is vigorous competition. Government policy can alter the dynamics of competition generally. In addition, sector-specific regulation can have an even bigger effect on competition. The remainder of this section details some of the policy changes that could make the biggest difference to boosting economic activity.

Government should focus innovation policy more on promoting framework conditions rather than subsidising specific inventions

Even though most productivity-enhancing innovation is adoption of ideas from elsewhere, most government support that is labelled ‘innovation’ goes towards basic research in public organisations.¹⁴⁸ This support is not obviously translating into much productivity-increasing innovation. Australia’s university researchers and industry collaborate

less than in the most innovative economies,¹⁴⁹ and Australian businesses see university research as much less important to innovation than suppliers, customers, and industry consultants.¹⁵⁰ Australian universities doubled research spending, research-only academic staff, research degree enrolments, and journal articles published over the past 15 years.¹⁵¹ It is not obvious that this increase in research expenditure translated into materially better economic outcomes.

Governments can ensure that the framework conditions for innovation (particularly adoption) are in place. Australia is not doing too badly. Australia’s labour force is relatively well-educated, with high levels of participation in higher education (Chapter 9). New businesses form faster in Australia than in other countries,¹⁵² and Australian consumers adopt new consumer technologies relatively quickly.¹⁵³ But while small firms in Australia tend to be early adopters of new technologies, large firms in Australia are less likely to use cloud computing services than large firms in many other countries.¹⁵⁴

Competition laws are unlikely to require major changes, but regulation of natural monopolies should be strengthened

Australia’s general competition laws are unlikely to require any immediate changes. The 2015 Harper Review of competition policy found that Australia’s competition law regime has generally served

146. Dodgson and Gann (2010). A little more descriptively, the OECD defines innovation as: ‘the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organisational method in business practices, workplace organisation or external relations’ (OECD (2005)).

147. Daley et al. (2012a, pp. 17–18).

148. Daley et al. (2013c, p. 7).

149. Banks (2012); and ABS (2018g).

150. ABS (2018g).

151. A. Norton et al. (2018a, pp. 41–44, 57).

152. World Bank (2018a).

153. Australia is ranked fifth out of 20 selected countries in the proportion of consumers adopting selected Fintech services such as borrowing used peer-to-peer platforms, investing in crowdfunding platforms, and mobile money transfer and payments (EY (2017, Figure 3)).

154. Ellis (2017).

the country well.¹⁵⁵ It recommended some amendments – including a change to the test for establishing a misuse of market power – which have largely been adopted by government.¹⁵⁶

More recently the ACCC has flagged that it may seek amendments to the mergers regime to deal with the market power of some digital platform providers, but its review has not finished.¹⁵⁷

There are potentially large benefits from tightening regulation in natural monopoly sectors where little direct competition is possible. Firms in natural monopoly industries subject to regulation tend to have higher risk-adjusted returns. For example, returns to electricity distribution have been nearly double their cost of equity, and returns to electricity transmission have also been well above normal.¹⁵⁸ Returns to the wired telecommunications sector, airports and some ports have also been significantly above the cost of equity.¹⁵⁹ Grattan's *Competition in Australia* report details some sector-specific suggestions for increasing regulatory pressure in these natural monopoly sectors.

Improve business regulation

Australia is a relatively business-friendly environment, and ranks highly on international comparisons of the ease of doing business.¹⁶⁰ But we should not be complacent. Regulations and red tape that unjustifiably drag on business activity should be adjusted or abandoned.

Grattan's *Competition in Australia* report found that:¹⁶¹

- **Overall**, government should cut the regulatory burden by removing constraints on entry and exit, cutting preferential treatment of firms, and reducing impediments to efficient allocation of labour and capital. The main opportunities in these areas, identified by the Harper Review and the Productivity Commission, include reforming the industrial relations system, and aligning Australian product standards with those in other major markets.¹⁶² Government could also improve government procurement, and mandate company director identification numbers.
- **In banking**, government should make it easier for customers to switch banks, and make it easier for new competitors to enter the market. Government could cut switching costs by making it easier for customers to share their data, to transfer their direct debits to a new bank, and to free-up their data from the control of their current bank.¹⁶³ The Consumer Data Right (currently before parliament) is a step in the right direction.¹⁶⁴ Competition should also be strengthened in other parts of the financial services industry, including superannuation and foreign exchange.¹⁶⁵
- **In health insurance**, APRA and government should increase the pressure they apply on premiums, and should consider reviewing premiums less frequently.¹⁶⁶

155. Harper et al. (2015, p. 9).

156. Competition and Consumer Amendment (Misuse of Market Power) Act 2017; Competition and Consumer Amendment (Competition Policy Review) Act 2017.

157. ACCC (2018a).

158. See Chapter 6, Section 6.2.7 on page 86 for a discussion of competition in the electricity sector.

159. Minifie (2017, pp. 32–33).

160. World Bank (2019).

161. Minifie (2017, p. 44). See also Productivity Commission (2017a, p. 154), particularly Appendix B.

162. Harper et al. (2015); and Productivity Commission (2017a).

163. Treasury (2017a); and Productivity Commission (2018c).

164. Treasury Laws Amendment (Consumer Data Right) 2019 Bill.

165. Minifie et al. (2015).

166. See Laffont and Tirole (1993, Chapter 9) for a discussion of how repeatedly reset short-term prices can deter regulated firms from reducing costs.

- **In pharmacies**, government should finally remove constraints on competition, as many reviews have urged.¹⁶⁷
- **Elsewhere**, government should relax restrictions on retail trading hours, review industry assistance, relax restrictions on cabotage and shipping, improve trade in books and second-hand cars, implement the National Water Initiative, and review competition in the gas market.

Government can also improve market functioning by mandating that providers share information so customers can compare them more easily. Government can reduce customer-switching costs through initiatives such as mobile number portability. And government should design more wholesale forms of competition to increase competitive intensity in markets such as superannuation where members are highly disengaged.¹⁶⁸

2.2.5 Encourage states to reform land-use planning rules

The Commonwealth Government should provide incentives to state governments to reform land-use planning rules to allow more housing to be built in the inner and middle rings of our major cities, and to provide firms with more flexibility in where they locate (Chapter 5 and Chapter 3).

Land-use planning policies are arguably the biggest policy lever for governments to boost economic growth.

Geography matters a lot to economic growth.¹⁶⁹ An advanced economy like Australia is dominated by services industries,¹⁷⁰ which often benefit

from collocation, and tend to concentrate in major cities.¹⁷¹ Cities tend to be more productive, as is reflected in higher wages, GDP and rates of innovation per worker (Chapter 3).¹⁷² Jobs are well-distributed across major cities,¹⁷³ but CBDs contain about 15 per cent of all jobs, are growing relatively fast, and contain a disproportionate share of high-productivity jobs.¹⁷⁴

How much businesses can collocate is affected by planning rules that guide the availability of land for businesses and the homes of the people that work in the businesses. Planning systems play an important role in managing the growth of cities. Land-use planning rules set out how competing land uses should be managed to coordinate the provision of infrastructure and to minimise the costs that some land users impose on their neighbours – such as pollution, noise, congestion, or poor design.¹⁷⁵

But the benefits of these restrictions for the neighbours can be outweighed by the costs that they impose. Fewer restrictions on land use and subdivision can increase economic growth by enabling more people to access more jobs, while allowing firms to optimise their location.

If people are forced to live on the edge of cities, with less access to jobs, then employers have a smaller pool of workers to choose from, and some employers don't set up at all, and so productivity is lower than otherwise. Fewer restrictions on development can also reduce

167. Productivity Commission (2017a).

168. Retail energy: T. Wood et al. (2017) and Ben-David (2015); mobile telecoms: Gans (2005); mortgages: D. Hughes (2017); superannuation: Minifie et al. (2015).

169. Moretti (2012).

170. Daley (2016a).

171. J.-F. Kelly and Donegan (2015).

172. Romer (2015); and SGS Economics & Planning (2018, p. 2).

173. Terrill et al. (2018, pp. 14–23).

174. For example, in Melbourne, new medium-sized and large businesses mainly choose to locate in the CBD and its immediate surrounds, or close to the airport: Rasmussen (2016). And knowledge-intensive jobs are particularly concentrated towards the centre of large cities (Rawnsley (2018)), where productivity per worker is higher (J.-F. Kelly et al. (2013)).

175. Daley et al. (2018a, Box 4).

inequality of wealth and suburb-based segregation.¹⁷⁶ In particular, current planning rules make it hard to build more homes in the inner and middle-ring suburbs of our major cities.¹⁷⁷ Recent US studies estimate that GDP would be between 2 per cent and 13 per cent higher if enough housing had been built in cities with strong jobs growth such as New York and San Francisco.¹⁷⁸ Similar research shows that limits on subdivision in Sydney and Melbourne increase the price of housing by up to 40 per cent.¹⁷⁹ Even if *some* planning restrictions are justified, the costs that others impose on would-be home-owners are often much larger than the benefits they provide to existing residents.

The Commonwealth Government is not directly responsible for planning, but it can provide incentives for states to do better, as discussed in Chapter 5.

176. Ibid. (p. 86).

177. Ibid. (pp. 56–58).

178. Glaeser and Gyourko (2018, pp. 22–24); and Hsieh and Moretti (2017).

179. Kendall and Tulip (2018).

3 Cities and regions

3.1 Where we are

Australia is a highly urbanised country. Nearly two thirds of Australians live in cities.¹⁸⁰ In the OECD, only South Korea and Japan have a greater share of people living in metropolitan areas (Table 3.1).¹⁸¹

The fact that Australia is a wealthy country by international standards, and has been for a long time, is inextricably linked to the fact that we are a highly urbanised country, and have been for a long time.

This does not mean that Australia's regions are unimportant or getting a raw deal. The oft-repeated tale of 'two Australias' is an over-simplification – people in regional areas don't fare badly. Income growth per capita in the regions is keeping pace with the cities. Unemployment is not materially worse, although employment rates are lower for some groups.

People in regional Australia report higher wellbeing than people in the cities, although many perceive that there is a widening cultural gap between cities and regions, which can play out as concerns about migration – even though regional areas usually have far fewer migrants.

3.1.1 People are choosing cities

Large cities tend to dominate the national economies of OECD countries. Typically they comprise about 60 per cent of their nation's population and economy,¹⁸² and are generally growing more quickly

180. Defined by the OECD as functional urban areas containing 500,000 or more people, also referred to as 'metropolitan areas' (OECD (2018g)).

181. Excluding Luxembourg, which is defined as a single metropolitan area by the OECD (OECD (Figure 4.1 *ibid.*, p. 97)).

182. *Ibid.* (p. 100).

Table 3.1: International scorecard for cities and regions

	Metropolitan population	Metropolitan output
	% of total population	% of national GDP
Australia	65	65
Canada	61	51
Germany	49	55
Japan	70	75
Netherlands	46	54
New Zealand		
South Korea	77	78
Sweden	39	49
United Kingdom	55	61
United States	64	66

Notes: See Appendix A for notes and sources.

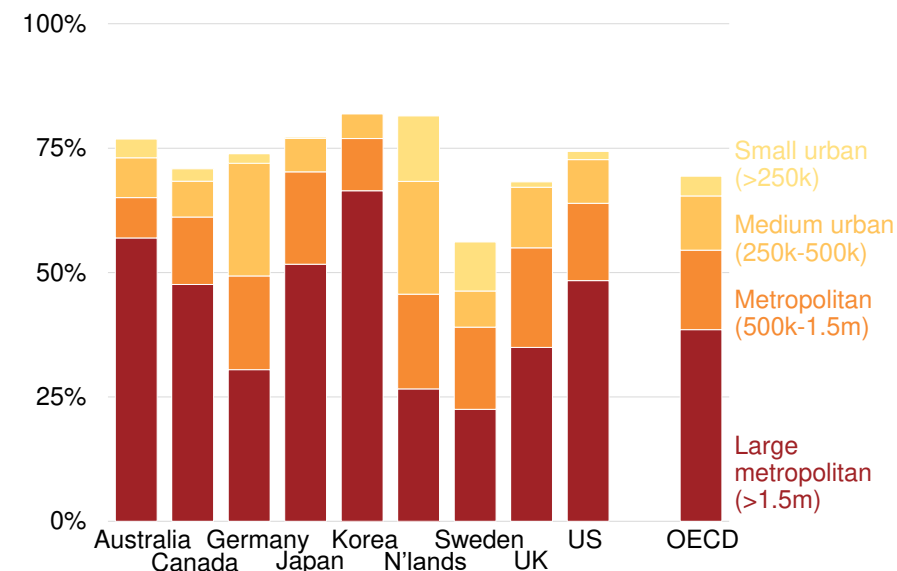
than smaller centres. Over the past 15 years, economic growth in OECD cities was 32 per cent higher than in less built-up regions.¹⁸³

This faster growth rate is more pronounced in larger cities.¹⁸⁴ It results in part from migration: in most OECD countries, migrants are more likely to settle in built-up areas, and two thirds of the foreign-born population in the OECD live in urban areas.¹⁸⁵ Internal migrants – people moving within the same country – also tend to make a city their new home.¹⁸⁶

Australia is no exception. Australia is more urbanised than many OECD countries (Figure 3.1). The populations (Figure 3.2) and economies (Figure 3.3) of Australia's largest cities have tended to grow more quickly than those of smaller cities, including by attracting the majority of overseas migrants.¹⁸⁷

Within Australia's regions, the distribution of population and economic activity is also changing. Population and employment are generally declining in small inland towns in the east-coast states and South Australia, but increasing in larger regional centres, and in regional towns on the east coast (Figure 3.2).¹⁸⁸

Figure 3.1: Australia's population is concentrated
Share of the population by area type



Note: New Zealand not included in original source.

Source: Reproduced from OECD (2018g, Figure 4.1).

183. Ibid. (p. 100).

184. Between 2000 and 2015, the population of large cities – with population of 1.5 million or more – in the OECD grew 13 per cent, smaller metropolitan areas (500,000 to 1.5 million people) grew by 11 per cent, and rural areas typically declined slightly (OECD (ibid., p. 96)).

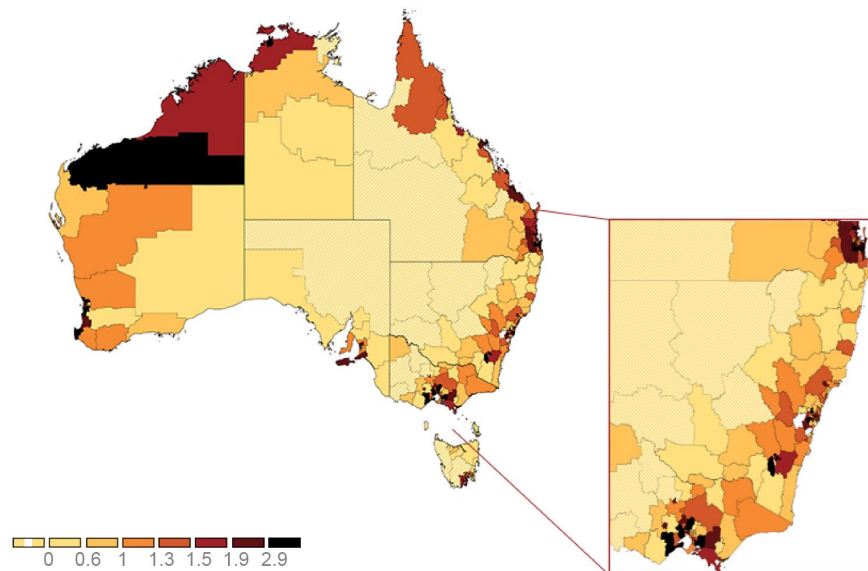
185. Ibid. (p. 100).

186. This is especially true for young people: 80 per cent of young internal migrants moved to an urban area (OECD (ibid.)).

187. Benson (2018) and Daley et al. (2017, pp. 24–25, 31). While Melbourne and Brisbane are gaining internal migrants, net internal migration is away from other capitals, primarily to areas within about two hours drive of a capital, particularly the Gold Coast and Sunshine Coast (Grattan analysis of ABS.Stat (2015)).

188. Daley et al. (2017, pp. 20–23) and Daley and Lancy (2011, pp. 11–14). More remote inland and coastal regions are typically reducing population through net internal migration: Grattan analysis of ABS.Stat (2015).

Figure 3.2: Populations of cities and coastal regions are growing faster
Population growth, 2006 to 2016, percentage

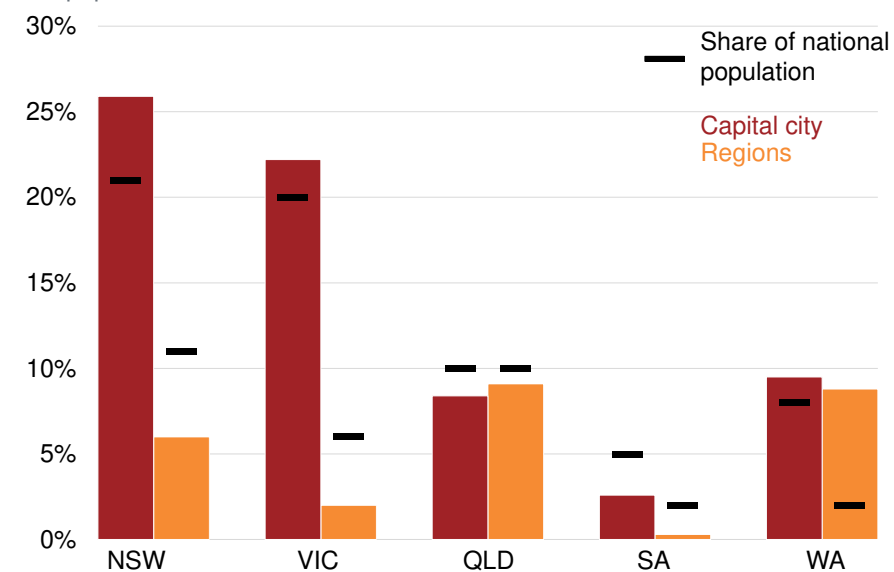


Note: See Daley et al. (2017) for methodological notes.

Source: Daley et al. (Ibid.).

Figure 3.3: Sydney and Melbourne are major drivers of Australia's economy

Contribution to national GDP growth, volume measure, 2009-10 to 2017-18, and population share



Source: ABS (2018h) and SGS Economics & Planning (2018).

As in many other countries, agriculture and manufacturing, which have tended to dominate regional labour markets, are using more capital,¹⁸⁹ but employing fewer people.¹⁹⁰ Services are tending to concentrate in larger regional centres,¹⁹¹ and higher-end services in cities.¹⁹²

3.1.2 Bigger cities mean a richer country

The more Australians choose to live in cities, the wealthier the country can expect to be. Countries with more of their population in cities tend to have higher incomes, and as more of the population moves to the cities, countries tend to become wealthier.¹⁹³ And within countries, those in the larger cities have higher incomes than those living elsewhere.¹⁹⁴ Cities grow because more and more people want to take advantage of these opportunities.¹⁹⁵

Australia's five largest cities are more productive than the smaller cities and regional areas. This is evident from the fact that employers are prepared to pay higher wages in bigger cities (Figure 3.4),¹⁹⁶ people

are prepared to pay higher rents in the larger centres (Figure 3.5), and the typical city-dweller contributes more to GDP.¹⁹⁷

The mechanisms by which large markets enable people to be more productive in cities are sometimes described as “agglomeration economies”, and can be summarised as matching, sharing and learning.¹⁹⁸

For workers, matching is perhaps the most important source of advantage. In the city, people are more likely to find a job that they are willing and able to do, and if they lose their job, to find another one quickly. It is more worthwhile to specialise, and working with specialists also helps people to develop more specialist skills themselves.¹⁹⁹

Employers reap matching benefits in finding staff, and they also gain from the matching opportunities that cities offer if their business relies on passing trade.

Sharing means less idle capacity for either workers or businesses. Idle capacity can be under-used rail yards or car-parks, or shopkeepers waiting around for a customer, or doctors in casualty wards managing the ebbs and flows of patient demand. With less idle capacity, bigger cities can support more efficient ports and road networks.

189. Campbell and H. Withers (2017, p. 6).

190. Agriculture comprises only 7 per cent of regional jobs (including forestry and fishing) (ABS (2018b)). About another 5-to-6 per cent of jobs are in food processing (Daley et al. (2018c, p. 31)). These shares have declined while service sector employment has increased over past decades (Daley (2016b, pp. 3–5), Daley et al. (2017, pp. 5–6), Minifie (2013, p. 8) and Minifie et al. (2017, p. 21)).

191. Productivity Commission (2017b, pp. 19–20).

192. J.-F. Kelly and Donegan (2014); J.-F. Kelly et al. (2013); J.-F. Kelly and Donegan (2015, pp. 23–36); and Rawnsley (2018).

193. Gibbons and Graham (2018); and Romer (2015).

194. Angel and M.Blei (2016, p. 38). Australia is unusual in that those in remote WA and remote QLD also have relatively high incomes, due to mining.

195. See, for example, O'Flaherty (2005) and Glaeser (2008).

196. See also Daley et al. (2017, pp. 8, 37–39), based on ATO Tax Stats data, by postcode.

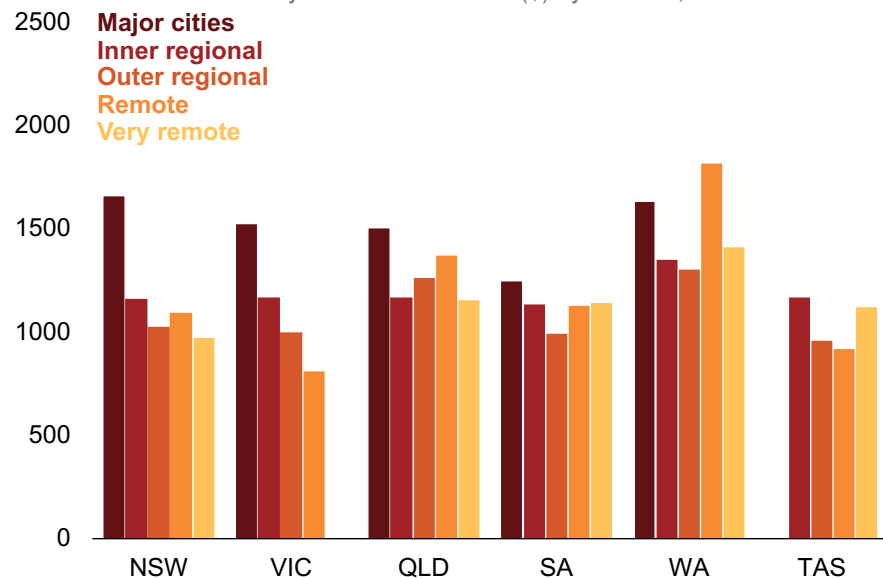
197. Angel and M.Blei (2016, p. 3), Glaeser and Gottlieb (2009, pp. 160–161) and SGS Economics & Planning (2017). The five main capital cities contain 64 per cent of the total population, and generate 66 per cent of GDP. In NSW, Sydney is home to 65 per cent of the population but generates 75 per cent of that state's contribution to national GDP. Melbourne is home to 77 per cent of Victoria's population but generates 83 per cent of that state's contribution to national GDP (ABS (2018h) and SGS Economics & Planning (2018, p. 10)). Table 3.1 shows that in Australia, Canada and South Korea, the regional contribution to GDP is relatively strong in aggregate terms. In Australia's case, this is due to the contribution of mining: in WA, Perth is home to 79 per cent of the population but generates only 59 per cent of that state's contribution to GDP.

198. This terminology was coined by Duranton and Puga (2004).

199. Moretti (2012, pp. 126–127).

Figure 3.4: Workers command higher incomes in larger cities

Estimated median weekly household income (\$) by location, 2016

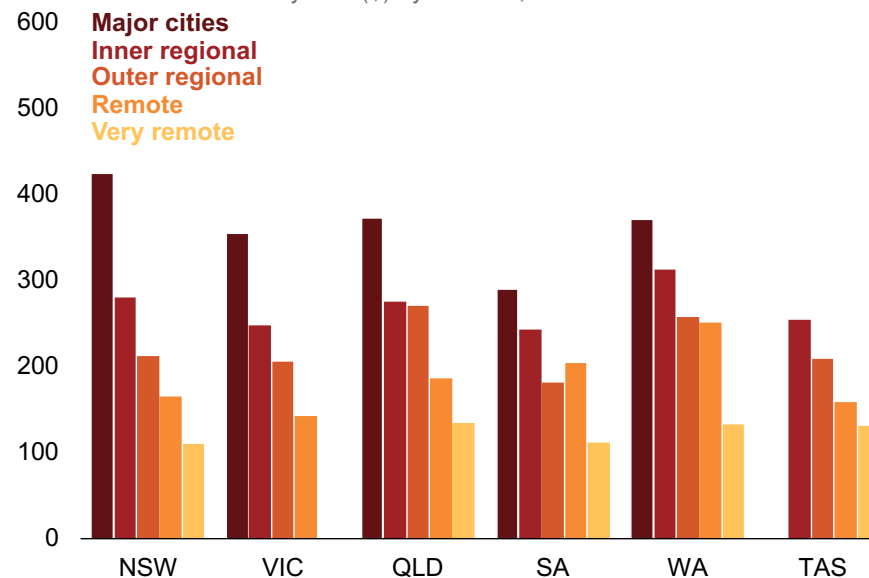


Notes: Median values have been estimated because income is reported by bracket. Categories based on the ABS Census Remoteness Areas. Victoria does not have a 'Very remote' category. Tasmania does not have a 'Major cities' category. NT and ACT have been omitted because the ABS data omits several categories for the territories.

Source: Grattan analysis of ABS (2017c).

Figure 3.5: People value land more highly in larger cities

Estimated median weekly rent (\$) by location, 2016



Note: Categories based on the ABS Census Remoteness Areas, as described in Figure 3.4.

Source: Grattan analysis of ABS (*ibid.*).

Learning opportunities tend to be greater in bigger cities, as workers see what others are doing and imitate it. Much know-how is informal, and people are more likely to share informal knowledge face-to-face than through channels that operate at a distance.²⁰⁰ Because job turnover is faster in cities, people take their knowledge with them to new jobs more quickly than in regional areas.

Sharing, matching and learning can occur in two distinct ways. In some cases, they arise where there are many firms in one industry, such as finance industry firms in Sydney, or mining businesses in Perth. In other cases, these agglomeration benefits arise from having many people located together, regardless of their industry;²⁰¹ for example, only Melbourne, Sydney, Brisbane and Perth are large enough to support heart and lung transplant centres.²⁰²

These economic advantages make larger cities more productive than smaller cities, but they are accompanied by higher crowding and higher costs for people to get to their jobs and for firms to reach suppliers and customers.

3.1.3 The growth of big cities doesn't mean regional dwellers are struggling

While people are choosing cities, and larger cities, at increasing rates, this does not mean that those in regional and rural areas are economically or socially excluded. Most regional residents have reasonable income and employment outcomes and the gap between regional dwellers and city dwellers is not widening. Regional residents

200. The learning aspect of agglomeration appears to be an important productive advantage, even though the mechanisms by which it operates are not well understood theoretically (Duranton and Puga (2004, pp. 2098–2110)) and generally hard to identify empirically (Glaeser and Kahn (2001, pp. 2148–2152) and Gibbons and Graham (2018, pp. 2–3)).

201. O'Flaherty (2005, pp. 12–33) and Gordon and Lee (2015, pp. 87–88).

202. ANZCOTR (2017).

typically report *higher* well-being, although there is a widening cultural gap.

Average incomes for regional Australians are lower than for those in the cities. Average taxable incomes per worker are typically about \$75,000 in inner-city suburbs, about \$50,000 in middle and outer suburbs, and a little lower in most areas more than 100km from a major city.²⁰³ While it's rare for suburbs in Sydney, Melbourne or Brisbane to have incomes below the national average, this is common in rural NSW, Victoria, and southern Queensland.²⁰⁴ This may explain why people in regions report being a little more worried about their finances.²⁰⁵

But the gap is not growing between regional and urban incomes. Since 2003, average growth rates have been similar for rural and city workers.²⁰⁶ Incomes grew particularly quickly in mining areas in Western Australia and Queensland, but even in non-mining states average income growth per capita was similar between the cities and the regions. And people in regional areas have accumulated wealth at a similar rate to their city cousins.²⁰⁷

The story is more patchy for employment. Employment rates are materially lower in the regions in NSW, Victoria, Queensland, and

203. Daley et al. (2017, pp. 8, 37–39), based on ATO Tax Stats data, by postcode.

204. By SA3s (Daley et al. (Ibid., p. 8)), and see state-based analysis by postcode in Daley et al. (Ibid., pp. 37–39). The difference in incomes between city and regional Australia is not particularly large compared to other OECD countries – the gap is bigger than in Canada, but smaller than in the US (OECD (2018g, p. 108)).

205. D. Wood et al. (2018b, p. 46).

206. Daley et al. (2017, pp. 7, 37–39) based on ATO data. ABS data for 2011–2016 is consistent with this pattern (Daley et al. (2018c, p. 31)).

207. D. Wood et al. (2018b, p. 43). Dwelling prices grew rapidly in regional areas in all states between 2001 and 2016 (Daley et al. (2018a, p. 18)).

Tasmania,²⁰⁸ although there are both high- and low-unemployment areas in different parts of cities and different regions.²⁰⁹

Young people aged 15-19 living in regional areas tend to have less education, enter the workforce at a younger age, and are more likely to be employed than their city counterparts.²¹⁰ By contrast, 25-to-64 year-olds in the regions are less likely to be working, particularly in NSW, Victoria, and Queensland.²¹¹

The falling demand for workers in agriculture and manufacturing is particularly affecting regional men. Men aged between 25 and 64 in regional NSW and Victoria are 7 percentage points less likely to be employed than men of that age in Sydney and Melbourne.²¹²

Where populations actually shrink, this does raise concerns in small regional towns.²¹³ More than 60 per cent of people in regions are worried about population decline, saying that ‘people shifting away from the area’ presents a big problem for their community.²¹⁴ When a town’s population is shrinking, those who are left are often older,²¹⁵ community groups such as football clubs often lose critical mass,²¹⁶ and the town may also lose people with leadership expertise and important skills.

Nevertheless, despite regions having lower incomes and slower population growth, people who live in the regions consistently report

higher well-being across a range of measures, including personal relationships, standard of living, and sense of community.²¹⁷

Perhaps the biggest challenge for regional policy is the widening cultural gap between big cities and regions.²¹⁸ A slightly bigger proportion of people in regions are likely to think that ‘there is too little emphasis on traditional values’.²¹⁹ Their concerns are less about social issues such as same-sex marriage,²²⁰ and more about the relative emphasis on city and regional culture in national identity. Many more people in regions are concerned about migration²²¹ – even though there are far fewer recent migrants in the regions.²²² Increasing cultural anxiety appears to explain in large part why the vote for minor parties is higher, and rising faster, in the regions.²²³

3.2 What we should do

With cities growing more uniformly on many dimensions, there are understandable concerns about what this means for regions, especially in those places where there is a decline in population.

Fears that regional Australia has been left behind may encourage politicians to make grand promises to restore regional prosperity. All too often, these promises fall short – governments can’t push economic water uphill. Policies designed to artificially hold jobs or people in regional areas have not fared well in the past.

This is all the more problematic when such efforts distract from the growing pains of fast-growing cities.

208. Daley et al. (2018c, p. 31).

209. Daley et al. (2017, pp. 17–19). For interactive maps, see <https://grattan.edu.au/report/regional-patterns-maps/>.

210. ABS (2018f).

211. Ibid.

212. ABS (ibid.). Some of this is due to regions having a greater proportion of older people, who are less likely to be employed. But for a given age group (35-39), employment rates for men are materially lower in regional NSW than in Sydney (Daley et al. (2018c, p. 31)).

213. Productivity Commission (2017b).

214. University of Canberra (2018).

215. Daley et al. (2017, pp. 30–32).

216. Productivity Commission (2017b). See also Brett (2011).

217. Capic et al. (2017); NAB Behavioural and Industry Economics (2018); and University of Canberra (2018).

218. D. Wood et al. (2018b, pp. 56–58).

219. Ibid. (p. 64).

220. Ibid. (pp. 54–55).

221. Ibid. (p. 64).

222. Daley et al. (2017, pp. 25–29).

223. D. Wood et al. (2018b, pp. 56–58).

The Australian Government can best support both urban and regional Australians by working with the states and local government to deal with the pressures of population growth wherever they arise, and to support the population centres that are important both for those who live in them and for the wealth they generate for all Australians.

Governments should be very wary of subsidies to industry to relocate or prop up a struggling operation. Rather, they should focus on ensuring a decent standard of government services notwithstanding the challenges of distance from a major centre, which is a particularly important way of strengthening the connections between regional and city dwellers.

3.2.1 The Australian Government should not fight the gravitational pull of the cities

There is plenty of upside to urbanisation. The more Australians choose to live in cities, the wealthier the country can expect to be.

But there are downsides. Those who live in the largest cities have experienced a period of very rapid population growth, with some cities' growth amongst the highest in the developed world. For these people, the pressures of crowding and congestion are paramount. Meanwhile, those in regions and rural areas that are growing slowly or even shrinking may feel as though they are missing out.

There are two key ways that governments should deal with the gravitational pull of cities: to tread lightly on people's decisions about what is best for them and their families, and to deal with the growth in demand for services where they find it.

Tread lightly on people's decisions about where to live

Many commentators²²⁴ and politicians²²⁵ have suggested ideas to spread population growth more evenly between cities and regions. The Federal Government recently announced plans for new regional migration visas, in an attempt to stem the tide of population growth in the cities. New arrivals would have to settle in regional areas for at least three years to receive permanent residency.²²⁶

Schemes to divert population and economic activities from cities to regions aren't new. State and federal governments have tried to lure people, trade and business away from capital cities since Federation, and are still trying, despite the lack of success.²²⁷

But it is a mistake to imagine that both congestion and declining regional towns can be fixed with one bold gesture. It is not that people will not move to the regions: they did so in large numbers when the mining investment boom presented attractive job opportunities. Rather, it seems that the living and employment conditions currently on offer in some regional areas are not attractive enough to induce more internal or overseas migrants. Of course, there are many people in the world who would be prepared to migrate to regional Australia, but are prevented from doing so by restrictive visa and migration policies.

This has nothing to do with crowding in cities. The downsides of crowding, congestion and competing for scarce resources in the city are important effects, and many people feel them acutely and daily. They are the other side of the productivity benefits, which also accrue through proximity and density. Governments should be very wary

224. Regional Australia Institute (2017).

225. Gothe-Snape (2018a); Hunter and Bagshaw (2018); and Reece (2018).

226. The Government also announced incentives for international students to study at regional universities (Coorey (2019), Crowe (2019), Datzell (2019) and Kainth (2019)).

227. Daley and Lancy (2011).

about stymying urban growth, because by so doing, they deaden these productivity benefits.²²⁸

There are substantial risks that sending migrants to the regions may send them to areas with few jobs that match their qualifications, less scope to adapt their work to the variety of Australian conditions, and often less connection to family or community to help with settlement.

In any case, these programs don't seem to be having much effect. While the Federal Government says the new regional migration visas should increase regional migration from about 8,500 people a year to 23,000,²²⁹ regional migration is currently at a ten-year low,²³⁰ and applications (as well as approvals) for existing regional visas have dropped substantially in recent years.²³¹

Even if the scheme were successful in increasing migration to regions, it would not reduce city population pressures. Net overseas migration is dominated by migrants on temporary visas that are uncapped, particularly international students and working holiday ('backpacker') visas. Migrants on the new regional visas might well be additional migrants attracted by the promise of easier access to a permanent visa.

Demand-driven approaches may work better.²³² The Designated Area Migration Agreements (DAMAs) – implemented in the Northern Territory and Victoria – at least send migrants to places they are

actually needed.²³³ Employers in designated areas may sponsor a migrant to fill a demonstrated worker shortage. The scheme lowers skills requirements for new arrivals, including English-language proficiency levels.²³⁴ A similar scheme in Canada has had some success retaining migrants in the regions once their visa conditions are met.²³⁵ However, only 60 migrants have moved to the Northern Territory under the DAMAs program over the past two years.²³⁶

Many suggest that large scale transport infrastructure could substantially change patterns of population growth by encouraging the growth of regional towns as dormitory suburbs for people working in cities.²³⁷ Obviously, this only works for regional towns that are within reasonable commuting time of capital cities. But additional transport links to regional dormitory towns are unlikely to substantially reduce the demand for new suburbs on the city fringe that involve similar travel times to jobs. There are already a number of existing regional satellites with reasonable commuting times to Melbourne and Sydney, but their population growth rates are no higher than the greater capital cities overall, and are small in absolute numbers relative to the growth on the suburban fringes of Melbourne and Sydney. Suburban fringe suburbs typically have the advantage of a more diverse range of employment, which is particularly important for households with two partners who both work. The experience of Australia's population patterns today is that much greater numbers will only choose a regional town over new

228. Productivity Commission (2017b, p. 2).

229. Coorey (2019). 9,000 visas will come from the Regional Sponsored Migration Scheme, where there are existing backlogs.

230. Gothe-Snape (2018b).

231. Davidson (2019). The fall may be due in part to higher skills requirements (Gothe-Snape (2018b)) and slow processing times (Davidson (2019)). The intake on non-regional specific visa categories – such as the Skilled Independent stream – could potentially be reduced or limited in such a way as to increase the rate of uptake of regional visas.

232. 9,000 of the Government's proposed 23,000 regional visas will come up from the existing Regional Sponsored Migration Scheme, which is demand-driven.

233. Acharya (2018); Department of Home Affairs (2018a); and Department of Home Affairs (2018b).

234. Gothe-Snape (2018a).

235. Research and Evaluation Branch Immigration Refugees and Citizenship Canada (2017).

236. Davidson (2019). Abul Rizvi, a former senior official at the Department of Immigration, is quoted in *The Guardian* as saying that while DAMAs are good 'in theory', in practice they pose difficulties and are slow and expensive to negotiate (Davidson (ibid.)).

237. ABC News (2019).

suburbs on the suburban fringe if government artificially constrains the release of new land on the suburban fringe.

A service response to population growth, wherever it arises

The challenges of service levels, congestion and housing affordability must be addressed for cities to work well. The federal government needs to work with the other levels of government to help metropolitan areas through growing pains. Improving housing policy (Chapter 5) and picking the right infrastructure projects (Chapter 4) are vital.

Some service needs grow in line with the population, particularly housing, education and health services. For other kinds of services, like transport, there can be economies of scale, such as in how much road length or rail track length is needed per capita.²³⁸

And people find their own ways of dealing with population growth: some move house; some change their job or workplace, or work more from home; some change their time or method of travel. Other people simply accept a longer commute, particularly if they earn a high income.²³⁹ While growing cities need new infrastructure, new infrastructure is far from the only way to cope with population growth.

The federal government should articulate a population policy that takes account of the planning and resources available to support rapidly growing populations, especially in Sydney and Melbourne (Section 5.2.5 on page 72).

238. Terrill et al. (chapter 3 2018).

239. BITRE (2016).

3.2.2 Be very sparing with regional development subsidy schemes

As well as migration schemes, governments are often tempted by regional development schemes that involve industry or individual incentives.

But such schemes have two fundamental drawbacks. One is that they encourage businesses to locate in places that they wouldn't otherwise choose on commercial grounds or individuals to move to places that they wouldn't otherwise choose as best for their work, family and community options. The second is that such programs have a poor record of influencing people to move.

Individuals and businesses have not responded much to existing and past schemes

The NSW regional relocation home buyers' grant of \$7,000 to people who moved from cities to regions began in 2011. Initial take-up was projected at 10,000 per year; in practice only 4,800 grants were made over three years, and many of these were probably made to people who would have moved anyway – many of them retirees.²⁴⁰ A parallel scheme, the skilled regional relocation incentive, which provided \$10,000 grants to people moving to a regional job, was closed in 2015.²⁴¹

Policies to encourage more jobs in regional areas also have a poor record: monetary incentives from government are rarely large enough to outweigh the economic advantages for businesses of locating in cities. In recent years, state and federal governments have committed

240. Norington (2017).

241. Revenue NSW (2017). The combined budget for the two regional relocation programs was capped at \$10.4 million in 2013-14 after poor take-up in their initial years. (NSW Office of Finance & Services (2014, p. 140)).

significant sums to regional development programs.²⁴² There is little evidence that such programs succeed,²⁴³ although this is in part because there is a systemic pattern of not evaluating them.²⁴⁴ In addition, state and federal programs often overlap, leading to confusion, ‘doubling up’ on development initiatives, and unhelpful rivalry between jurisdictions.²⁴⁵

Despite policy experience, wishful thinking persists that government policy can somehow shift significant populations from capital cities to regions. The fantasy is popular: many people who live in congested cities, or who already own their home there, would much rather that additional population went elsewhere. But it is a dangerous fantasy. It provides an excuse for governments to avoid making the hard decisions that would improve housing affordability (Chapter 5) and how our cities work (Chapter 4).

Very occasionally, it may be necessary for the federal government to provide industry assistance to regions suffering a significant economic shock. Assistance should be given only if economic changes threaten to impart on-going, pervasive, and significant disadvantage on people in regional areas, and if the existing social security system won’t be enough to support people through the transition.²⁴⁶ Such cases are rare.

If given, industry assistance packages should focus on helping the people who are most severely affected.²⁴⁷ They should be directed

primarily to providing retraining and income assistance to people made redundant by industry closures. Any industry assistance should be temporary, transparent in its policy goals and implementation, and subject to on-going evaluation.

Special schemes for farmers have been expensive and ineffective

Drought assistance is another mechanism used to support people in regional areas, and it will be increasingly important as climate change increases the frequency and severity of drought. Agricultural businesses should be designed so that they are financially sustainable through periodic droughts. This implies saving through the good times, storing feed, and carefully managing stock levels. Well-managed farms should not need government assistance in drought any more than other businesses that periodically face adverse conditions.²⁴⁸

But not all farms are sufficiently prepared. The Federal Government recently announced additional spending to help farmers hit by drought.²⁴⁹ The Government will provide \$6.3 billion in assistance and concessional loans to households affected by drought.²⁵⁰ The scheme includes a ‘Future Drought Fund’ worth \$3.9 billion,²⁵¹ which will invest in drought infrastructure projects and provide grants to assist communities and farmers with drought preparation. The scheme also extends an earlier program that provides income support to farming households that are experiencing hardship.²⁵²

242. Productivity Commission (2017b, p. 24).

243. Ibid. (pp. 176–187).

244. Daley and Lancy (2011); Productivity Commission (2017b, pp. 148–152); and Daley et al. (2018c, pp. 35–36).

245. Productivity Commission (2017b, p. 27).

246. Ibid. (p. 29).

247. Providing money to prop-up ailing businesses may be tempting, but is unlikely to be sustainable. Enterprise support is expensive, harms the rest of the economy, and is likely to succeed only in supporting enterprises whose decline is inevitable (Beer (2015)).

248. Productivity Commission (2017b, p. 407).

249. Morrison (2018) and Treasury (2017b, pp. 1–17). Much of the scheme is still before the House of Representatives.

250. The Government has pledged an additional \$3.3 billion to assist those affected by flood (Treasury (2017b, pp. 1–18)).

251. The balance will be reinvested so the Fund will be worth \$5 billion over the next decade (Treasury (ibid., pp. 1–17)).

252. Usually payments are set at the same rate as Newstart. The program also provides a supplement worth \$7,200 for singles and \$12,000 for couples (Department of Human Services (2019)).

Drought subsidies should be reserved for extreme events and designed so that they encourage farmers to self-insure against future droughts.²⁵³ Farms that are unsustainable without financial assistance should only be supported onto a pathway that leads them either to become self-reliant or to exit the market. The Federal Government's package meets some of these criteria. The test of the package will be whether the infrastructure and community projects undertaken enable remaining farmers to manage drought without ongoing government support.

3.2.3 Governments should ensure reasonable access to services

Cities, regional and rural areas all have calls on government services and support. There should be a minimum decent level of services that Australians can expect from government, even if these services are delivered in different ways in different locations. Rather than playing up the needs of one geography over another, service needs should be the focus of government.

The federal government can support people in regional areas by adjusting national policy settings that affect spending on regional services, such as in education, health, communications, defence and trade.²⁵⁴ By working with state and local governments, the federal government can ensure people in regional areas have access to services that meet their needs.²⁵⁵

State governments already spend more per person on services in the regions than the cities, partly because it's more expensive to provide services to dispersed populations.²⁵⁶ But even if the numbers suggest

otherwise, many people in regional areas believe that they do not get a 'fair share' of Australia's resources.²⁵⁷ Nevertheless, concerns about service levels do not appear to be the main cause of growing cultural divides between cities and regions.²⁵⁸

Policy makers should be explicit that additional spending on regional services should be justified on social equity grounds rather than because it is likely to sustainably increase economic growth.²⁵⁹ Subsidies should therefore be measured and published. As well as answering the popular misconception that governments ignore regional interests, this may provoke a realistic conversation about the level of service governments are able to fund in more remote areas, given the costs of servicing them.

3.2.4 Politicians should avoid stoking cultural divides between the city and the regions

The rise of populist politics across the globe has undermined democratic institutions in many countries. Australia is not immune.

Protest votes for minor parties are on the rise, especially in regional Australia. The loss of economic and cultural power in the regions looms large in regional voters' dissatisfaction. As regions hold a falling share of Australia's population and economy, Australia's cultural symbols are becoming more city-centric – from mateship to multiculturalism, from *The Man from Snowy River* to *MasterChef*. Regional voters increasingly fear they are being 'left behind' and that 'the Australian way of life is under threat'. The rhetoric and policies of some minor parties tap into these concerns and values.²⁶⁰

253. N. Hughes and Hatfield-Dodds (2018).

254. Productivity Commission (2017b, p. 27).

255. For a discussion on state regional services and infrastructure spending, see Daley et al. (2018c, pp. 36–37).

256. Ibid. (p. 34).

257. Brett (2011); and D. Wood et al. (2018b, pp. 46–47).

258. D. Wood et al. (2018b, pp. 47, 60–65).

259. Daley and Lancy (2011).

260. D. Wood et al. (2018b, pp. 60–66).

Voter disillusionment – consistently higher in the regions, and a strong predictor of minor-party support – might also be wound back with a period of leadership stability and quiet policy development.²⁶¹ Politicians should stop over-promising and under-delivering when it comes to regional development. It is not possible for governments to reverse long-running structural economic shifts, and nor should they try. Instead, federal ministers should cooperate with all levels of government on realistic goals to promote sustainable economic growth across the nation.

Politicians should also avoid inflaming cultural tensions. They should especially avoid stoking anti-immigrant sentiments, which are linked to some minor parties and are more concentrated in the bush. Instead they should aim to strengthen the cultural connections between regional and city Australia through ministerial connections, student exchanges, culturally inclusive rhetoric (particularly about migrants) and cultural policy.²⁶²

And politicians should avoid falling for the tale of ‘two Australias’. Understanding the nuanced nature of the wedge between the city and the bush is the first step towards ensuring everyone gets a fair share of Australia’s economic prosperity, no matter where they live.²⁶³

261. Ibid. (p. 83).

262. Ibid. (pp. 84–86).

263. Ibid. (pp. 84–86).

4 Transport

4.1 Where we are

The Commonwealth Government does not itself build roads, railway lines, bridges, busways, or tram routes. It contributes to such infrastructure primarily by granting funds to state governments.

Most of these grants are National Partnership payments, governed by rules established by the Council of Australian Governments. National Partnership payments for transport infrastructure specify a dollar contribution for a specific project, and are reported each year in the Commonwealth's budget papers.

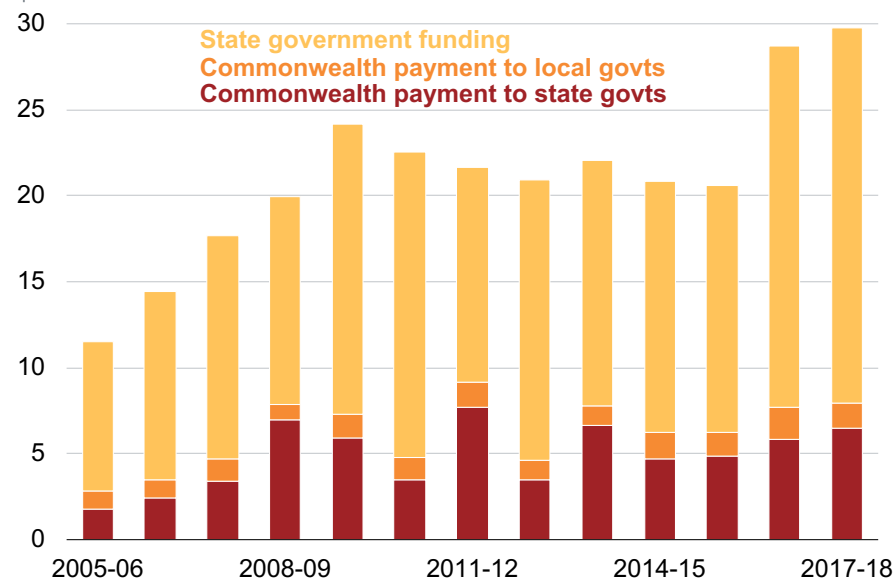
The Commonwealth's contribution to the states for transport infrastructure under National Partnership grants constitutes one-quarter to one-third of states' spending on transport infrastructure (Figure 4.1). In 2017-18, the Commonwealth contributed \$6.5 billion, with the states collectively spending \$22 billion of their own revenue. At present, NSW and Victoria are spending heavily on transport infrastructure, while some of the smaller states are spending below their long-term average.

The Commonwealth's role is to focus on transport infrastructure that supports the national economy, or is important beyond a single state's borders.²⁶⁴ It is on this basis that the Commonwealth might be seen to have a role in cities. The Commonwealth can also play a useful role where harmonised policy would benefit the states and territories.

But in practice, the Commonwealth's deep pockets have led it beyond infrastructure projects that are important to more than one state or are particularly important to the national economy. Because of its funding contribution, the Commonwealth has a substantial say in what is funded.

264. COAG (2011, paragraph E21).

Figure 4.1: Transport infrastructure spending from 2005–06 to 2017–18
\$2018 billions



Notes: Estimates used where available from following year's budget. Otherwise, budgeted amounts used.

Source: Grattan analysis of Commonwealth, state and territory budget papers 2005-06 to 2017-18.

As a result, spending is politically skewed to favour particular states, locations and projects, rather than focusing on pursuing national economic growth and productivity. And what does not happen, but should, is better evaluation of project proposals, by collating and using the data from past projects, and by applying an appropriate discount rate.

4.1.1 Infrastructure decision-making is too politicised

Governments and would-be governments are very fond of promising infrastructure. In the 2016 federal election campaign, the Coalition promised \$5.4 billion to transport infrastructure, the ALP \$6.7 billion and the Greens \$6.5 billion.²⁶⁵

Most of this promised money was for projects that had not been properly assessed. Between a quarter and half of the promised money was for projects that had not been submitted to Infrastructure Australia for assessment, or had been assessed and judged as not nationally significant or not worth building. The proportion of the promised money that was for projects that had been assessed as nationally significant and worth building ranged from 15 per cent for the Coalition to 3 per cent for the ALP to none for the Greens.²⁶⁶ Sadly, there is no reason to expect anything different in the 2019 election campaign.

It is normally premature and unwise to announce projects with their costs this early in the planning process. History shows that projects with costs announced prior to a formal budget commitment experience far larger cost overruns than projects with later cost announcements. Over the past 15 years, 74 per cent of the total value of cost overruns is accounted for by the 32 per cent of projects with early cost announcements.²⁶⁷

265. Terrill (2016).

266. Terrill et al. (2016, p. 19).

267. Ibid. (p. 16).

It comes as no surprise that ad hoc announcements before formal budget commitments tend to be extremely optimistic. Once such announcements are scrutinised as part of the budget process, their early cost estimates need to be revised upwards by an average of 25 per cent.²⁶⁸

But the poor cost performance of projects with early cost announcements is not just a warning to mistrust politicians' infrastructure promises. Premature cost announcements also appear to haunt projects throughout their lives.

Figure 4.2 on the following page shows that projects announced early tend to perform worse than average against their cost estimates, not only in the early stages but also later in the project's life. After formal budget commitments, the costs of projects with early cost announcements typically increase by a further 26 per cent. This suggests that overly optimistic initial cost estimates are rarely adequately adjusted straight away – reliable estimates may only eventuate well into the construction phase.

What makes the risk of cost overruns worse is that these low-quality cost estimates are often imposed on the highest-risk projects. Figure 4.2 shows that projects with early cost estimates are substantially bigger, on average, than projects with later cost announcements. Not surprisingly, larger and more complex projects are more prone to cost overruns than smaller and less complex projects.²⁶⁹

As Infrastructure Australia has argued:

*Governments should undertake detailed analysis of a potential project through a full business case and should not announce a preferred option or cost profile before undertaking detailed analysis involving multiple options.*²⁷⁰

268. Ibid. (p. 16).

269. Ibid. (pp. 30–31).

270. Infrastructure Australia (2018, p. 2).

These large projects can become political footballs. There has been \$3 billion in the contingency reserve for Melbourne's East West Link since the 2015-16 Commonwealth Budget, for 'the first Victorian Government willing to build the East West Link'.²⁷¹ This is an attempt by the Commonwealth to skew project selection and override the Victorian Government's decision to abide by its election commitment to cancel the project.

Similarly, the 2016-17 Commonwealth Budget included in the contingency reserve \$1.2 billion for 'the first Western Australian Government willing to build the Perth Freight Link'.²⁷² This, too, was an attempt to skew project selection in the face of the incoming WA Government seeking to abide by its election commitment to cancel the project.

In the absence of structural change, there is little likelihood that politicians will stop making poorly founded infrastructure promises that include cost estimates. And there is little likelihood that, having made the promise, they and the public will stop regarding that promise as binding: over the past 15 years, two thirds of all projects announced with a cost figure have been completed. Even those announced before a formal funding commitment are usually completed.²⁷³

4.1.2 Infrastructure proposals use the wrong discount rates

There are many shortcomings in Australian transport project selection and evaluation. Experts point to overly optimistic cost estimates and inflated benefit assessments, with any improvement occurring only very gradually.

Discount rates are one of the core elements of the cost-benefit analysis of transport projects. The way it works is that the costs and benefits

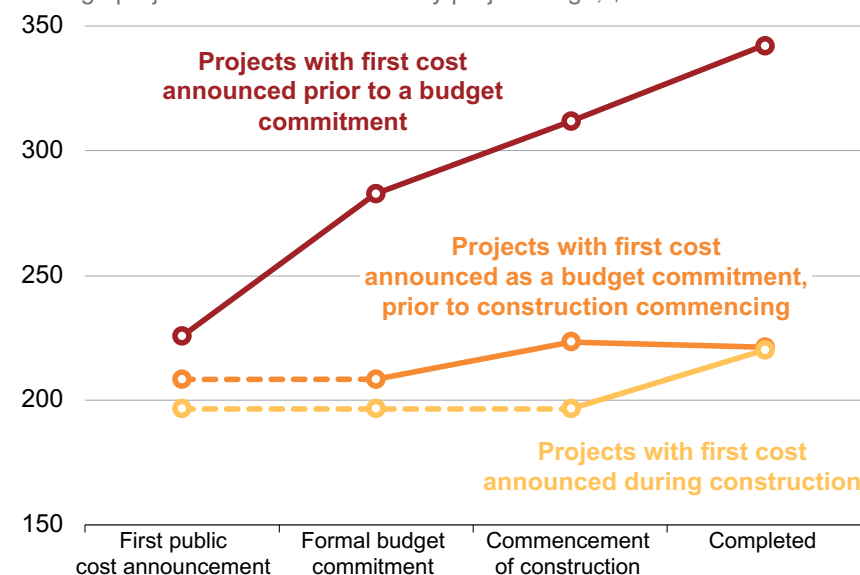
271. Treasury (2019b, section 8-37).

272. Ibid. (section 8-37).

273. Terrill et al. (2016, p. 26).

Figure 4.2: Projects announced earlier have larger cost overruns at all stages of the project lifecycle

Average project size of each cohort by project stage, \$2016 millions



Note: Australian transport projects completed between 2001 and 2015.

Source: Grattan analysis of Investment Monitor. See Terrill et al. (2016, p. 17).

of a project that occur in different time periods are discounted by a particular rate in order to convert them into today's dollars. This enables the project to be compared to rival projects that have costs and benefits with different time trajectories. In essence, the discount rate expresses how much we value costs and benefits in the future relative to costs and benefits occurring today.

The discount rate is one of the most controversial aspects of cost benefit analysis. Yet despite – or perhaps because of – this controversy, almost all Australian jurisdictions have opted, since at least 1989, to use a discount rate of 7 per cent for most transport and other infrastructure projects, irrespective of project risk and real interest rates.²⁷⁴

In the private sector, and in many agencies that regulate non-transport infrastructure, it is standard practice to vary the discount rate according to the level of risk entailed in a project. The type of risk that matters for discounting is the sensitivity of a project's expected returns to the economy generally – the systematic risk – also explained as the extent to which a road or railway line's use is affected by whether the economy is booming or in the doldrums. There is no rationale, aside from the difficulty of agreeing how to do it, for not taking the same approach when doing cost-benefit analysis for transport projects.

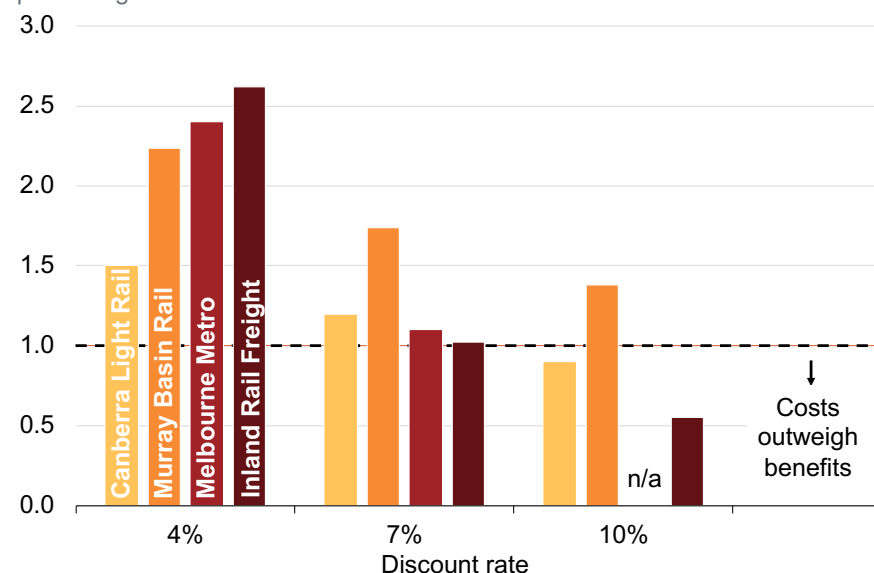
Real borrowing rates are another key component of discount rates, yet whether they have been 8 per cent or 1 per cent, government agencies have chosen to keep their discount rates at 7 per cent. Back in 1989, when it seems that the 7 per cent discount rate was established in Australia, the risk-free rate was 6.8 per cent in real terms; in 2017, it was 0.8 per cent.²⁷⁵ Discount rates should reflect such a dramatic change.

274. Terrill and Batrouney (2018, p. 7).

275. Ibid. (p. 3).

Figure 4.3: The choice of discount rate can change whether and in what order projects are worth building

Benefit-cost ratio of selected projects at discount rates of 4, 7 and 10 percentage



Note: The Canberra Light Rail results include 'wider economic benefits' and 'land-use' benefits that are not included for the other three projects.

Sources: Project business cases; see Terrill and Batrouney (2018, p. 9).

Because discount rates are higher than they should be, two consequences follow. First, some projects are being assessed as not worth building when they would be assessed as worthwhile under a more realistic discount rate. Second, the ranking of potential projects may change; in particular, very long-lived projects may get less priority than they otherwise would (Figure 4.3).

It is a significant distortion that too high a discount rate prompts decision-makers to prefer projects with near-term priorities over those with benefits that extend long into the future. It will tend to discourage

decision-makers from substantial economic reforms, because these often entail short-term costs before higher economic growth in the future. In effect, an artificially high discount rate focuses benefits on current generations at the expense of the interests of younger people and future generations.²⁷⁶

An artificially high discount rate is sometimes defended as a counter to problems of overly-optimistic cost estimates and inflated benefit estimates. The argument is that an artificially high discount rate makes it a little harder for decision-makers to defend poorly chosen and politicised projects.²⁷⁷

But using the discount rate in this way exacerbates the bigger problem of the poor overall quality of Australian transport project evaluation. This is because it creates perverse incentives, such as inflating the future benefits of investments in the knowledge that they will be effectively revised downward by an artificially high discount rate. It also muffles information that could lead to better infrastructure decision-making, and creates an environment in which decision-makers are discouraged from relying on the findings of project appraisals.²⁷⁸

4.1.3 Project cost estimators cannot learn from the experience of past projects

It is impossible to perfectly predict the costs of any individual infrastructure project. Cost estimators need to make many assumptions, particularly in the early stages of estimation, when there is greater uncertainty.

But when cost estimates are wrong *on average*, there is clearly scope to improve. It's not as if we see one over-estimate cancelling out

another under-estimate across the whole portfolio of projects. Rather, there is a substantial gap between estimated and actual costs *overall* that suggests a more fundamental underlying problem (Figure 4.4).

The information gap is not in the aspect of cost estimation that involves adding up the costs of materials, equipment, labour, and other impacts. This information is widely available. Rather, the information gap is in data that would enable a comparison of a particular project with others like it.²⁷⁹

The gap arises from the lack of data on past projects in Australia. There is no consistent post-implementation review of projects,²⁸⁰ nor are data collected on how projects of various kinds performed against the original cost and benefit estimates.²⁸¹

This lack of data is concerning for two reasons. One is the unfortunate incentives it creates for governments to promise to build projects for unrealistically low costs. The second is that lack of data makes it impossible for those estimating project costs to do so properly. They can estimate the costs of inputs, but they lack the data to make robust comparisons with past projects.

The cost estimation toolkit relies on historical cost outcomes to calculate key aspects of a cost estimate. Probability pricing and reference class forecasting depend entirely on knowing the historical outcomes of similar projects. Not knowing these has three important consequences.

First, many guidelines suggest to cost estimators that overruns and underruns are equally likely. They do so by recommending that symmetric probability distributions should underpin the typical approach

276. Ibid. (p. 10).

277. Bagshaw (2018b).

278. Terrill and Batrouney (2018, p. 22).

279. Terrill et al. (2016, chapter 3).

280. Infrastructure Australia (2018, p. 3).

281. Terrill et al. (2016, p. 34).

to estimating probability prices, known as Monte Carlo simulation. This advice contradicts Australian experience (Figure 4.4).

A second consequence of not knowing historical outcomes of similar projects is that it deprives cost estimators of an effective counter to known psychological biases. Just as trains or aeroplanes more often arrive late than early, so too cost estimates tend to ramp upwards more often and to a greater degree than downwards. The psychological tendency to believe that project outcomes will be better than they turn out to be is known as ‘optimism bias’, and arises from the combined impacts of cost underestimation and benefits overestimation. Unfortunately, optimism bias is especially acute when the most money is at stake, in the larger and more complex projects where the interdependence of risks is particularly hard for experts to judge accurately.²⁸²

A third consequence of not knowing historical outcomes is that cost estimators lack an effective counter to ‘strategic misrepresentation’ – when proponents deliberately manipulate the cost estimates to make them look more favourable than they really are. Project proponents have an incentive for strategic misrepresentation to the extent that they are judged more on how much they build rather than how well they manage their budget. Lack of historical outcomes data makes this behaviour hard to counter.²⁸³

The discrepancy between expert expectations and historical experience shows that the reliability of risk assessments of Australian transport infrastructure projects would be substantially improved by equipping risk experts with better information. The Productivity Commission’s 2014 Public Infrastructure inquiry report highlights the need for an accurate database of historical cost outcomes for Australian projects.²⁸⁴

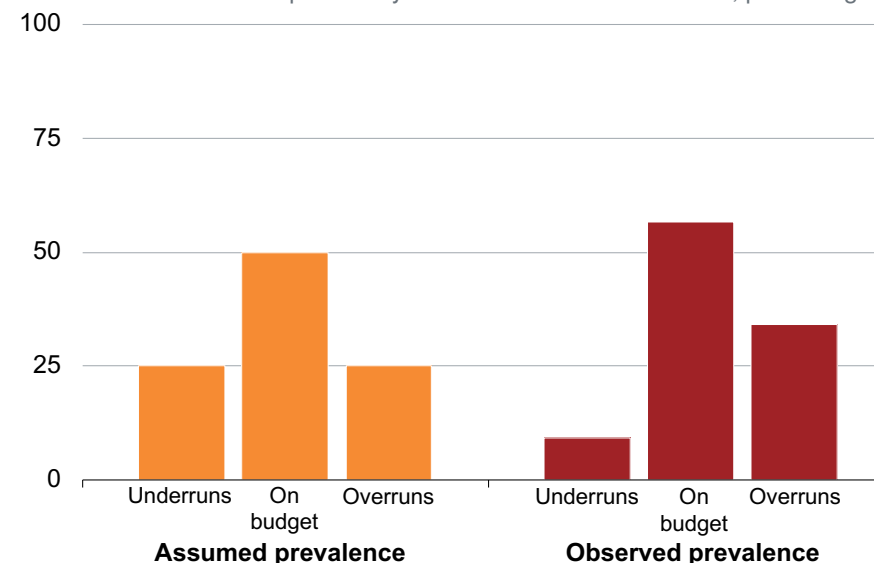
282. Ibid. (p. 36).

283. Ibid. (p. 36).

284. Productivity Commission (2014, p. 102).

Figure 4.4: Experts systematically underestimate the likelihood of cost overruns

Assumed and observed probability distributions of cost overruns, percentage



Notes: The assumed prevalence of cost overruns is inferred from the common representation of cost risk as symmetrically distributed in cost estimation guidance. See Appendix B.2.6 of Terrill et al. (2016, pp. 70–73) for further details.

Sources: Australian risk management guidelines listed in Appendix A.4 of Terrill et al. (Ibid., pp. 56–61) and Investment Monitor; Grattan analysis.

4.2 What we should do

For the most part, it is the states that own and operate the transport network. But the Commonwealth has a strong interest in the effective functioning of the transport network, and works in partnership with state governments to achieve this.

The interests of the Commonwealth arise from its role as contributory funder, and in this capacity it influences the selection, assessment and post-completion appraisal of projects. This role, and its implication for policy-setting, is outlined in further detail in Section 4.2.1, and the following three sections lay out recommendations that flow from these roles.

4.2.1 The Commonwealth should focus on being an exemplary funder and policy leader on standards

While the Commonwealth generally does not own or operate transport networks, each budget it announces a suite of transport projects. The associated funding usually takes the form of grants to state governments.

Nevertheless, it is easy to overstate the role of the Commonwealth from the perspective of an individual state. Although the Commonwealth announces funding for transport projects each year, in many cases the decision is effectively unravelled by the processes of the Commonwealth Grants Commission. If a project is not on the National Land Transport Network, the Commonwealth's decision to fund it has no practical effect for that state. This is because decisions to fund projects outside the National Network are included in Grants Commission calculations when it carves up the GST pool. It is as if the project funds were not given to the state, but added to the GST pool. If one state receives more than its share of off-network funding, it gets a smaller GST share over the following three years – that is, until the GST distribution unravels the Commonwealth's funding decisions.

The same is not true of National Network roads and railway lines and selected additional roads and rail; rather, half or all of the value of funds allocated to these projects is quarantined from consideration in the GST distribution.

Given this arrangement, the two most important roles for the Commonwealth to play in transport are first, as contributor to a general funding pool, and second, as a standard-setter. The following recommendations are concerned with the Commonwealth in the role of exemplary funder, and as policy leader on standards.

4.2.2 Take some of the politics out of decision-making

A structural change is needed to put more distance between statements that governments and oppositions might make, particularly in election campaigns, and the spending of public money on those promises.

This structural change should ensure that governments spend public money on infrastructure projects only when they have done their due diligence. The Commonwealth should consider contributing funding to projects only where the state government or project proponent has done a full business case, and that business case has been evaluated by Infrastructure Australia and made public. In the case of larger projects, valued at \$50 million or more, Infrastructure Australia should make public its assessment of the reliability of the business case.²⁸⁵

This approach would not stop governments funding projects where the business case is weak. But where the benefits are smaller than the costs, the government would need to present the reasons for its decision to go ahead, such as to assure a minimum standard of access for a rural community, facilitate a major international event, or some other reason.

285. Terrill et al. (2018, pp. 48–49).

High-risk projects should be more closely scrutinised, and parties promoting them should seek to negotiate bipartisan support. Before they proceed, public infrastructure projects that are anticipated to cost \$1 billion or more should need the support of the parliament, not just the party in or seeking office.²⁸⁶ The Commonwealth should require states to pass stand-alone legislation for these mega projects.

4.2.3 Use more realistic discount rates that reflect the cost of money and project risk

Discount rates should typically be much lower than the long-standing default central discount rate of 7 per cent. And they should change when there are material changes in the economy and for different levels of systematic risk.

This change would require an independent agency such as the Parliamentary Budget Office to publish annual guidance on the discount rates regime that would apply in the coming year. The guidance should take account of the cost of money as it varies over time, based on government borrowing costs. It should also take account of different levels of systematic risk that arise within the portfolio of government transport infrastructure projects; that is, how much the returns to a particular project are sensitive to expected returns to the economy generally. Most such projects have very low levels of systematic risk. But some are more sensitive, and the discount rate should be higher for them.²⁸⁷

A change in approach will take time, particularly the investigation of the systematic risk of public infrastructure project types. In the interim, government departments and agencies should adopt a temporary fix, moving to two standard discount rates. Projects with very low systematic risk should use a discount rate of **3.5 per cent**. These may

typically include bus, urban road, and urban passenger rail projects. Projects with somewhat low systematic risk should use a discount rate of **5 per cent**. These may typically include ferry and freight rail projects.²⁸⁸

Changing the discount rates is important, but it is by no means the only change to project appraisal that is needed. The Commonwealth Government's ambition should be to improve project evaluation and reduce the chance of choosing the wrong projects because of inadequate information about the relative merits of different proposals, as discussed above.

4.2.4 Learn from the experience of past projects

Australian governments have a major untapped resource in the form of data on completed projects. Some of this data is collected but not collated, and some is not collected but should be.

Collecting nation-wide information about completed projects would enable all states and territories to benefit from understanding the entire portfolio of past projects. Since the number of projects in any given state is not huge, information limited to a single state is less informative than data for all states.

The Commonwealth could play a useful role in harmonising, collating, and sharing information on past projects. This would enable learning from past experience as well as improving accountability.

The data that is collected but not collated is the report that states provide to the Commonwealth as a condition of their final milestone payment. The Commonwealth could readily collate and publish this information on data.gov.au. Reports should detail any scope changes and their justification, agreed and actual construction start and finish

286. Terrill et al. (2016, pp. 30–31).

287. Terrill and Batrouney (2018, pp. 20–21).

288. Ibid. (p. 21).

dates, actual project costs, reasons for overruns or underruns, and progress against performance indicators.²⁸⁹

A more demanding but also valuable innovation would be to conduct post-completion reviews of infrastructure projects. These reviews should focus on whether the economic case for the project, as outlined in the business case, was realised over time through performance measures, as well as whether the project was delivered on time and on budget, and how unforeseen risks were managed. The insights from post-completion reviews should also be summarised in an easily useable data set.²⁹⁰

Over the next three years, the most important priorities for an incoming government are to focus on how the Commonwealth can contribute to higher quality infrastructure investment. This means committing to independent assessment of business cases before committing to funding projects, and creating a culture of post-completion reviews afterwards to understand how the project performed against the cost and benefit estimates underpinning the original decision to invest. Readily implementable changes are to create a benchmarking dataset using data collected from final milestone payments, and to adopt a more realistic discount rate pending a proper review.

289. Terrill et al. (2016, p. 24).

290. Ibid. (p. 24).

5 Housing

5.1 Where we are

Australian housing has become increasingly expensive, and public anxiety about housing affordability is rising. In recent decades, house prices have grown much faster than incomes, and rents have risen faster than inflation.²⁹¹ While house prices are now falling, they remain well above the levels of even five years ago.²⁹²

Record low interest rates pushed house prices sharply higher in recent years, although this in itself did not affect the amount that households pay for housing.²⁹³ Mortgage costs and rents rose because incomes increased, while tax and welfare settings and rapid migration fed demand. Housing costs would have risen less if more housing had been built.

Australian cities have not built enough housing to meet the needs of Australia's growing population. Australia has 535 dwellings per 1,000 adults, which is among the least housing stock per adult in the developed world (Table 5.1). Among OECD countries with comparable data, Australia has experienced the second greatest decline in housing stock relative to the adult population over the past 15 years (Figure 5.1 on the following page). The mismatch between supply and demand has created a 'zoning premium' for well-located housing²⁹⁴ that benefited existing property owners, but imposed additional costs on new purchasers and renters.

291. Daley et al. (2018a, p. 25).

292. Australian dwelling prices have fallen 6 per cent in the past year. House prices in Sydney have fallen 10.5 per cent since their peak in June 2017. Melbourne house prices have fallen 7.5 per cent since their peak in December 2017. Dwelling prices are still 15 per cent higher nationally, 17 per cent higher in Sydney, and 27 per cent higher in Melbourne than they were at the end of 2014 (Domain (2018)).

293. Saunders and Tulip (2018).

294. Kendall and Tulip (2018).

Table 5.1: International scorecard for housing

	Housing <i>per 1,000 residents aged 20+</i>	Median housing costs <i>% of disposable income</i>
Australia	535	23.3
Canada	556	19.8
Germany	624	19.7
Japan	580	20.4
Netherlands	581	23.9
New Zealand	545	
South Korea	480	10.0
Sweden	614	16.8
United Kingdom	569	22.2
United States	565	19.5

Notes: See Appendix A for notes and sources.

Rising housing costs mean Australians now pay 23.3 per cent of median incomes on housing costs, higher than all other comparator countries except for the Netherlands (23.9 per cent) (Table 5.1).²⁹⁵ Among the OECD countries with comparable data, Australians have the 7th highest median spending on housing out of 36 countries. To some extent this may reflect an Australian preference to spend more resources on better housing.²⁹⁶

Lower-income Australian households in particular are spending more of their income on housing.²⁹⁷ Almost half of low-income Australians in the private rental market suffer rental stress, especially those in the capital cities.²⁹⁸ And rising housing costs for low-income earners mean income inequality has been increasing.²⁹⁹

Worsening housing affordability also means that home-ownership rates are falling among Australians younger than 65, especially those with lower incomes. Owning a home increasingly depends on who your parents are, a big change from 35 years ago when home-ownership rates were high for all levels of income (Figure 5.2). Younger people on low incomes no longer have a real choice about the trade-off between

295. Median housing costs are defined as mortgage burden (principal repayment and interest payments) or rent burden (private market and subsidised rent) as a share of disposable income.

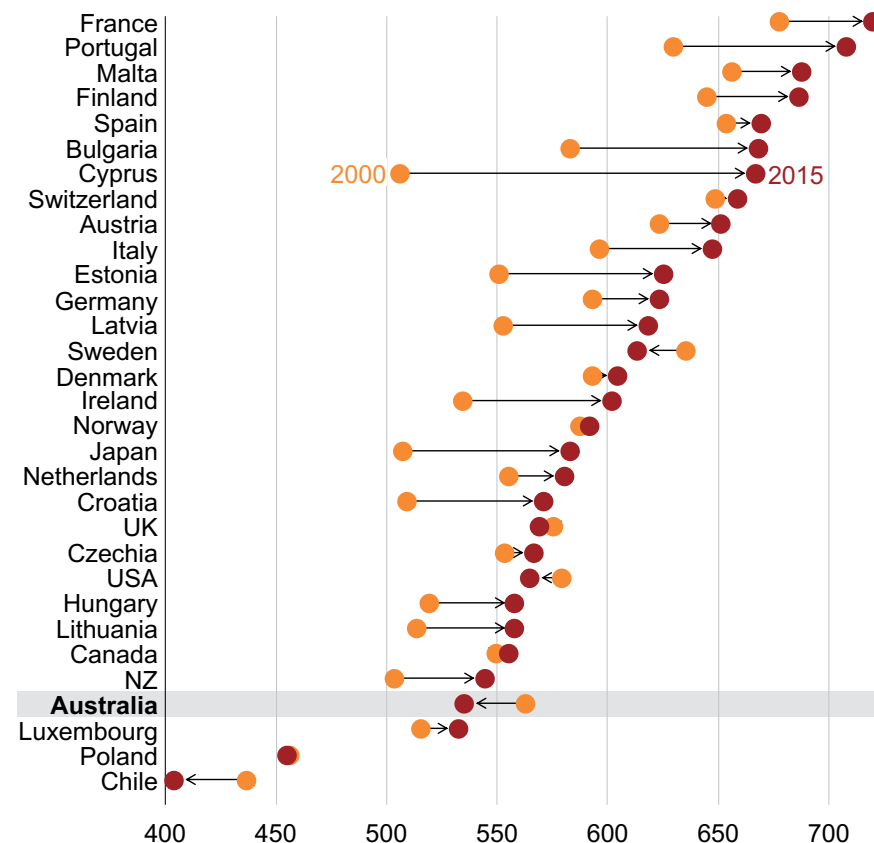
296. James and Felsman (2018, p. 3). New Australian homes (houses and apartments) are the second largest by floorspace among 18 countries, second only to the US. In 2017-18, the average size of a new house built in Australia was 230.8 square metres, down from a record high of 247.7 square metres in 2008-09.

297. Daley et al. (2018a, p. 15).

298. Daley et al. (Figure 2.14 *ibid.*). Rental stress for low-income households is defined as the bottom 40 per cent of households with respect to equivalised disposable household income (excluding Commonwealth Rent Assistance), spending more than 30 per cent of gross income on rent.

299. Daley et al. (*Ibid.*, p. 69). See also Section 2.1.2 on page 26.

Figure 5.1: The amount of housing per adult has fallen in only 6 countries since 2000, and Australia has had the second largest fall
Dwellings per 1000 people aged 20 and over, 2000 and 2015



Notes: Figures are for total occupied and unoccupied private dwellings. Data for 2015 series refer to: 2013 for Chile and Cyprus; 2014 for France, Lithuania, Luxembourg, Poland, Switzerland and the UK. Data for 2000 series refer to: 1998 for Italy; 2001 for Australia, Austria, Bulgaria, Canada, Croatia, Czech Republic, Hungary, Luxembourg, New Zealand, Norway, Portugal and Spain; 2002 for Chile and Latvia; 2005 for Malta.

Source: OECD (2017a).

home-ownership and renting. Australia now ranks 29th out of 37 OECD countries for rates of home-ownership.³⁰⁰

Rising housing costs also contribute to increased homelessness.³⁰¹ Almost 50 of every 10,000 Australians were homeless in 2016.³⁰² Australia's rate of homelessness has increased in the past five years. Among countries with similar definitions of homelessness, Australia ranks better than New Zealand, which has almost 90 homeless per 10,000 people, but worse than the UK, which has around 25 homeless households per 10,000.³⁰³

5.2 What we should do

Given the allocation of federal responsibilities, the most direct way the Commonwealth Government can improve affordability is by reforming tax and welfare policies that distort demand for housing.

Affordability – both to buy and to rent – will only get a lot better if governments permit more homes to be built. Building an extra 50,000 homes a year for a decade could leave Australian house prices and rents 5-to-20 per cent lower than they would have been otherwise.³⁰⁴ This is primarily a problem for state governments: they set the overall framework for land and housing supply, they govern the local councils that assess most development applications, and they set building regulations that affect building costs. But the Commonwealth can

300. OECD (2019d). Based on 2014 data, or latest year available.

301. G. Johnson et al. (2018).

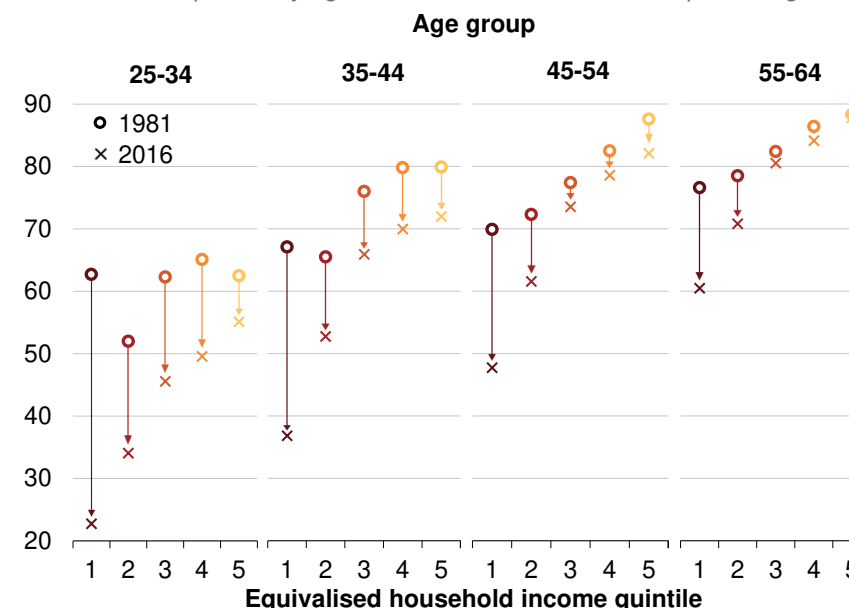
302. Daley et al. (2018c, p. 51).

303. The definition of homelessness varies significantly across countries. The Australian definition includes: people living in improvised dwellings, tents, or sleeping out; people in supported accommodation for the homeless; people staying temporarily with other households; people living in boarding houses; people in other temporary lodgings; and people living in 'severely' crowded dwellings. See: Daley et al. (Ibid., p. 109).

304. Daley et al. (2018a). Saunders and Tulip (2018) estimate this would reduce the cost of housing by 11 per cent.

Figure 5.2: Home-ownership is falling particularly fast for low-income earners

Home-ownership rates by age and income, 1981 and 2016, percentage



Notes: Household incomes based on Census data are approximate, and so small changes in ownership rates may not be significant. Excludes households with tenancy not stated (for 2016) and incomes not stated.

Source: Daley et al. (2018a, Figure 4.3).

encourage the states to boost supply by reforming land-use planning and zoning laws and releasing greenfield land.

There is also a powerful case for additional Commonwealth Government support for the worst-off. But not all policies will be equally effective. Any boost to social housing will be expensive, and therefore should be reserved for people at greatest risk of long-term homelessness. Any further support for those on low incomes should be focused on direct financial assistance for low-income renters rather than building more social housing. And state governments should change planning laws to increase supply and improve housing affordability more generally, because making housing cheaper overall will help low-income earners.

Over the next three years, the priorities for the Commonwealth Government should be: winding back negative gearing and capital gains tax concessions (which would also boost budget outcomes at relatively little economic cost); increasing Rent Assistance; funding the construction of additional social housing by the states; and providing incentives to the states to relax planning restrictions.

5.2.1 Reform tax and welfare rules to reduce demand for housing

Housing demand would be reduced a little if the Commonwealth Government reduced the capital gains tax discount and limited negative gearing – and there would be substantial economic and budgetary benefits (Section 2.2.1 on page 32).³⁰⁵ The effect on property prices would be modest – they would be roughly 2 per cent lower than otherwise – and would-be homeowners would win at the expense of investors. House prices at the bottom would probably fall by more, since these tax breaks have channelled investors into low-value homes

that are lightly taxed under states' progressive land taxes and tax-free thresholds.³⁰⁶

The dominant rationale for these reforms is instead their economic and budgetary benefits. The current tax arrangements distort investment decisions and make housing markets more volatile (see Section 2.2.1 on page 32). Our proposed reforms would boost the budget bottom line by about \$5 billion a year.³⁰⁷ Contrary to urban myth, rents wouldn't change much, nor would housing markets collapse.

Including more of the value of the family home in the pension assets test would also marginally reduce housing demand (Chapter 10). Under current rules only the first \$203,000 of home equity is counted in the pension assets test; the remainder is ignored.³⁰⁸ Inverting this so that all of the value of a home is counted above some threshold – such as \$500,000 – would be fairer, and contribute to the budget. Again the dominant rationale for this reform is the budgetary benefit, rather than housing affordability. Many Age Pension payments are made to households that have substantial property assets. Half of the government's spending on the Age Pension goes to people with more than \$500,000 in assets.³⁰⁹

This reform would also encourage a few more senior Australians to downsize to more appropriate housing, although the effect would be

306. Daley et al. (2018a, pp. 97–98).

307. Daley et al. (2016b).

308. Daley et al. (2018b, p. 84).

309. Daley et al. (Ibid., p. 98). Excludes impact of changes to the Age Pension assets test that took effect from 1 January 2017, reducing the pension entitlements of 326,000 pensioners. But these changes will reduce overall pension payments to part-rate pensioners by only about \$1 billion in 2017-18, which is unlikely to substantially change the distribution of pension payments by net wealth, given total pensions spending of \$45 billion in 2017-18 (Morrison (2015) and Treasury (2017b)).

305. Daley et al. (2016b).

limited given that research shows downsizing is primarily motivated by lifestyle preferences and relationship changes.³¹⁰

Other tax and transfer settings that affect housing include the (non) taxation of imputed rent, the corresponding (non) deductibility of mortgage costs, and the (non) taxation of capital gains and imputed rents on owner-occupied housing. But the policy merits of change are debatable, especially when the politics is likely to be intractable.³¹¹

5.2.2 Relax planning rules to allow more density in established suburbs

The Commonwealth Government should provide incentives to state and local governments to increase the supply of housing in good locations.³¹² Coordinating action by the states is worthwhile because improved housing supply in one state spills over into lower prices in other states.³¹³ And the Commonwealth tax base is more likely than the state tax base to capture the increased revenues that flow from higher economic growth as a result of better housing supply.

The Commonwealth Government has sought to use the new intergovernmental housing agreement to encourage state and local

governments to boost housing supply.³¹⁴ But the Commonwealth has not put enough money on the table to get states to make the politically difficult decisions on planning reform.³¹⁵

The Commonwealth should also increase the pressure on states to make good planning decisions by re-establishing a National Housing Research Council as an independent statutory body with a mandate to collect nationally consistent data on issues related to housing supply and demand, including on the operation of state and local government land-use planning systems, infrastructure charges, and migration. A re-constituted Council should also have a substantial independent housing research function. This new body could be used to hold the states to account on any government promise to boost housing supply and reform land-use planning rules.³¹⁶

5.2.3 Macro-prudential rules should be used to manage financial sector risks where required, but they also have costs

Macro-prudential rules – which restrict bank lending – have been tightened. Although their primary purpose is to promote financial stability, in practice they also affect housing affordability. Many of these macro-prudential rules have been relaxed again, but they have contributed to falls in house prices in the past year.³¹⁷

310. Daley et al. (2018b, p. 38); Productivity Commission (2015b); and Valenzuela (2017).

311. Investment would be less biased towards housing, where any capital gains and imputed rents – the value of owning the home that you live in – are untaxed, compared to investing in other more productive assets. But it would be difficult to resist calls to allow deduction of interest payments and the cost of any capital improvements made to the home such as renovations, which could wipe out most or all of the benefit to the budget. Taxing imputed rents in particular presents a number of practical policy design and implementation challenges, which is why only five OECD countries – the Netherlands, Iceland, Slovenia, Luxembourg, and Switzerland – tax imputed rents, and they often substantially under-estimate the rental value (Daley et al. (2018a, pp. 101–102)).

312. Daley et al. (Ibid., pp. 128–130). See also Deloitte Access Economics (2016).

313. Daley et al. (2018a, p. 129); Abelson (2016); and Aura and S. Davidoff (2008).

314. The National Affordable Housing Agreement specifies national performance indicators including the total number of dwellings relative to the population, and increases in the number of dwellings permitted by zoning in major cities. But no funding is attached to achieving these milestones (Treasury (2018a) and Milligan (2018)).

315. The Commonwealth's City Deals could be used for this purpose, but so far they have focused not on housing affordability but on the broader objectives of increasing economic growth and stimulating urban renewal: see Department of Infrastructure, Regional Development and Cities (2019).

316. Daley et al. (2018a, p. 129).

317. Daley et al. (2018a, p. 101); and RBA (2018a, p. 75).

In late 2014 the Australian Prudential and Regulatory Authority (APRA) imposed limits so that each bank did not increase its total lending to property investors by more than 10 per cent each year.³¹⁸ In March 2017 APRA told banks that new interest-only housing loans must be less than 30 per cent of their total new housing loans.³¹⁹ Both these limits were relaxed in 2018.³²⁰ Meanwhile the Financial Services Royal Commission has led to stricter enforcement of responsible lending laws, including more stringent verification of borrowers' expenses. As a result of these changes, the cost of borrowing to investors increased,³²¹ loans to investors grew more slowly, and house prices are lower than otherwise.³²²

But lending should not be restricted just to bring down house prices.³²³ Instead, Australia's financial regulators – APRA and the Australian Securities and Investments Commission – should use macro-prudential tools primarily to minimise macro-economic risks if there are signs that bank lending is becoming unacceptably risky.³²⁴

When used carefully to target financial stability risks, macro-prudential rules provide a net benefit to the community, because they can enable

318. APRA (2014).

319. APRA (2017).

320. The cap on growth on investor lending was removed in April 2018 and the limit on interest-only lending was relaxed in December 2018 (Chau (2018)).

321. Kent (2017).

322. For example, RBA (2018a, p. 86) estimates that macro-prudential policy changes account for around two-thirds of the 7 percentage-point difference in average cumulative housing price growth between high and low investor regions from December 2014 to mid 2018. However, Debelle (2018) argues that the slowing in housing credit reflects reductions in both the demand and supply of credit. Similarly, G. Price (2014) found that New Zealand rules restricting loans to higher-risk buyers with small deposits led to house prices 3 per cent lower than otherwise. An international survey of macro-prudential tools found evidence that they slowed growth in both credit and house prices (Cerutti et al. (2015)).

323. Byres (2017); and Coates (2019a).

324. Orsmond and F. Price (2016).

the RBA to keep interest rates low without increasing housing market risks.³²⁵

But the benefits of macro-prudential rules should always be weighed against their costs.³²⁶ People who as a result can't get a loan would be the losers.³²⁷ Less lending would reduce construction, resulting in higher rents in the long-term.³²⁸ And tighter credit controls could also raise the costs of credit, boosting banks' profits at the expense of borrowers.³²⁹

The international evidence that macro-prudential rules reduce housing price over the long term is mixed, especially if there is strong underlying demand or weak supply.³³⁰

5.2.4 Better enforcing existing rules on foreign investment could make housing more affordable

Limiting purchases by foreign investors, and taxing them more, can reduce demand to purchase housing. But the long-term effects will be small in the scheme of Australia's \$7 trillion residential housing market.³³¹ Foreign buyers own only about 2 per cent of Australian property.³³²

325. Daley et al. (2018a, p. 101) and RBA (2018a, p. 75).

326. For example, see Yellen (2017).

327. Tripe (2014).

328. For example, Saunders and Tulip (2018) find that construction activity seems to be highly responsive to changes in interest rates and changes in existing housing prices.

329. Daley et al. (2018a, p. 102).

330. Lowe (2017); Daley et al. (2018a, p. 102); and Coates (2019a).

331. Daley et al. (2018a, p. 102). However restrictions on foreign purchasers can have larger price impacts in the short-term in certain sub-markets, such as inner-city apartments, where foreign buyers constituted a larger share of new purchasers.

332. Ibid. (p. 37).

Australia already has far stricter rules governing foreign investment in housing than most comparable countries.³³³ These laws are supposed to channel any foreign investment into new dwellings, thereby adding to Australia's housing stock, rather than simply adding to demand for existing homes. The evidence suggests that overall foreign investment has both increased prices a little, and increased the supply of housing a little. Overall, foreign investors would reduce housing supply for Australian residents only if the foreign investors bought a property and left it vacant. It appears that few do so.³³⁴

Ensuring that foreign investment is channelled towards new housing, and levying higher taxes on foreign investors, would ensure that Australia gains the benefits of foreign investment in housing, while minimising the costs. The Commonwealth Government should:

- Enforce the existing limits on foreign investors buying established housing. In particular, the Commonwealth Government should explicitly require real estate agents to ensure that purchasers are either local residents or have Foreign Investment Review Board (FIRB) approval.³³⁵
- Tighten anti-money laundering laws to stop Australian real estate being used as a store of value for corrupt or black money illegally taken from other countries.³³⁶ In particular, the Commonwealth Government should proceed with the second tranche of the reform

of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth), which remains under consideration nine years after introduction.³³⁷

- Encourage foreign (and domestic) investors to rent out their investment properties. The Commonwealth Government has introduced vacant dwelling taxes as a 'stick' to encourage foreign investors to rent out properties,³³⁸ although enforcement will be difficult.³³⁹

5.2.5 Reducing immigration would improve housing affordability but probably leave Australians worse off

Australia's migration policy is its de-facto population policy. The population is growing by about 350,000 a year. More than half of this is due to immigration. Some have called for fewer migrants to be allowed into Australia, to improve housing affordability and reduce congestion in our biggest cities.³⁴⁰

Lower migration would make housing somewhat more affordable, but only in the long term.³⁴¹ We estimate that curbing net overseas migration by 30,000 a year would result in house prices and rents about 3-to-4 per cent lower after a decade.³⁴² But lower migration would probably leave Australians worse off.

333. Ibid. (p. 40).

334. Ibid. (p. 37).

335. Third parties are legally prohibited from knowingly assisting another person to breach foreign investment rules. But it appears that this may allow real estate agents to turn a blind eye to whether a purchaser has FIRB approval when buying a house. Daley et al. (Ibid., p. 103).

336. APG and FATF (2015). Anti-money laundering authorities believe overseas criminals use Australian real estate to launder money. In particular, real estate agents, lawyers and accountants currently sit outside anti-money laundering rules (Daley et al. (2018a, p. 104)).

337. Ibid. (p. 104).

338. The Commonwealth Government will charge foreign investors \$5,500 for a property priced at less than \$1 million if it is left vacant for more than six months in a year (Treasury (2017c)).

339. Daley et al. (2018a, p. 103).

340. For example, NSW Premier Gladys Berejiklian has called for the state's migrant intake to be halved (McGowan and Evershed (2018)).

341. Daley et al. (2018a).

342. Coates (2018b) estimated that a 50,000-a-year cut to the migrant intake would reduce house prices by 6-to-7 per cent after a decade.

Slowing migration, especially skilled migration, would probably reduce Australians' per-capita incomes.³⁴³ Cutting migration would also hit the Commonwealth Budget in the short term.³⁴⁴ Most migrants are of working age and are liable to pay personal income tax. And many temporary migrants, such as 457 visa holders, can't draw on a range of government services and benefits, including welfare and Medicare.

More importantly, cutting back on younger, skilled migrants is likely to hurt the budget and the economy in the long term. New migrants are younger than many previous waves of migrants when they arrived. And they are much younger than the incumbent Australia population.³⁴⁵

Consequently, they provide a 'demographic dividend' over the medium run by increasing the proportion of Australians in the workforce, thus smoothing the negative economic and budgetary impacts of an ageing population over a longer period.³⁴⁶ While immigration does not eliminate the costs of population ageing, since migrants themselves also age, it has smoothed out the baby-boom 'bump' that created a cohort much larger than the age group born in the years before or after.³⁴⁷

The combined effect of these factors is that net overseas migration modestly boosts average Australians' living standards. Productivity Commission modelling found that if migration continues at the long-term historical average rate, and assuming the same young age profile as the current intake, then GDP per person will be 7 per cent higher in 2060 than if there were zero net migration.³⁴⁸

Such modelling does not identify all the impacts of migration on the incumbent Australian population. Migrants themselves may capture more of the increase in GDP if they have above-average incomes. More GDP per capita may not improve overall community well-being, after accounting for the social and environmental impacts of migration such as reduced housing availability, increased transport congestion and environmental degradation. But on the other hand, migration brings diversity and dynamism that many value.

At the least, the Commonwealth Government should develop and articulate a population policy to be published with the Intergenerational Report, as the Productivity Commission recommended.³⁴⁹ Ideally, population policy should articulate the optimal migration policy settings given *actual* planning policy, rather than just assuming *optimal* policy. If housing policies do not improve, then the Commonwealth Government should consider policies that effectively slow Australia's net migration intake.

But this would require substantial changes to long-standing migration policy settings, and the approach needs to be more sophisticated than recent changes to be effective, and to avoid unintended consequences. The Commonwealth Government recently announced a 30,000 per year cut to Australia's permanent migration intake, to 160,000 a year.³⁵⁰ This will do little to improve housing affordability in the short-term, because housing affordability is affected by *net* migration.³⁵¹ Changing the number of new permanent visas has no impact on net migration if it

343. Daley et al. (2018a, pp. 105–106).

344. Belot (2018). Then Treasurer Scott Morrison warned that reducing Australia's permanent migration cap by 80,000 people a year would cost the budget between \$4 billion and \$5 billion over four years.

345. Productivity Commission (2016, p. 125); and Daley et al. (2018a, p. 34).

346. Daley et al. (2018a, p. 105).

347. Daley et al. (Figure 3.4 2018a); and R. Norton and Tanner (2017).

348. Productivity Commission (2016, p. 15); and Daley et al. (2018a, p. 106).

349. Productivity Commission (2016).

350. SBS News (2019). The Government also announced an extra 23,000 regional visas, which require skilled workers to live and work in regional Australia for three years before they can apply for permanent residency.

351. *i.e.* the change in the number of people in Australia this year, compared to last year, as a result of migration in and out of Australia.

simply leads to more people in Australia staying on temporary visas for longer.³⁵²

Consequently any decision to reduce net overseas migration would need much more careful thought, and would require changes to the rules around temporary visas, which typically involve difficult trade-offs.

5.2.6 Boost Commonwealth Rent Assistance

Rent Assistance materially reduces housing stress among low-income Australians.³⁵³ But the value of Rent Assistance has not kept pace with rent increases. The maximum Rent Assistance payment is indexed in line with CPI, but rents have been growing faster than CPI for a long time.³⁵⁴

Boosting the rate of Commonwealth Rent Assistance would help low-income earners with their housing costs, and reduce poverty more generally. A 40 per cent increase in the maximum rate of Rent Assistance – worth \$1,410 a year for singles – would cost \$1.2 billion a year.³⁵⁵ Commonwealth Rent Assistance would then provide the same real level of assistance to low-income earners as it did 15 years ago, taking into account the rising cost of their rent. In future, Rent Assistance should be indexed to changes in rents typically paid by

352. For example, the 2019-20 Budget included both a 30,000 cut to the permanent migration program for 2019-20 and a 40,000-a-year increase in forecasts of net overseas migration for the same year (Treasury (2019c, p. 92)). But changes in the number of permanent visas issued should affect the stock of temporary migration in the long-term.

353. In June 2016, 68 per cent of Rent Assistance recipients would have paid more than 30 per cent of their income on rent if Rent Assistance were not provided. With Rent Assistance provided, this proportion was reduced to 41 per cent (Daley et al. (2018b, p. 76)).

354. Ibid. (p. 76).

355. Ibid. (p. 76).

people receiving income support, so that its value is maintained, as recommended by the Henry Tax Review.³⁵⁶

A common concern is that boosting Rent Assistance would lead to higher rents, eroding much of the gains in living standards for low-income earners.³⁵⁷ But an increase in Rent Assistance is unlikely to substantially increase rents.³⁵⁸ Households are unlikely to spend all of the extra income on housing.³⁵⁹ Households receiving Rent Assistance are only a small proportion of low-income renting households. And only half of low-income renters actually receive Rent Assistance, since eligibility is linked to receiving an income support payment.

But boosting Rent Assistance would not solve all the issues around housing affordability. Boosting Rent Assistance by 40 per cent would only modestly reduce the proportion of low-income earners in housing poverty. Many low-income Australians are spending up to 50 per cent of their incomes on housing.³⁶⁰ And private rental is likely to be inappropriate for people at severe risk of long-term homelessness.

5.2.7 The Commonwealth Government should help boost the supply of social housing to reduce homelessness

The Commonwealth Government should increase funding through the National Affordable Housing Agreement³⁶¹ for social housing, provided that it is tightly targeted to help Australians at serious risk of homelessness.

356. Treasury (2009, p. 595). While the rental component of the CPI is a readily available and transparent measure, an index of rents paid by Rent Assistance recipients would provide a more accurate assessment of their rental costs.

357. Senate Economics References Committee (2015, Chapter 22).

358. Daley et al. (2018b, pp. 77–79).

359. Each dollar of additional Rent Assistance should lead to an increase in spending on housing of only between 9 cents and 15 cents (Daley et al. (Ibid., p. 78)).

360. Ibid. (p. 77).

361. Treasury (2018a).

The best Australian evidence shows that social housing substantially reduces tenants' risk of homelessness.³⁶² Social housing can make a big difference to the lives of those worst off. While lots of landlords rent to low-income households, many are prepared to leave their property vacant if the only person seeking tenancy faces the many issues typical for those who are at severe risk of, or already experiencing, homelessness. These issues include living with a disability, domestic violence, poor mental health, drug and alcohol misuse, a history of state care, or long-term disadvantage.³⁶³

The stock of social housing – currently around 400,000 dwellings – has barely grown in 20 years, while the population has increased by 33 per cent.³⁶⁴ As a consequence, there is little 'flow' of social housing available for people whose lives take a big turn for the worse,³⁶⁵ and many people who are in greatest need are not assisted (Figure 5.3). Tenants generally take a long time to leave social housing; most have stayed for more than five years.³⁶⁶

But boosting social housing will be expensive: increasing the stock by 100,000 dwellings – broadly sufficient to return the total social housing stock to its historical share of the total housing stock – would require additional *ongoing* public funding of about \$900 million a year, or an upfront capital cost of \$10-to-\$15 billion.³⁶⁷ People in social

362. Prentice and Scutella (2018) studied the benefits of social housing, comparing the outcomes of those who entered social housing to similar individuals in the private rental market. They find that social housing tends to be effective at reducing homelessness rates. Only 7 per cent of residents placed in social housing subsequently become homeless, compared to 20 per cent of similar renters in the private market.

363. Daley et al. (2018a, p. 134).

364. Daley et al. (Ibid., p. 62). This is despite some significant investments in public housing, including under the controversial and now discontinued National Rental Affordability Scheme.

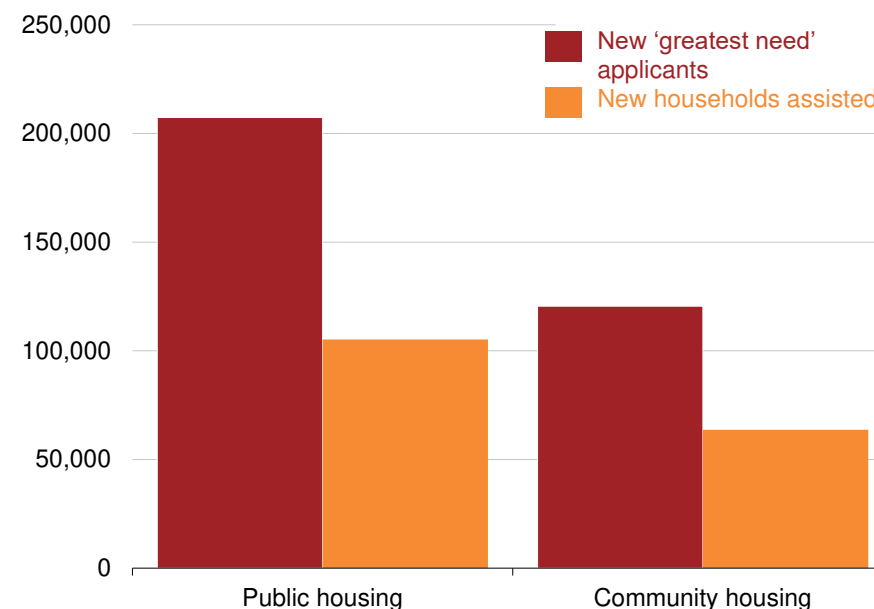
365. Daley et al. (Ibid., p. 132).

366. AIHW (2017).

367. Coates and Wiltshire (2018).

Figure 5.3: Demand for social housing has outstripped the number of new households assisted

Number of new 'greatest needs' applicants and number of new households assisted for social and community housing, 2013-2017



Note: A 'greatest need' applicant is a low-income household which at the time of allocation was either homeless, had their life or safety at risk in their current accommodation, had housing inappropriate to their needs, or had very high rental housing costs.

Sources: Productivity Commission (2018a); Grattan analysis.

housing receive a much greater average level of assistance – at much greater cost to government – than private renters receive from Rent Assistance.³⁶⁸

Given its costs, social housing should be reserved for those most in need, and at significant risk of becoming homeless for the long term.³⁶⁹ While a substantial boost to the social housing stock – such as an extra 200,000 dwellings – would make a big difference to people who are homeless if it were tightly targeted towards them,³⁷⁰ more than two thirds of low-income Australians would still remain in the private rental market.

Private housing can and does help those on low incomes by lowering the rents they pay. Rents have increased more slowly over the past decade in Victorian suburbs in which more housing has been constructed.³⁷¹ Increasing the supply of housing as we recommend would, over a decade, be sufficient to reduce the number of low-income households suffering housing stress by up to one-third, or around 170,000 households.³⁷² And all low-income households would be paying less for their housing.

Claims that direct investment in affordable housing is the only way to boost the stock of homes available to low-income earners are based

on misleading research.³⁷³ More housing supply will ultimately free-up less expensive housing stock, making rents cheaper for low-income earners.³⁷⁴ International evidence suggests that this ‘filtering’ does occur in practice. For example, US estimates suggest that 45 per cent of homes that were affordable to very low-income earners in the US in 2013 had filtered down from owner-occupier or higher-rent categories in 1985.³⁷⁵ And higher rents increase the risk of homelessness for those who are already vulnerable.³⁷⁶

Therefore, beyond ensuring a flow of additional social housing for people most at risk of long-term homelessness, further support for low-income housing should be focused on direct financial assistance for low-income renters, and improving housing affordability more broadly by increasing the number of homes constructed.

368. Productivity Commission (2018a, p. 174).

369. New allocations of social housing are better targeted to those most in need. Of all social housing allocations in 2017, almost three quarters went to ‘greatest needs’ applicants (Productivity Commission (ibid., Chapter 18)).

370. For example, there were 116,000 homeless Australians on Census night in 2016 (ABS (2017c)).

371. Each 1-percentage-point increase in the amount of new housing constructed in a local government area resulted in rents growing 3.7 per cent slower over the decade (Grattan analysis of ABS (2017c) and Victorian Department of Health and Human Services (2019)).

372. Grattan analysis of ABS (2017b). Based on a 20 per cent fall in rents.

373. For example, Ong et al. (2017) claims that most of the additional dwellings built over the past decade were substantially more expensive than the existing housing stock. But this study is flawed because it groups price deciles by the number of local government areas, rather than by the number of dwellings. Grattan Institute’s new analysis of the data, updated to 2016-17, shows that two thirds of new houses have been built in the cheapest half of all suburbs, and most new units and apartments have been built in Sydney and Melbourne, where median prices are higher (Coates and Wiltshire (2018)).

374. See: Daley et al. (2018a, p. 64). The people who move into newly constructed more expensive housing are either existing residents who move out of less expensive housing, or new residents who would otherwise have added to the demand and pushed up the price of existing housing. Irrespective of its cost, each additional dwelling adds to total supply, which ultimately affects affordability for all homebuyers.

375. Weicher et al. (2016).

376. For example, G. Johnson et al. (2018) find that a \$100 increase in 20th percentile weekly rents raised an individual’s risk of becoming homeless by almost 3 per cent among a sample of welfare recipients who had been flagged by Centrelink as being at risk of housing insecurity. In fact, increasing rents actually had a greater impact on the risk of homelessness than frequent illicit drug use, experiencing physical or sexual violence in the past six months, or a history of being in state care.

5.2.8 Repeating recent affordable housing policies is unlikely to be effective

The federal Labor Opposition recently announced a policy to build 250,000 more affordable homes in the next decade.³⁷⁷ The plan would provide subsidies of \$8,500 a year over 15 years to community housing providers and investors who build new dwellings and rent them at 20 per cent below market rates. More funding to help low-income earners with rising housing costs is welcome, but many details remain unannounced. It appears the scheme would operate through a similar mechanism to the earlier *National Rental Affordability Scheme* (NRAS). One important difference is that only community housing providers would be eligible,³⁷⁸ so developer surpluses (which were substantial for NRAS) would mostly be captured by not-for-profits, rather than private developers.

But any future scheme would need to be much better designed than NRAS. Beyond its widely publicised administrative failures,³⁷⁹ NRAS was poor value for money for four reasons:

1. It was expensive. NRAS offered investors a subsidy of \$8,000 a year (\$11,192 in today's money) in exchange for providing new dwellings for rent for at least 20 per cent below market rents. The average private renter pays rent of \$18,460 a year.³⁸⁰ Providing a 20 per cent discount to market rents for the median private renter should therefore cost only \$3,692 a year, much less than

the \$11,192 subsidy offered per dwelling.³⁸¹ The COAG Affordable Housing Working Group estimated the annual public subsidy required to offer housing at a 25 per cent discount to market rents at just \$3,100 a year.³⁸² Any extra subsidy beyond the cost of providing affordable housing flowed to NRAS property developers.³⁸³

2. Subsidies offered to developers through NRAS were not tied to the type and location of any new affordable dwelling constructed. As a result, the same subsidy was offered for a new one-bedroom apartment or a three-bedroom home in the same location, and for dwellings in central Sydney and rural NSW.³⁸⁴
3. Affordable housing constructed under NRAS was not targeted at those most in need. Eligibility thresholds for NRAS were set far too high: \$50,000 for a single adult, or nearly \$70,000 for a couple – much higher than the equivalent thresholds for accessing Commonwealth Rent Assistance.³⁸⁵ About half of all Australian households that rent qualify to live in an NRAS-subsidised home. Half of these households would not be eligible for Commonwealth

377. Crowe (2018). The program would cost \$102 million over the forward estimates to 2021-22 and \$6.6 billion over the decade to 2028-29.

378. Australian Labor Party (2018).

379. See: ANAO (2015) and ANAO (2016).

380. Median rents varied from \$26,000 a year in the NT to \$13,000 a year in Tasmania in 2015-16. Therefore the cost of providing a dwelling at 20 per cent below market rent will vary from \$5,200 a year in the NT to \$2,600 a year in Tasmania. ABS (Table 13.2 2017d).

381. While the market rent on a new dwelling built under the scheme may be higher than the median, the rents paid by low-income earners are likely to be lower than the median since they have lower incomes.

382. Council on Federal Financial Relations (2017, p. 14).

383. The presence of a secondary market for trading NRAS incentives suggests the subsidy exceeded the cost of providing affordable homes in many instances. For example, see: Ross (2014) and Wallace (2016).

384. Participants in NRAS receive a subsidy of \$8,000 per year for 10 years (indexed) for new dwellings that were rented out for 20 per cent below market value rent to eligible tenants. Department of Social Services (2018). Studios and one- and two-bedroom dwellings accounted for two-thirds of all homes constructed under NRAS (Department of Social Services (2019b, p. 4)).

385. Department of Social Services (2018). For example, the income cut-off for a single receiving Newstart Allowance is \$27,577 a year.

Rent Assistance. And a substantial proportion of those actually allocated NRAS housing were on moderate to higher incomes.³⁸⁶

There is no point in making the same mistakes again. Any new subsidised housing scheme should be reserved for people at serious risk of homelessness. A centralised waiting list for newly constructed properties using state and territory social housing registers would be the best way to allocate dwellings under any future affordable housing scheme.³⁸⁷

To minimise the developer surplus, subsidies to investors should reflect the cost of discounts provided to tenants. This could be done either by setting subsidies that vary depending on dwelling size and location, based on independent assessments of the costs, or by running a tender in which the relevant department calls for bids on particular projects by interested developers.³⁸⁸

4. Even though deeper housing subsidies for low-income earners are warranted, NRAS was an expensive way to boost the *overall* supply of housing. New housing construction in Australian cities is relatively unresponsive to demand,³⁸⁹ largely because land-use

386. Department of Social Services (2016). Just one third of tenants had gross household incomes less than \$30,000, and one third had incomes greater than \$50,000 a year.

387. Some states and territories already keep centralised registers of interest for social housing, in most cases separated into priority bands based on income, assets and other criteria for assessing need.

388. Quotas would be set on the number, size and location of affordable housing dwellings to be provided in each tender round. This approach would motivate developers to deliver affordable housing projects at the lowest possible cost, and enable the department to target areas of need (an area with a lack of affordable one-bedroom apartments, for example). Contestable arrangements, where providers are selected by governments through competitive processes such as tenders, are widely used in human services (Productivity Commission (2017c)).

389. The best estimate of the 'price elasticity of supply' in Australia is that a 10 per cent increase in dwelling prices leads to an increase in the stock of new housing of between 3 and 5 per cent. See: Daley et al. (2018a, p. 46).

planning rules prevent greater density – especially in established suburbs with good access to jobs and transport.³⁹⁰ Since even affordable homes are subject to those planning rules, many homes constructed under the scheme were likely to have been built anyway.³⁹¹

Given these issues, and to avoid the administration problems that plagued NRAS,³⁹² the bulk of extra support for housing costs for low-income earners should be provided via Commonwealth Rent Assistance, along with funding for more social housing targeted at the long-term homeless.³⁹³ Commonwealth Government funds to boost housing supply might well do more to improve housing affordability for low-income earners – and everyone else – if they were used to encourage state and territory governments to relax land-use planning rules generally.³⁹⁴

5.2.9 Don't subsidise first home-buyers and downsizers

Over recent decades, Commonwealth, state and territory governments have spent billions of dollars giving cash incentives and stamp duty concessions to first-home buyers.³⁹⁵ These policies have typically

390. Several other Australian government, academic and private sector studies have pointed to restrictive zoning as being an important factor in Australia's high housing prices. See Daley et al. (Ibid., p. 57).

391. Senate Economics References Committee (2015, p. 362).

392. See: ANAO (2015), ANAO (2016) and Senate Economics References Committee (2015, Chapter 20).

393. For example, the former Commonwealth Government's Social Housing Initiative provided \$5.6 billion from 2008-09 to 2011-12 for construction of new and maintenance of existing social housing dwellings (Swan (2008) and KPMG (2012)).

394. Daley et al. (2018a, pp. 128–129).

395. Eslake (2013). Daley et al. (2013b, p. 49) estimated that abolishing all subsidies for first home-buyers could save Commonwealth, state and territory budgets a combined \$1.3 billion a year. Stamp duty concessions act in a similar way to cash grants for first home-buyers (I. Davidoff and Leigh (2013)).

resulted in spikes of first home-buyer activity as they bring forward purchases, then there is a lull in activity, and in the end housing affordability is actually worse because additional demand drives up prices.³⁹⁶

Some argue that governments should give senior Australians more incentives to downsize their homes through stamp duty concessions, exemptions from the Age Pension means test, or additional superannuation tax concessions.³⁹⁷ It sounds good: new incentives would encourage seniors to move to housing that better suits their needs, while freeing up equity for their retirement and larger homes for younger families.

But the reality is different. Most seniors are emotionally attached to their home and neighbourhood and don't want to downsize.³⁹⁸ So most of any financial incentives will go to people who were going to downsize anyway.³⁹⁹ And, as the Productivity Commission found, these incentives have a material budget cost, and distort the housing market by adding even more tax and welfare incentives to own a home.⁴⁰⁰

If governments really want to encourage seniors to downsize, they should do so by including the family home in the Age Pension assets test (Section 10.2.3 on page 131) – which would at least have the virtue of improving the budget bottom line, even if it would have little impact on housing affordability.

396. Daley et al. (2018a, pp. 135–137).

397. For example, see Ong et al. (2016).

398. For two thirds of older Australians, the desire to 'age in place' is the most important reason for not selling the family home. Often they stay put because they can't find suitable housing in the same local area (Daley and Coates (2017)).

399. Daley et al. (2018a, pp. 140–141).

400. Productivity Commission (2015b).

6 Energy

6.1 Where we are

Australia's electricity supply is more polluting, less reliable, and more expensive than many comparable countries (Table 6.1).

A recent health check by the Energy Security Board (ESB) rated the security and reliability of the National Electricity Market (NEM) as moderate/critical.⁴⁰¹ This is more than two years after the state-wide blackout in South Australia that triggered much media commentary, political grandstanding and government reviews, but little real policy change.

Since the publication of Grattan Institute's Commonwealth Orange Book 2016⁴⁰² just before the last federal election, things have not gone well:

- Electricity and gas prices have increased (Figure 6.1), with only minor relief on the horizon. Government actions designed to 'ease price pressures' have had little impact. The Australian Competition and Consumer Commission (ACCC) produced a major report on electricity affordability,⁴⁰³ but only a few of its recommendations are being pursued.
- The 2016 SA blackout triggered the Finkel Review of security in the NEM.⁴⁰⁴ The COAG Energy Council endorsed almost all of its recommendations, yet many of them have not been implemented. Concern about the tight supply-demand balance is high after the

Table 6.1: International scorecard for energy

	Electricity outages	Electricity carbon intensity	Residential electricity price	Industry gas price
	<i>minutes per year</i>	<i>tonnes of CO₂e/MWh</i>	<i>cents per KWh</i>	<i>dollars per Gj</i>
Australia	73	0.76	30.8	8.9
Canada	58	0.15	14.2	6.2
Germany	13	0.45	44.7	10.0
Japan	12	0.54	29.4	15.3
Netherlands	29	0.46	23.1	9.8
New Zealand	138	0.11	26.8	6.4
South Korea	4	0.52	14.2	15.8
Sweden	67	0.01	23.2	14.7
United Kingdom	24	0.28	26.7	9.1
United States	70	0.43	16.8	4.9

Notes: See Appendix A for notes and sources.

401. ESB (2018).

402. Daley et al. (2016c).

403. ACCC (2018b).

404. Finkel et al. (2017).

closure of large power plants and then rolling blackouts in Victoria during the 2018-19 summer.⁴⁰⁵

- Australia is on track to meet its 2020 target of a reduction of 5 per cent below the 2000 level of emissions, but it is not on track to achieve the Coalition Government's 2030 target of 26-to-28 per cent below the 2005 level (Figure 6.2).⁴⁰⁶ There is no policy framework that could credibly deliver this target, let alone one that could be ramped up to meet Labor's proposed 2030 target of 45 per cent below the 2005 level.
- Australia's electricity produces a lot more emissions than comparator countries (Figure 6.3), even though it is also among the most expensive (Table 6.1).
- Multiple reports and reviews over the past three years⁴⁰⁷ have provided a multitude of recommendations to reduce costs and emissions and increase reliability. Many of them are sensible and should be adopted. But Australia does not have a cohesive plan for delivering a comprehensive market reform agenda based on this work. Instead of the hard work of market reforms, governments seem to prefer intervening in the market and criticising the big energy companies.

6.2 What we should do

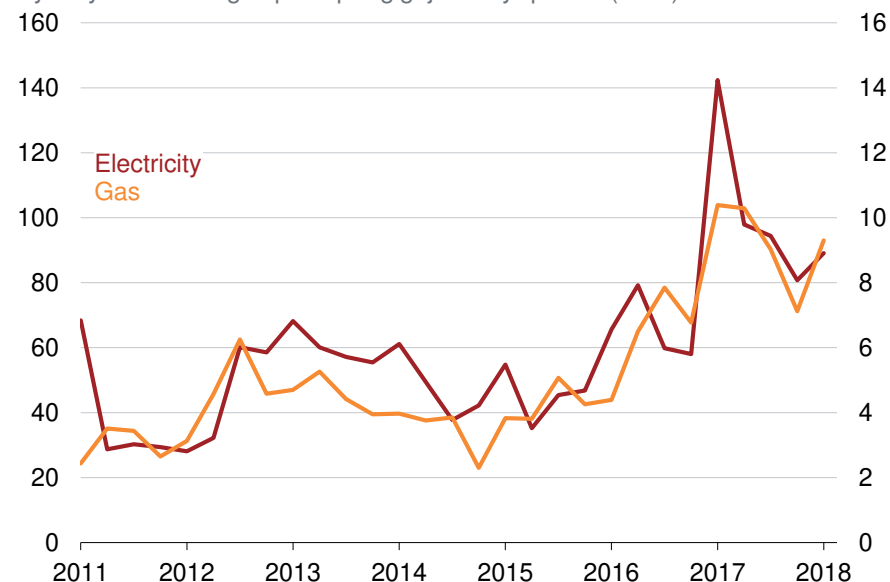
The next federal government will have large body of proposals, programs and new policies to address immediate energy priorities and create momentum for a longer-term transition. A focused agenda will be essential.

405. T. Wood et al. (2019).

406. Department of Environment and Energy (2018).

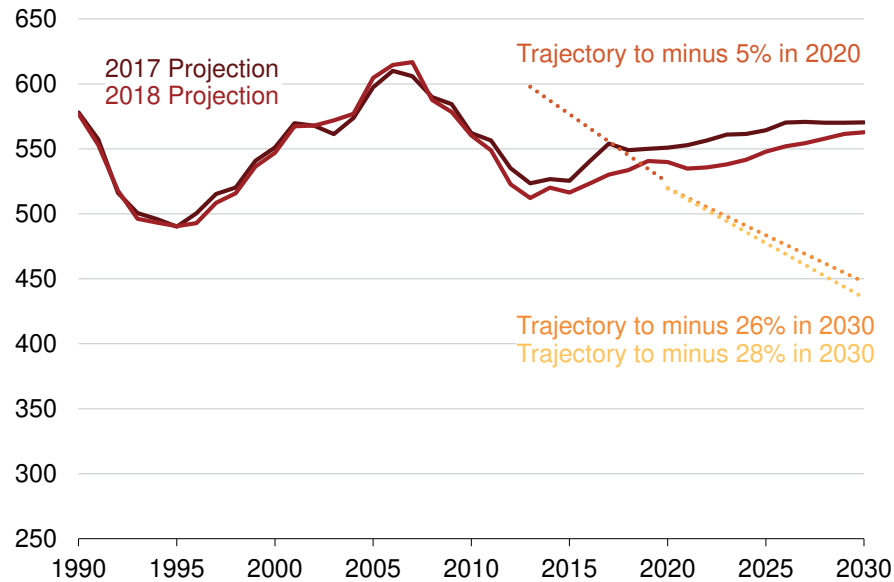
407. For example ACCC (2018b), ESB (2018) and Finkel et al. (2017).

Figure 6.1: Australian electricity and gas prices have risen sharply
National Electricity Market average price per MWh by quarter (LHS)
Sydney wholesale gas price per gigajoule by quarter (RHS)

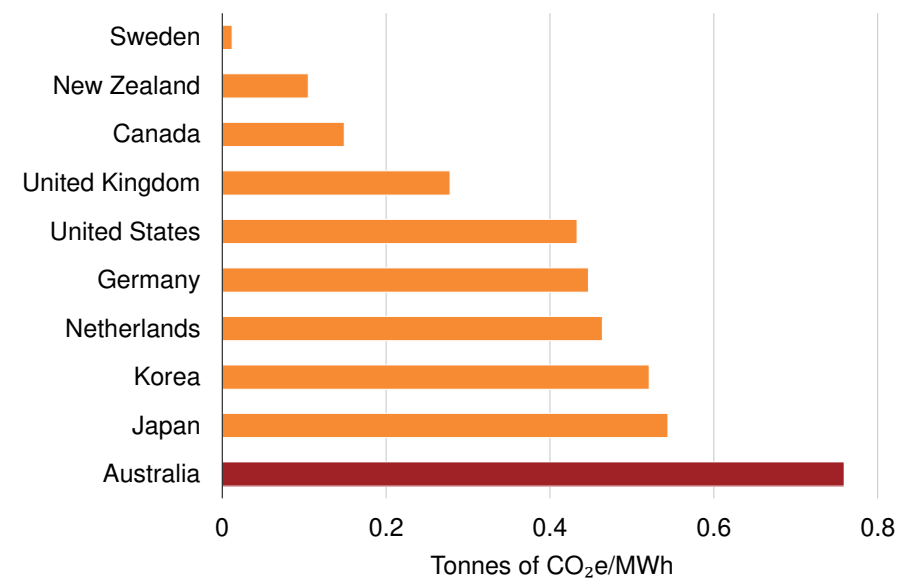


Note: Nominal prices in Australian dollars.

Sources: AER (2019) and AEMO (2019).

Figure 6.2: Australia is likely to miss its 2030 emissions targetAustralia's emissions trends, Mt CO₂-e

Source: Department of Environment and Energy (2018).

Figure 6.3: Australian electricity is much more carbon intensive than electricity in other countries

Notes: Values may not align with nationally reported emissions intensity due to International Energy Agency (IEA) methodology. This measure uses average carbon content for fuels, which varies by source.

Source: IEA (2018).

The Commonwealth is responsible for Australia's climate change targets and policy. The federal minister has no choice but to work with the COAG Energy Council to develop national energy policy and implement it through the market agencies.

Businesses and households want action on climate change. Whoever wins the election should focus on four priorities to deliver the biggest results over its three year term:

1. Implement the emissions obligation of the National Energy Guarantee (NEG) for electricity, integrated with specific mechanisms in other sectors.
2. Lead the COAG Energy Council to implement the reliability obligation of the NEG.
3. Negotiate a new Australian Energy Market Agreement with the states and territories that commits to national markets, the policy making role of governments, and the implementation role of the market agencies.
4. Develop and deliver a clear, credible and compelling narrative for an energy transition that will win public support. Failure on this task destroyed the prime ministerships of Kevin Rudd and Malcolm Turnbull. It will be a tough journey, weighed down by the baggage of the climate wars. But it's a journey Australia must make and complete.

6.2.1 Introduce an emissions reduction obligation for the electricity sector

An economy-wide carbon price through a market mechanism is the best way to reduce emissions to meet Australia's targets without excessive cost to the economy.⁴⁰⁸ But in the absence of the political

408. Daley and Edis (2011); and Daley and Edis (2010).

consensus needed to implement the best policy, we should work with what we have.⁴⁰⁹

The work of the past two years means the incoming federal government, whether Coalition or Labor, will have the content and should have the political opportunity to introduce a stable and credible emissions reduction policy for the electricity sector. Reverting to subsidies and direct government funding would almost certainly be less effective and less efficient.

The ESB in 2017 proposed an emissions reduction obligation, as well as a retailer reliability obligation, as part of the NEG. Unfortunately, the emissions reduction obligation fell victim to politics in 2018 and failed to secure the support of the COAG Energy Council or the federal Coalition Government.⁴¹⁰ Labor says it will introduce this mechanism if it wins the 2019 federal election.

The design of the proposed emissions reduction obligation was compromised by a Commonwealth requirement that there be no form of tradable permits or certificates. The next federal government should adopt the ESB's proposed mechanism, but with the flexibility and cost benefits of explicit trading. The mechanism should be implemented through the National Electricity Law and linked to the Commonwealth Government's emissions reduction target.

6.2.2 Adopt the Safeguard Mechanism to create the platform for an economy-wide climate change policy

The current government and opposition have focused on emissions reduction in the electricity sector. The next government will need to reduce emissions across the economy, consistent with Australia's

409. T. Wood et al. (2015); and T. Wood et al. (2016).

410. ESB (2017).

commitments under the Paris Agreement. It should adopt a three-step approach.⁴¹¹

First, the next government should adopt the existing Safeguard Mechanism – a policy that covers about 140 of Australia’s highest-emitting businesses.

Second, the government should provide incentives for low-cost emissions reductions by auctioning tradable permits that allow businesses to emit above the baselines, but within the target trajectory to 2030. This will lower the cost of reducing emissions.

Third, the government should expand the Safeguard Mechanism to cover more emitters, while reducing baselines to zero. Businesses covered by the scheme would then have to hold permits for all their emissions. This would create an economy-wide, market-based structure to meet tougher future targets at low cost – ideally an emissions trading scheme.

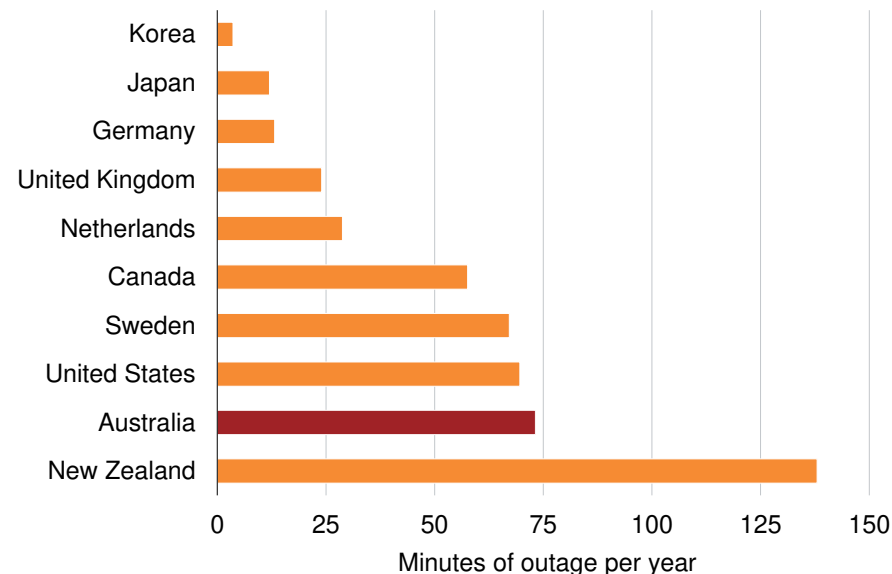
6.2.3 Implement the retailer reliability obligation for the electricity sector

A combination of falling demand, subsidised renewable supply, falling renewables costs, ageing coal plants, and the absence of credible, stable climate policy led to a rapidly changing generation mix in Australia. The policy and regulatory framework did not accommodate the changing technical characteristics of the new generation. There is a risk that a lack of dispatchable capacity will emerge if this trend is allowed to continue and as climate change leads to hotter temperatures and higher peak demand. Australia’s electricity supply is relatively unreliable (Figure 6.4), although to date, outages to date have been overwhelmingly caused by problems in transporting power through the distribution and transmission networks, not inadequate supply.⁴¹²

411. T. Wood et al. (2016).

412. T. Wood et al. (2019, p. 10).

Figure 6.4: Electricity is less reliable in Australia than many other countries



Notes: Five-year average for the largest business city, except Japan and the US, which are population-weighted two-largest cities. Includes all planned and unplanned outages.

Source: World Bank (2018b).

The COAG Energy Council is on track to implement the retailer reliability obligation of the NEG by 1 July 2019. This will encourage investment in dispatchable capacity and support reliability.⁴¹³

The Commonwealth Government should continue to support this mechanism. More interventionist policies, such as underwriting investment, are unnecessary and will not improve reliability.

6.2.4 Adopt recent recommendations to improve the efficiency of the wholesale electricity market

The major causes of high wholesale electricity prices since 2015 have been plant closures and high coal and gas prices.⁴¹⁴ Politicians should tell consumers the harsh truth: higher wholesale electricity prices are the new normal.

The Government should implement the ACCC's recommendation (Recommendation 3) to amend the National Electricity Law to give the Australian Energy Regulator (AER) the power to "address behaviour which has the effect of manipulating the proper functioning of the wholesale market".⁴¹⁵

Governments and the market operator should consider additional changes to the bidding rules to reduce gaming.⁴¹⁶ But more drastic actions, such as lowering the cap on wholesale prices or intervening in the market to break-up private energy companies, should be rejected because they are likely to create even bigger problems.⁴¹⁷

413. Ibid. (p. 22).

414. T. Wood et al. (2018b, p. 11).

415. ACCC (2018b, p. xvii).

416. T. Wood et al. (2018b, pp. 44–45).

417. T. Wood and Dundas (2019).

6.2.5 Don't underwrite new generation

The ACCC recommended that the Government underwrite new generators in limited cases of market failure where market concentration is a barrier to entry.⁴¹⁸ But the Coalition Government has taken this recommendation much further and is seeking to underwrite investment in new electricity generation where there is no apparent market failure. This is an extraordinary market intervention.

The peak industry body, the Australian Energy Council, has strongly opposed this proposal.⁴¹⁹ But, inevitably industry players will be happy to take the Government's money, even if they view the policy regime as contrary to the public interest.

Labor has proposed to directly contract new investment in renewable energy if it cannot get bipartisan support for an emissions reduction policy.⁴²⁰

Both proposals are further steps down the road of government intervention and regulation, at a time when Australia needs clear and stable policy for well-regulated markets.

6.2.6 Privatisise the remaining publicly-owned energy businesses, in concert with relevant states and territories

Energy market reform began in the early 1990s⁴²¹ but stalled in the 2000s. Privatisation, a key part of that reform agenda, became politicised and stalled.

A well-regulated market will deliver lower-cost, reliable electricity through privatised businesses.⁴²² Competition from government-owned

418. ACCC (2018b, p. viii).

419. Skinner (2019).

420. Murphy (2018).

421. Hilmer et al. (1993).

422. T. Wood et al. (2012).

businesses distorts the competitive dynamics in the market, leading to higher cost with little benefit. The Commonwealth Government should work through the COAG Energy Council to prosecute the arguments for generation, network, and retail privatisation. The ACCC has made a similar recommendation (Recommendation 2).⁴²³ Cheaper electricity will result.

Some jurisdictions may withhold their support because they still own parts of the electricity supply chain and have conflicting interests as both shareholder and regulator. This conflict applies to some state-owned network businesses, to the Commonwealth as sole owner of Snowy Hydro, which owns both generation and retail businesses, and to the Queensland Government as owner of most generation and network assets in that state.

6.2.7 Implement rule changes and ACCC recommendations to deliver effective retail competition

Competition in electricity retailing hasn't delivered what was promised: lower prices for consumers (Figure 6.5).⁴²⁴ Profit margins appear to be higher than in other retail sectors. And adding more competitors hasn't helped – it has merely created more complex and confusing retail offers, adding to consumer frustration. These issues were one of the catalysts for the ACCC's major 2018 report on electricity affordability.⁴²⁵

The Commonwealth Government should do more to implement two of the ACCC's recommendations:

1. Improve the quality of information that active consumers can use to make an informed decision on their retail supply. This includes communication on contract terms and expiry,⁴²⁶ advertising

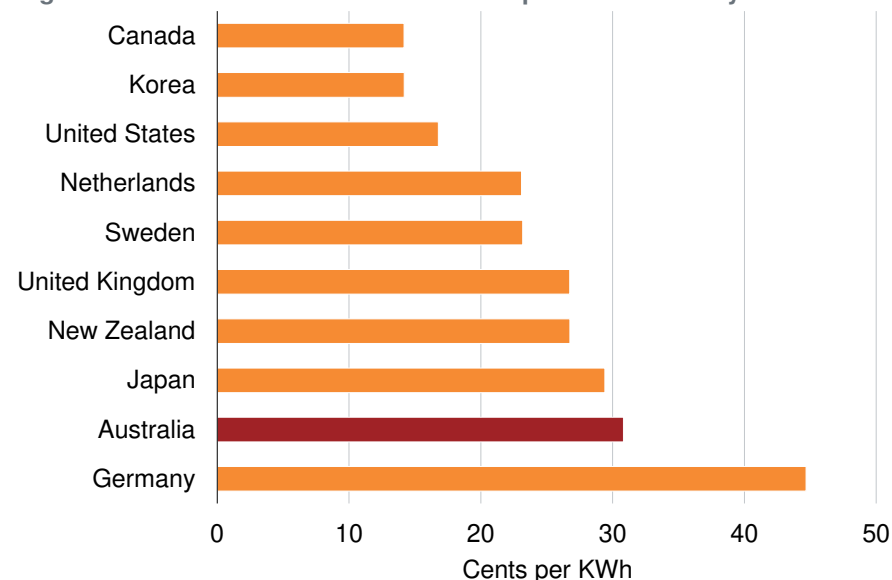
423. ACCC (2018b, p. xvii).

424. T. Wood et al. (2017).

425. ACCC (2018b, p. v).

426. AEMC (2018a); and AEMC (2017).

Figure 6.5: Australian households have expensive electricity



Sources: Grattan analysis of OECD (2018h) and RBA (2018b).

of discounts, comparator websites, and the use of conditional discounts.

2. Ensure greater transparency to reduce costs and address emerging issues through streamlined price monitoring and reporting.

At the request of the Government, the AER has made a draft determination on a third recommendation: the introduction of a default or safety-net price that would apply to consumers who do not actively choose a deal from a retailer.⁴²⁷ The Government should be wary of this approach and take time to fully work through the details and review processes. Introducing a price cap as a 'quick fix' may lead to unintended and unhappy consequences.⁴²⁸

The market behaviour of retailers should be monitored against the realistic expectations of competition. Competition has delivered lower costs in the wholesale/generation sector where the purchasers are specialised and sophisticated. In contrast, the benefits of retail competition in electricity may be less than the costs.

The industry is on notice. We may yet see fairer prices. We may yet see real innovation. But if not, governments will have no choice but to give up on retail competition and return to direct price regulation.

6.2.8 Pursue with state governments the effective write-down of overvalued network assets

Poor decisions by state governments in NSW, Queensland and Tasmania drove excessive investment in power networks over the past decade. Grattan Institute has calculated that up to \$20 billion of investment in the networks, mostly in NSW and Queensland, was

427. AEMC (2018b).

428. Daley et al. (2018c, pp. 79–80).

excessive, and that consumers in those states now pay \$100-to-\$400 more for electricity each year than they should.⁴²⁹

The ACCC endorsed our recommendation that this excessive investment should no longer be paid for by consumers but should be corrected by the relevant state governments.⁴³⁰ The ACCC suggested that the Commonwealth Government provide appropriate assistance to the states to address this issue, but it is unclear how this could be done in a way that avoided rewarding bad behaviour.⁴³¹

Consumers will be paying for decades to come for investments that are neither used nor useful, unless state governments agree to address this issue. Inefficiently high prices will encourage consumers to overspend on other energy solutions. But that still won't reduce the burden of paying for the grid – it may instead shift more of the burden to those who can least afford it.⁴³²

While responsibility for this situation rests with the relevant state governments, its impact on consumers is such that finding a solution should be a priority for the Commonwealth as chair of the COAG Energy Council.

6.2.9 Implement a nationally consistent gas development regime, but do not reserve gas for domestic consumption

Historically, Australia had low gas prices relative to other countries. It had abundant local gas and no means to export. But opening the east-coast domestic gas market to international demand has pushed prices up to the international level (Figure 6.6), putting substantial cost pressure on Australia's gas-intensive industries. These pressures are exacerbated by slow progress toward a transparent and liquid

429. T. Wood et al. (2018a, p. 33).

430. ACCC (2018b, p. x).

431. Ibid. (p. 171).

432. T. Wood et al. (2018a, pp. 33–34).

wholesale market, and by bans on unconventional extraction, such as fracking, in several jurisdictions.⁴³³

The Commonwealth Government introduced the Australian Domestic Gas Security Mechanism to “ensure there is a sufficient supply of natural gas to meet the forecast needs of energy users within Australia”.⁴³⁴ It had some success, but the bigger problem was, and remains, the price of gas to the domestic east-coast market.

The ACCC now regularly publishes export equivalent prices,⁴³⁵ and domestic wholesale prices have generally responded. But these prices are proving very difficult for some energy-intensive gas consumers, resulting in regular threats⁴³⁶ and announcements⁴³⁷ of business closures. The political pressure is unlikely to diminish any time soon.

Historically, Australia has largely missed out on royalties from gas exports due to overly generous tax concessions.⁴³⁸ Profitable companies avoided the Petroleum Resource Rent Tax because uplift rates on carried-forward expenditure were too high. This has now been rectified.⁴³⁹ But there should be ongoing monitoring to ensure Australia receives a fair share of the benefits from gas exports.

The Commonwealth Government should not, however, revert to protectionism by reserving a proportion of gas for domestic use: in the long run that would reduce the availability of domestic gas, drive up prices, and reduce export revenue.⁴⁴⁰

433. T. Wood et al. (2014, p. 40).

434. Department of Industry (2017).

435. ACCC (2019).

436. Garvey (2018).

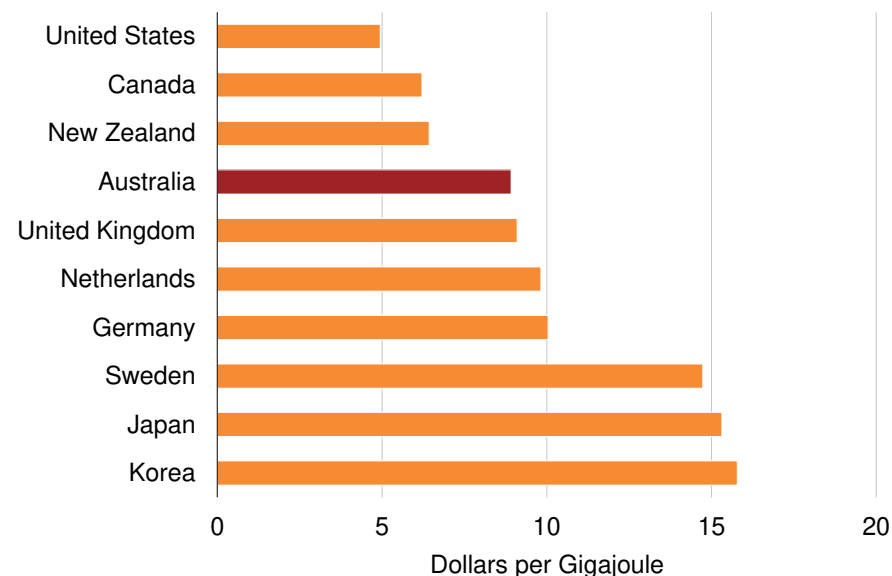
437. Macdonald-Smith (2019).

438. Treasury (2017d); and Khadem (2019).

439. Treasury Laws Amendment (2019 Petroleum Resource Rent Tax Reforms No. 1) Bill 2019 passed both houses on 3 April 2019.

440. T. Wood et al. (2014, pp. 32–33).

Figure 6.6: Australian industries pay lower gas prices than industries in many other high-income countries



Notes: End-use prices include all the various forms of taxation that affect the final amount spent by end-users. The methodology for the Australian values may be different to the other countries because Australian industry gas prices are not reported in the OECD (2018h) Energy Prices and Taxes report. Australian gas price is the national volume-weighted average. In 2017, the Australian east coast delivered gas price was \$10.08 and the Western Australian price was \$6.97.

Sources: Grattan analysis of OECD (2018h), RBA (2018b) and Department of Environment and Energy (2017).

Instead, the Commonwealth should work with the states, notably Victoria, to resolve the issue of unconventional gas extraction and remove barriers to more gas supply entering the market. All parties should be guided by the finding of the NSW Chief Scientist and Engineer that ‘CSG [coal seam gas] extraction and related technologies are mature and Australia is well equipped to manage their application’.⁴⁴¹

As recommended by the Finkel Review,⁴⁴² the Commonwealth should lead Australian governments to adopt evidence-based regulatory regimes to manage risks of gas extraction projects. A nationally consistent regime would be best.

6.2.10 Negotiate a new Australian Energy Market Agreement

The Finkel Review recommended improvements to the governance of the energy market during a challenging time of transition. These included the creation of the ESB to provide a single point of accountability and coordinate the way the market bodies (Australian Energy Market Commission, Australian Energy Market Operator and AER) exercise their respective accountabilities.⁴⁴³ The ESB has delivered some success with the NEG and the annual Health of the National Electricity Market Report. The Commonwealth should ensure that this new governance structure remains fit-for-purpose through a targeted review in 2020.

But the recent experience with the NEG and the ACCC report on electricity affordability illustrate the challenges of dealing with multiple jurisdictions that are sovereign governments. This is exacerbated by conflicts of interest created by government ownership. Separate initiatives by individual jurisdictions on climate policies, retail

competition and gas development can interfere with national priorities or just add costs.

The Commonwealth should lead the COAG Energy Council to adopt the Finkel Review recommendation for a new Australian Energy Market Agreement. The agreement should include a nationally consistent approach to energy policy that recognises Australia’s emissions reduction commitment. All parties should adopt an approach that better manages, and ideally avoids, conflicts between unilateral actions and the national agreement.

6.2.11 Develop a comprehensive narrative for the energy transition

Energy and climate change policy needs to be a core priority for the Commonwealth Government. A patchwork of ‘flip-flopping’ policies has eroded investment incentives and contributed to high prices and high emissions.

The Commonwealth Government should be honest and explain to the public that Australia must continue the transition to a low-emissions economy, and that it will cost money. This will require a compelling narrative, covering a vision for a very different energy system and a long-term commitment to get there.

441. O’Kane (2014, p. 9).

442. Finkel et al. (2017, pp. 116–117).

443. Ibid. (p. 157).

7 Health

7.1 Where we are

Australia has a good health system that mostly delivers high-quality care at a reasonable cost.

A newborn Australian today can expect to live 82.5 years, a longer life than would be expected for a baby in most comparator countries (Table 7.1). Australia also ranks highly on more comprehensive measures of health. Australians' long life expectancy isn't just due to our health care system – a range of social and economic factors affect our health – but the quality of care we receive contributes to these good outcomes.

Good health comes at a price. Nearly one in every ten dollars spent in Australia is spent on health; health is the second largest line item in the Commonwealth Budget.⁴⁴⁴ Health spending has been growing faster than the overall economy.⁴⁴⁵ Nonetheless, health spending is lower and growing less rapidly than in most comparator countries (Figure 7.1).

Australia has a desirable combination of good health outcomes and relatively low health spending. An OECD report earlier this decade concluded that, among all the OECD countries, “Australia, Iceland, Japan, Korea and Switzerland perform best in transforming spending into health outcomes”.⁴⁴⁶ Among the ten countries considered in this Orange Book, none achieve higher life expectancy with lower health spending than Australia (Table 7.1).

444. Treasury (2018b, pp. 6–7). ‘Health’ is the second largest category of expenditure behind ‘social security and welfare’, excepting the ‘other purposes’ category which encompasses a variety of miscellaneous expenditure.

445. Daley et al. (2013b).

446. OECD (2010b).

Table 7.1: International scorecard for health

	Life expectancy at birth, total population	Health care expenditure	Out-of-pocket costs
	years	% of GDP	% of household consumption expenditure
Australia	82.5	9.1	3.0
Canada	81.9	10.4	2.7
Germany	81.1	11.3	2.6
Japan	84.1	10.7	2.5
Netherlands	81.6	10.1	2.6
New Zealand	81.7	9.0	2.2
South Korea	82.4	7.6	5.7
Sweden	82.4	10.9	3.8
United Kingdom	81.2	9.6	2.3
United States	78.6	17.2	2.8

Notes: See Appendix A for notes and sources.

But there is no room for complacency about Australia's health system. There is clearly room to improve. For example, poorer Australians and people in remote areas have worse outcomes than richer urban populations. On spending, too, this chapter identifies a number of ways to improve efficiency without reducing the quality of care.⁴⁴⁷

Australia relies heavily on out-of-pocket health spending. Among the comparator countries, Australia has the third-highest spending on out-of-pocket costs as a percentage of total household expenditure (Table 7.1) and the second-highest level of out-of-pocket spending as a percentage of total health expenditure. This heavy reliance on out-of-pocket costs creates a barrier to health care for people on low incomes, which can deter them from seeking care, affect their long-term health, and contribute to increased health care costs in future.

7.1.1 The cost of care

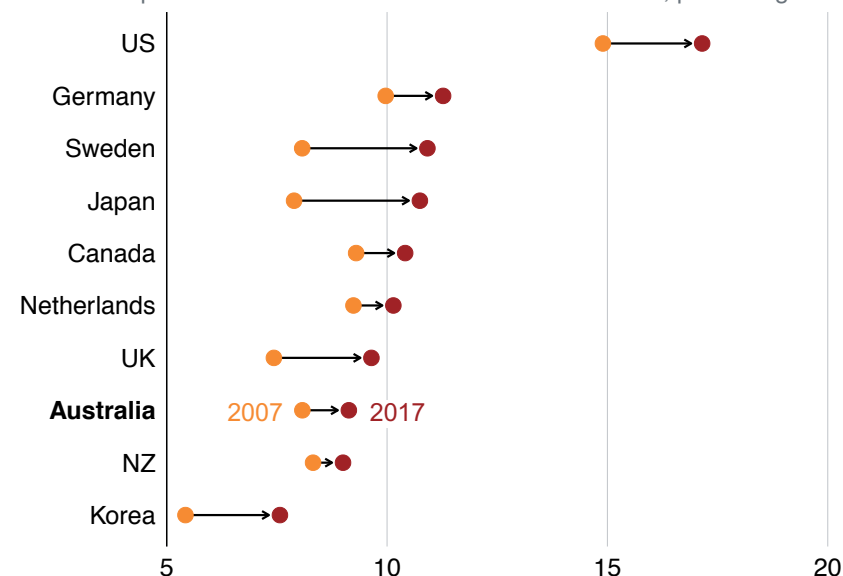
Australia spends less on health, as a proportion of the economy, than any of the comparator countries other than New Zealand and Korea. It's notable that both New Zealand and Korea have substantially lower average incomes than Australia,⁴⁴⁸ and that countries tend to spend more on health, as a proportion of income, as their income rises.

Not only is Australia's spending on health comparatively low, the growth in Australian spending on health has been relatively modest over the past decade (Figure 7.1).

There is no need for major surgery on the health budget. But some minor procedures now will avert financial emergencies down the track.

Figure 7.1: Australia's health spending has grown less quickly than most comparator countries

Total health expenditure as a share of GDP in 2007 and 2017, percentage



Source: OECD Stat.

447. Comparative studies also show Australia has scope to increase efficiency in the health system; see, for example, Çelik et al. (2017).

448. Australia's net national income per capita, in US dollar terms converted at purchasing power parity, was \$39,839 in 2016, compared to \$32,358 in New Zealand and \$30,104 in Korea (OECD (2018a)).

The Commonwealth Government should work to ensure that spending remains sustainable and efficient as the population ages and demand for health care continues to grow.

The Commonwealth Government spends more than \$75 billion each year on health, either directly or through the states and territories. Health is one of the biggest components of the Commonwealth Budget, and the Commonwealth is the biggest source of health spending in the economy. More than 40 per cent of all spending on health in Australia comes from the Commonwealth Budget (Figure 7.2).

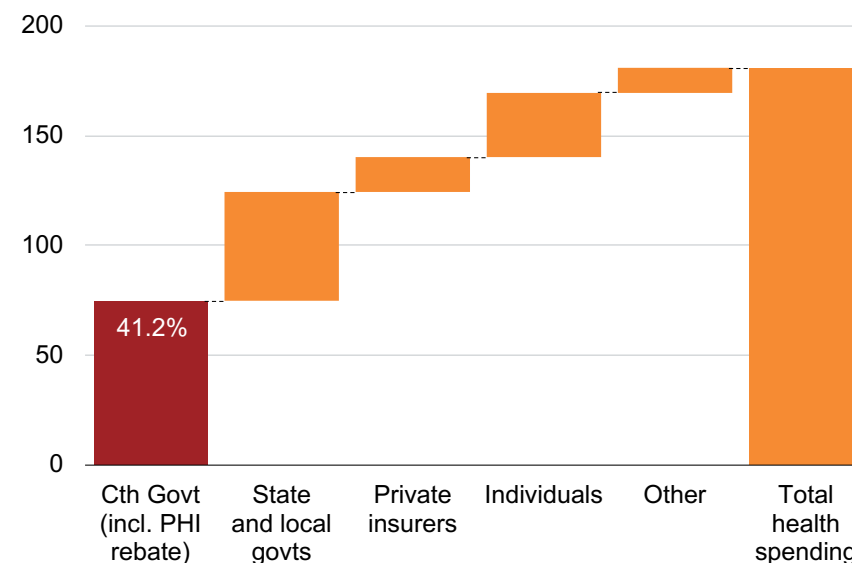
The latest Intergenerational Report projects that the Commonwealth's health spending will increase from 4.2 per cent of GDP to 5.5 per cent by 2054-55, a 31 per cent increase as a share of the economy.⁴⁴⁹ This implies that some combination of increased taxes and reduced spending in other areas will be required to accommodate rising health spending. Every dollar wasted on unnecessary or questionable care, or on inflated drug prices or uncoordinated primary care, is a dollar that could be put to better use, either within the health system or elsewhere.

Some states, and some hospitals, are already demonstrating that increased efficiency is possible. Public hospital treatment in Victoria is one-third cheaper per admission – after taking into account the complexity of the patient's condition and treatment – than in the most expensive state (SA).⁴⁵⁰ Lifting the worst-performing hospitals up to the best-performing would save the Commonwealth significant amounts.

The Commonwealth Government spends about \$5.8 billion per year subsidising private health insurance premiums.⁴⁵¹ There has been no substantial review in the past 20 years of whether this spending –

Figure 7.2: The Commonwealth is responsible for nearly half of all health spending in Australia

Health expenditure in Australia by source of funds, 2016-17, \$ billions



Note: PHI = Private Health Insurance.

Source: AIHW (2018).

449. Treasury (2015a, p. 60).

450. Daley et al. (2018c).

451. AIHW (2018).

representing nearly 8 per cent of all federal spending on health – yields good value for taxpayers.⁴⁵²

7.1.2 The quality of care

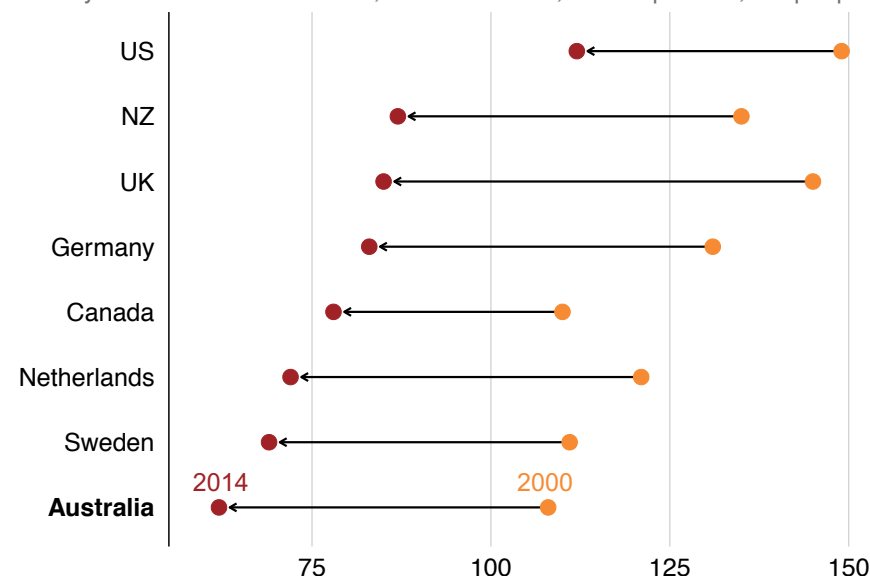
Australia has the second-highest life expectancy of the countries considered in this report (Table 7.1). Other measures confirm that Australia is in the top tier of advanced economies when it comes to overall health outcomes. Amenable mortality – the rate at which people die from potentially treatable conditions – is lower in Australia than in the other countries, and has fallen over time (Figure 7.3). Five-year survival rates for a range of cancers in Australia are among the best in the OECD.⁴⁵³

But these population-wide measures mask substantial differences between Australians. Life expectancy for Indigenous men is 10.6 years lower than for non-Indigenous men, and for Indigenous women it is 9.5 years lower than for non-Indigenous women.⁴⁵⁴ Rural and regional Australians have worse health outcomes than people in the cities.⁴⁵⁵

On some indicators, patient safety is relatively bad in Australia. Compared to most other OECD countries, Australia has a higher rate of post-operative pulmonary embolism or deep vein thrombosis in hip and knee surgeries, a higher rate of post-operative sepsis in abdominal surgeries, and a higher rate of foreign objects left in the patient after surgical procedures.⁴⁵⁶ Despite good overall health outcomes, the rate

Figure 7.3: Australians are less likely to die from treatable conditions than people elsewhere

Mortality amenable to health care, 2000 and 2014, deaths per 100,000 people



Note: Data not available for Japan or Korea.

Source: Tikkanen (2017).

452. Industry Commission (1997).

453. OECD (2017b).

454. Department of the Prime Minister and Cabinet (2018a, p. 104).

455. Duckett (2018).

456. Forde and Nader (2017). International comparisons such as these are potentially fraught and subject to subtle differences in measurement and data collection practices. Nevertheless, Australia's ranking on each of these measures is cause for concern and policy action.

of complications and questionable care in Australian hospitals is an area of concern.

Australia also has an obesity problem. Most Australian adults (63.4 per cent) are overweight or obese, behind only the US and New Zealand among the countries considered in this report.⁴⁵⁷

7.1.3 Access to health care

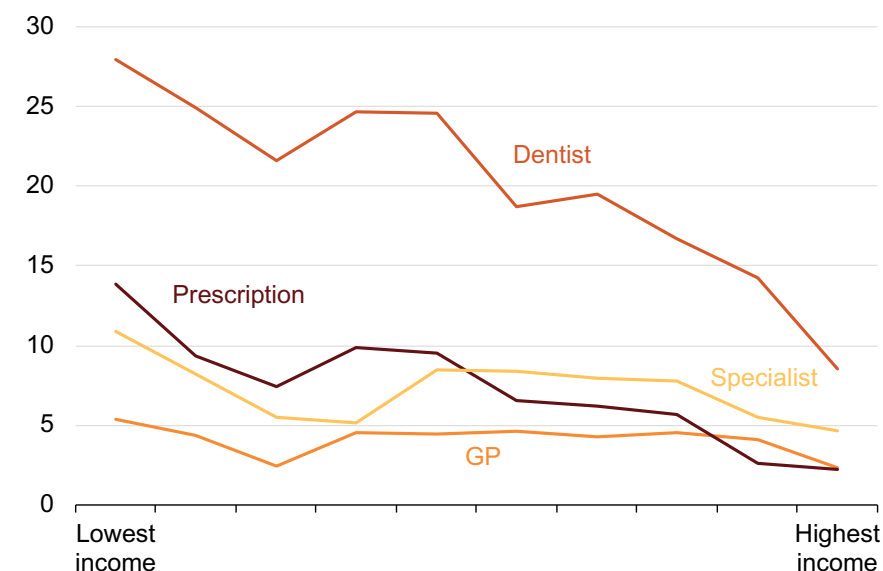
Nearly a fifth – 18.9 per cent – of health spending in Australia comes directly from patients' pockets. Australia relies more heavily on out-of-pocket health spending than most other countries, and out-of-pockets are a relatively heavy burden on Australian households (Table 7.1). Relying heavily on patients to fund their own health care can create financial barriers to care, particularly for low-income people. This causes some people to avoid care, which in turn affects their health and can create future costs.

About 14 per cent of Australians who need to see a doctor, get a test, or fill a prescription, do not do so because of the cost. This is about double the rate in Germany, the Netherlands, Sweden, or the UK, and slightly below the rates in Canada (16 per cent) or New Zealand (18 per cent). A third of Americans skip care because of the cost.⁴⁵⁸

Low-income Australians are more likely to skip or delay care due to the cost than high-income Australians (Figure 7.4). The problem is particularly acute for dental care, but substantial numbers of Australians also skip or delay specialist care or filling a prescription due to the cost.

Figure 7.4: Low-income people are more likely to skip care due to the cost

Per cent of people who needed health care and skipped or delayed getting it due to cost at least once in the past 12 months, by equivalised gross household income decile, 2016-17



Note: 'Prescription' refers to the proportion of people who did not fill, or delayed filling, a prescription.

Source: ABS (2018i).

457. OECD (2017b).

458. Osborn et al. (2016, p. 2329).

7.2 What we should do

The Commonwealth Government should use its role as key funder, and in many cases regulator, of health care to ensure all Australians can get high-quality care at an efficient price.

The remainder of this chapter details our policy recommendations. In particular we urge the Government to give priority to: boosting primary care, especially mental health care, which has long been under-funded and neglected; moving toward a universal dental care scheme, so all Australians can go to the dentist when they need to; establishing a Productivity Commission review of all aspects of private health, including private health insurance; reform pathology funding; and helping the states to reduce complication rates in public hospitals.

7.2.1 Increase the efficiency of health care provision

Reduce the National Efficient Price

The Commonwealth Government should encourage the states and territories to improve the efficiency of public hospitals through reducing the National Efficient Price (NEP).⁴⁵⁹

State governments manage public hospital systems and fund about 51 per cent of their costs, and the Commonwealth contributes 40 per cent.⁴⁶⁰ The efficiency of public hospitals varies dramatically. Some are much more efficient than others in the same state, even after taking account of differences in the type of patients and conditions the hospitals treat.⁴⁶¹ Bringing the least efficient hospitals up to the standard of the best would free up money for better uses.

459. See Duckett et al. (2014).

460. AIHW (2018). The remainder is borne by health insurance funds (2.3 per cent), individuals (2.7 per cent) and other sources (3.5 per cent).

461. Duckett et al. (2018a).

The price that the Commonwealth pays for hospital activity should reflect best practice, not average practice. The NEP, which underpins the Commonwealth's contribution to public hospitals through the activity-based funding system, is based on the average cost of public hospital activity.⁴⁶² The Commonwealth Government should encourage the Independent Hospital Pricing Authority to reduce the NEP so that it is set at the median cost of public hospital activity. The Government should develop a plan to further reduce the NEP from there over time.

At the same time, the Commonwealth Government should increase its share of funding for efficient growth in hospital activity, as discussed in Section 7.2.2.

Reform pathology funding

Pathology services account for about one eighth of Commonwealth Medicare spending. Almost 90 per cent of pathology services are bulk-billed, but the average out-of-pocket costs for the one-tenth of services not bulk-billed is about \$24 per test.

Pathology is a 21st century industry funded in a 19th century way – on a fee-for-service, professional practice model.

This may have been appropriate in times gone by when there were dozens of small pathology providers and a competitive market, but private pathology is now provided by a handful of large providers. Industry restructuring means that the benefits of economies of scale and increases in diagnostic testing accrue primarily to providers, rather than shared between the payer and the provider.

Pathology is now a big business – with more than \$3 billion in Commonwealth Medicare payments this year – and so business-like means should be used to pay for it. In a previous report, *Blood money*:

462. IHPA (2018).

paying for pathology services,⁴⁶³ Grattan Institute proposed a shift to a tender or contractual basis for purchasing pathology services. This should be on the agenda for a new government.

Reform the Pharmaceutical Benefits Scheme

The Commonwealth Government spends too much on drugs. It spends about \$12 billion each year subsidising prescription drugs through the Pharmaceutical Benefits Scheme (PBS).⁴⁶⁴ It can and should cut a better drug deal. Australia pays significantly more for the same drugs, on average, than the UK, New Zealand, or major Canadian provinces.⁴⁶⁵

The ‘therapeutic group premium’ policy aims to stop the Commonwealth wasting money on over-priced drugs that produce the same outcomes for patients as cheaper drugs. The policy is a good idea in theory, but in practice is full of loopholes and no longer works.

Under the policy, the Commonwealth Government pays only for the cheapest drug within a therapeutically-equivalent group of drugs. This leaves manufacturers of other drugs within the group with a choice to either cut their price, or pass on additional costs to patients – charging a ‘therapeutic group premium’. In practice, the policy applies only to seven groups of drugs – fewer than in comparable countries – and doesn’t apply to the large number of drugs that have been subject to price disclosure.⁴⁶⁶

Grattan Institute has estimated that the Commonwealth Government could save more than \$240 million each year by extending therapeutic group premiums to cover all gaps in drug costs within the seven

463. Duckett et al. (2016b).

464. Department of Health (2018).

465. Duckett and Banerjee (2017). The Canadian provinces used in the price comparison are Alberta and Ontario.

466. Ibid.

existing groups, regardless of whether drugs have been subject to price disclosure. Extending Australia’s relatively small list of therapeutic groups from seven to 18 could save the Commonwealth Government an additional \$205 million a year.⁴⁶⁷

The Government should also improve the way it administers the legislation regarding drug prices. Rather than relying on conservative, survey-based methods to measure the prices paid for prescription drugs, it should use the routine data it already collects to measure differences in drug prices.

The PBS is completely bound up in red tape.⁴⁶⁸ Who can own a local pharmacy is regulated by state governments; so too how many pharmacies they can own. There is no rhyme or reason about how many pharmacies can be owned in a state, and maximum numbers vary across the country. Where new pharmacies can be located is regulated by the Commonwealth Government, with strict rules limiting competition by specifying minimum distances between pharmacies.

This regulation benefits pharmacy owners more than consumers. The powerful voice of the owners has stymied proposed reforms by both state and federal governments.

Governments should roll back these regulations, starting by relaxing location rules and ownership controls in metropolitan areas to promote competition to reduce prices and improve services.⁴⁶⁹

Boost Primary Health Networks

The Commonwealth Government should enter into formal agreements with state governments and each Primary Health Network (PHN) to reduce duplication and improve responsiveness to local needs.

467. Ibid.

468. Duckett (2017).

469. Duckett and Banerjee (2017).

The Commonwealth Government and the states both play significant roles in funding and managing the Australian health system, but there is no overarching body charged with coordinating their roles. PHNs can and should play that role at local level.

The OECD has found that “assigning responsibility across government levels ... in a more consistent manner would lead to less duplication and better accountability” in Australia.⁴⁷⁰

PHNs should be charged with improving coordination of Commonwealth and state health activities within their area, with the goal of reducing duplication and improving responsiveness to local needs.

7.2.2 Improve the quality of care

Give patients better information

The quality of patient care differs substantially across hospitals. Patients deserve to know about these differences. The Commonwealth Government should report hospital outcomes data relevant to patients' care decisions in a way that is readily accessible to patients and GPs. Australians should have access to comprehensive information for every hospital, in a format that is easy to read, understand, and act on.

Public reporting of hospital quality data would help patients and GPs make better choices about which hospital to attend for elective procedures, and encourage poor-performing hospitals to lift their game. International evidence suggests public reporting prompts hospitals to redouble their safety efforts and rethink their hiring strategies.⁴⁷¹

Give hospitals and doctors better information

The Commonwealth Government should work with the states and territories to provide detailed data on patient outcomes to hospitals

470. OECD (2010b).

471. Chassin (2002), Fung et al. (2008) and Mukamel et al. (2002).

and clinicians. This would enable hospitals and doctors to compare their performance against their peers, and identify opportunities to improve.⁴⁷² And this data should be used to underpin a new system of hospital accreditation.⁴⁷³

To measure the quality of their care properly, hospitals need information about their patients. Hospitals should be supported to identify the areas where they can improve and develop plans to overcome their deficiencies. The current system of hospital accreditation should be replaced with a system based on engaging with hospitals to help their improvement efforts.⁴⁷⁴

Reform GP payments

General Practitioners are paid fees based on the services they provide to patients, and the fees provide an incentive for GPs to provide shorter consultations. GPs are not remunerated for time spent performing activities other than those on the fee schedule. This means GPs do not have a financial incentive to spend time doing things other than the activities listed on the fee schedule, even if it would help their patients. GPs are not paid to coordinate and manage the various streams of care that people receive. This is particularly a problem for people with complex needs.

The Government should introduce ‘blended’ funding, with GPs continuing to receive fees for the services they provide but also receiving additional payment in recognition of the time they spend, or should spend, on other activities.⁴⁷⁵

General practices should also be paid to collect and supply data about their activities. Too little is known about what actually happens in

472. Duckett et al. (2018a).

473. Duckett et al. (2018b).

474. Ibid.

475. Duckett et al. (2017b).

general practices in Australia.⁴⁷⁶ General practices should be required to provide much more information about their activities;⁴⁷⁷ in return, they should receive payment to compensate them for the cost of collecting this data.

Redesigning how GPs are remunerated will be complex as the international evidence about appropriate payment design is weak, and in any event, the starting point in Australia for payment reform is unique. Establishing a process to redesign primary care payment should also be a high priority for a new government.

Introduce a tax on sugary drinks

More than one-in-four adults in Australia are classified as obese, up from one-in-ten in the early 1980s. About 7 per cent of children are now obese.⁴⁷⁸ Tackling this epidemic of obesity will require a broad range of interventions at the individual and population level. But one important step the Commonwealth can take is to introduce a tax on sugar-sweetened beverages.

This tax should be levied at a rate of about 40 cents per 100 grams of sugar contained within sugar-sweetened beverages. This will increase the price of a two litre bottle of soft drink by about 80 cents and will raise around \$500 million a year.⁴⁷⁹

This would encourage Australians to make healthier choices. We estimate that the prevalence of obesity in the community would decline by around 2 per cent if the tax were introduced. The tax would also recover some of the costs that individuals' obesity imposes on the budget, and the funds raised could be directed to other measures that

will improve Australians' health, such as expanding access to dental care and other recommendations in this Orange Book.⁴⁸⁰

Tackle the societal conditions that cause ill health

Health is not just a matter for individuals. There is an extensive literature outlining the broad range of social and economic factors that exert a major influence on people's health.⁴⁸¹

The Australian health system – specifically the institutions charged with local coordination of care, PHNs – should place much greater emphasis on working with their local communities to change the societal conditions that cause ill health. This is particularly important in rural and regional Australia, where health outcomes are worse than in the cities for a range of complex, intertwined social reasons.⁴⁸² PHNs should not see their role as merely coordinating and administering the delivery of health care services within their areas. Aboriginal Community Controlled Health Organisations should continue to be supported in their endeavours to work with their local communities to improve health outcomes.

7.2.3 Ensure all Australians have access to health care

Overhaul private health insurance

Private health insurance (PHI) premiums are rising. People with PHI face large, and often unexpected, out-of-pocket payments for treatment. These facts combined are driving more Australians to drop their insurance, or not take out insurance in the first place.

The interaction between the public and the private health system is complex, and so changes need to be thought through carefully. The

476. Ibid.

477. Thorpe and Sweeney (2019).

478. Duckett et al. (2016a).

479. Ibid.

480. Duckett et al. (2019).

481. See, for example, Baum et al. (2009); CSDH (2008) and Marmot (2005).

482. Duckett (2018).

Commonwealth Government should direct the Productivity Commission to comprehensively review the private health system, including premiums and out-of-pocket costs.

Open up specialists' fees

Australian patients rarely know in advance what fees their medical practitioners will charge.⁴⁸³ This makes it hard for patients to make informed decisions about their care.

Medicare should publish, for each general practice and specialist, the proportion of services bulk-billed and the average out-of-pocket cost for non-bulk-billed services. For specialists, the average fee charged for different procedures should also be published, along with a comparison to other specialists in the area or state.

Expand outpatient services

The Commonwealth Government and the states jointly fund activity in public hospitals. Under the current National Health Reform Agreement, the Commonwealth funds 45 per cent of the cost of efficient growth in activity-based services. This proportion should rise over time; in the short-term, the Commonwealth's contribution should increase to 55 per cent.

This increase would encourage state governments, as the managers of public hospital systems, to expand outpatient services. More Australians would then be able to see a specialist in a public hospital, without out-of-pocket costs. This would also put downward pressure on fees charged by other specialists.

The Commonwealth Government should encourage state governments to expand outpatient services outside public hospitals. There is no

483. Duckett et al. (2017a).

compelling reason why all outpatient services should be delivered in the same physical building as other hospital activities. Dispersing outpatient services through a series of smaller clinics throughout the community would make them more attractive and accessible to patients.⁴⁸⁴

Introduce a universal primary dental care scheme

About 2 million Australians each year report that they didn't go to the dentist when they needed to, because of the cost of care. Australians are less likely to go to the dentist in a given year than their counterparts in many comparable countries.⁴⁸⁵

Oral health care is a conspicuous gap in Australia's universal health care system. Most dental care is funded out of patients' pockets, or through private health insurance. Existing public dental schemes are underfunded and have very long waiting lists.

The Commonwealth Government should incrementally introduce a universal primary dental care scheme for all Australians. It should take control of funding public dental care, then progressively expand the proportion of the population that is eligible for publicly-funded care.

Expand palliative care

About half of Australians die in hospital, and a further third die in residential care.⁴⁸⁶ This is higher than in most comparable countries. About 70 per cent of Australians want to die at home, but only 14 per cent do so.

More Australians should be able to die at home. To enable this, community-based support and palliative care should get more money.

484. Elrashidi et al. (2018).

485. Duckett et al. (2019).

486. Swerissen and Duckett (2014).

This investment should be offset by reducing funding for institutional care.

Give pharmacists a bigger role

Pharmacists are highly-trained medical professionals. Australia under-uses their skills.⁴⁸⁷ Care that could be delivered by pharmacists is instead reserved for general practitioners, which unnecessarily increases the load on GPs, at a cost to taxpayers.

The Commonwealth Government should empower local pharmacies, as part of a team with GPs: to provide repeat prescriptions, give drug information to patients and adjust their doses when required; and to work with GPs to help patients manage chronic conditions. Patients would benefit from the increased convenience that comes with seeing a pharmacist rather than a GP, and the increased coordination of care that comes from having a team of health professionals managing their care.⁴⁸⁸

487. See Duckett et al. (2013).

488. Duckett (2019).

8 School education

8.1 Where we are

Improving school education is a national priority.⁴⁸⁹ Better academic outcomes would lift future workforce productivity.⁴⁹⁰ Yet any benefits must always be compared against costs.

Table 8.1 shows that Australia should aim higher on both student outcomes and equity, but debunks the common notion that we are a big spender on school education (Box 2 explains why many other analyses of relative funding levels give the wrong answer). In 2015, Australia performed worse in maths (and also science and reading) than similar OECD countries, and was less equitable than average.⁴⁹¹ But Australia also spent less than the average of similar countries.⁴⁹² More broadly, no OECD country consistently out-performed Australia in both performance and equity while also spending less.⁴⁹³

If Australian schools were fully funded according to need,⁴⁹⁴ total spending per student would be in line with the average of comparator countries and other OECD high-performers. Of course, that extra money would only lift outcomes if it were targeted appropriately and spent well.

489. Productivity Commission (2017a).

490. Goss et al. (2016, p. 35); and Jensen (2010, p. 4).

491. We report results for maths because, as well as being important in its own right, it is the best predictor of a country's average score across all three PISA domains.

492. This includes public recurrent funding for schools, from both Commonwealth and state governments, as well as private spending. We include both public and private spending because both contribute to educational outcomes.

493. Grattan analysis of OECD (2016a), OECD (2017c) and OECD (2018i).

494. The current national definition of need is the Schooling Resource Standard. Most schools – especially public schools – are currently below their SRS target.

Table 8.1: International scorecard for school education

	PISA maths, 2015	Gap between top and bottom SES quartiles in PISA science, 2015	Spend per student
	<i>PISA score points</i>	<i>years</i>	<i>% of GDP/capita</i>
Australia	494	3.1	22.7
Canada	516	2.4	23.5
Germany	506	3.5	22.6
Japan	532	2.7	25.0
Netherlands	512	3.2	22.1
New Zealand	495	3.4	24.8
South Korea	524	2.6	33.2
Sweden	494	3.1	23.0
United Kingdom	492	2.8	26.4
United States	470	3.0	21.9

Notes: See Appendix A for notes and sources.

Box 2: International comparisons of school education funding

International comparisons of education spending are complex. For example, Australia spends more of its GDP on school education than the OECD average. This fact has been used to argue that our funding is high.^a But this ignores the issue that Australia's population is younger than most other advanced countries.

For example, Australia spent 3.9 per cent of its GDP on school education in 2015, compared to Canada's 3.5 per cent. Yet of every 1000 people in Australia, 166 are school-aged, compared to 133 in Canada.^b In effect, Canada spends 10 per cent more per student than Australia – not less, as the raw figures suggest.

Comparing spending per student in a common currency takes care of demographic differences, but ignores differences in national wealth and operating costs in different countries.

The best available metric is *spending per student as a percentage of Gross Domestic Product per capita*. This metric takes into account both demographics and national income.^c

Finally, Australia should not benchmark its education spending against OECD countries such as Turkey and Mexico, whose PISA results are dramatically worse than ours.

a. Joseph (2018).

b. See also Dodd (2017).

c. See OECD (2018i, Table C11.4.).

8.1.1 Student outcomes

This report compares student performance in PISA, the best-known cross-country benchmark.⁴⁹⁵ PISA tests students' problem-solving skills in maths, science and reading at age 15. Australian students scored on average 494 points in PISA maths in 2015.⁴⁹⁶ This was 11 points below the average of the comparator group.

Japan and Korea both scored at least 30 points higher in maths – the equivalent of an extra year of learning – while Canada and the Netherlands were about 20 points higher.⁴⁹⁷

Australia's below-average performance in maths appears across the whole distribution; high-achievers in Australia – those at the 90th or 95th percentile – scored below their peers in comparator countries, as did low-achievers (those at the 5th or 10th percentile).

Australia performed relatively better in science and reading, but still below the comparator group average (see Figure 8.1).⁴⁹⁸

495. PISA is the OECD's Programme for International Student Assessment. The other major international benchmarks are the Trends in International Mathematics and Science Study (covering maths and science in Grades 4 and 8) and the Progress in International Reading Literacy Study (reading in Grade 4). Australia performed below the average of the comparator countries in all four TIMSS tests in 2015, but at the comparator country average in PIRLS in 2016.

496. PISA is run every three years. The results for 2018 are not yet available, so 2015 is the most current data.

497. Individual country results should be interpreted carefully, because the participation rate varies widely by country, and non-participating students are likely to perform below the average. But Australia's relative under-performance holds true whether or not participation rate is taken into account.

498. Australia was 2 points below the average of the comparator group in science (510 points versus 512), and 5 points below in reading (503 points versus 508). The overall OECD average is lower than that of our comparator group because it includes low-performing countries (such as Mexico, Turkey and Chile) that are poor benchmarks for Australia.

Not all is doom and gloom. PISA looked at collaborative problem-solving skills for the first time in 2015. Countries' performance in collaborative problem-solving correlates with their performance in other domains. But Australian students perform much better in collaborative problem-solving than would be expected based on their average scores in science, reading and maths, and above the average for the nine comparator countries (see Figure 8.1).⁴⁹⁹

Media reports often focus on the relative rankings.⁵⁰⁰ More concerning is the drop in absolute terms; the fact that Australian students did worse in PISA in 2015 than Australian students in earlier years.⁵⁰¹

- The average maths score dropped from 524 in 2003 to 494 in 2015, the equivalent of a year's worth of learning;⁵⁰²
- The proportion of high performers in maths nearly halved during the same period (from 19.8 per cent to 11.3 per cent), while the proportion of low performers grew from 14.3 per cent to 22.0 per cent; and
- There were similar, if less dramatic, trends in science and reading.

The scores in many comparator countries also dropped over time, but none by more than Australia. But improvement is possible: the performance of German and Japanese students in reading increased by 18 points from 2003 to 2015.

499. OECD (2017c). Japan, Korea, New Zealand and the US also relatively out-perform in collaborative problem-solving compared to their results in other PISA domains.

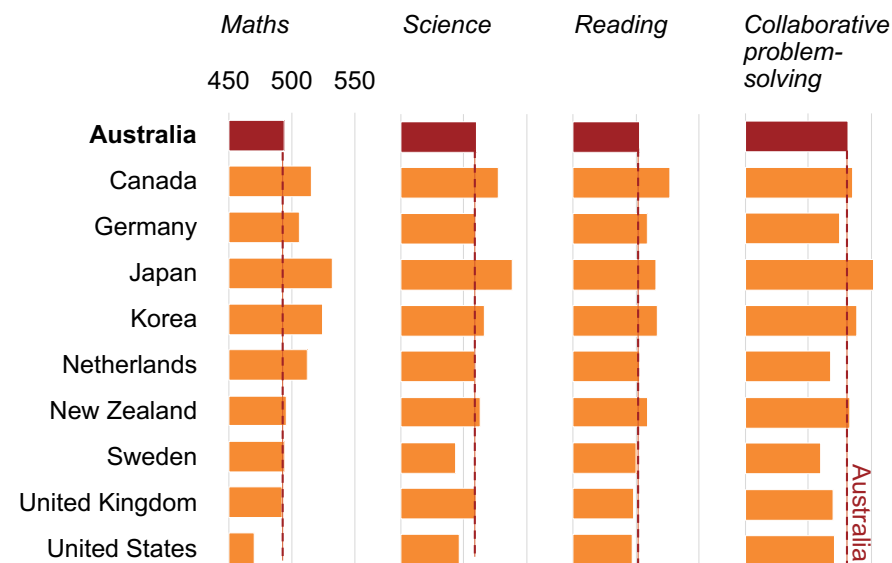
500. Relative rankings grab headlines, but are complicated because more and more countries are participating in PISA.

501. Australia's mathematics results in TIMSS also dropped up until 2007, but appear to have since recovered somewhat (Morsy et al. (2018)).

502. A detailed analysis of PISA microdata, Morsy et al. (Ibid.), confirms that maths results dropped from 2003 to 2015 for all states and territories, and for all three school sectors. However, the authors were not able to explain why results have dropped, despite testing a wide range of potential explanations.

Figure 8.1: Australia performs relatively better in collaborative problem-solving than in maths, science or reading

Mean score in PISA, by domain, 2015



Notes: Dotted lines represent Australia's mean score in each domain. 30 points in PISA is roughly equivalent to one year of learning.

Sources: OECD (2016a) and OECD (2017c).

8.1.2 Equity

According to the OECD, equity in education means that differences in students' outcomes are unrelated to their socio-economic status (SES).⁵⁰³ Under this definition, equity is a significant challenge in Australian schools.

On average, Year 9 students in Australia whose parents have a bachelor degree are more than four years ahead of those whose parents didn't complete Year 12.⁵⁰⁴

This difference cannot be explained away by claims about inherent ability; students who do well in Year 3 fall two-and-a-half years behind their Year 3 peers by Year 9 if they attend a disadvantaged school rather than a high-advantage school.⁵⁰⁵ Outcomes for Indigenous students are far worse.⁵⁰⁶

While a number of equity metrics might be used, this report measures the gap in performance between advantaged and disadvantaged students in PISA science in 2015.⁵⁰⁷

503. See OECD (2018j, p. 22). The 2011 Gonski report uses a similar formulation: differences in educational outcomes should not be the result of differences in wealth, income, power or possessions (Gonski et al. (2011)).

504. Grattan analysis of NAPLAN (the National Assessment Program – Literacy and Numeracy), using the same methodology as in Goss and Sonnemann (2016, p. 13).

505. Goss and Sonnemann (ibid., Figure 14). See also Figure 11 of that report, which shows that high-achieving Year 3 students whose parents have low education make nearly two years less progress by Year 9 than peers whose parents completed university.

506. Goss (2018).

507. Advantaged students are in the top SES quartile; disadvantaged students are in the bottom SES quartile. PISA 2015 had a specific focus on science, and this metric is not available in 2015 for reading or maths. This equity metric is chosen because it allows for an intuitive understanding of the impact of socio-economic differences on how well students perform in PISA.

The science skills of advantaged students in Australia were on average more than three years ahead of disadvantaged students.⁵⁰⁸ Australia's equity gap is slightly wider than the average of similar countries, and the OECD average. Germany has the biggest gap, perhaps because of its historical model of early streaming of students. Canada has the smallest gap.⁵⁰⁹

Figure 8.2 on the next page shows Australia's advantaged students do reasonably well, but our disadvantaged students are a long way behind those in Canada, Japan and Korea. This may be linked to the relatively high level of segregation among Australian schools – 51 per cent of disadvantaged students in Australia attend disadvantaged schools, 5 percentage points more than in comparable countries.⁵¹⁰ And segregation among schools continues to grow in Australia, akin to an ever-strengthening tide against which students and staff in disadvantaged schools must swim.⁵¹¹

Disparate access to resources may explain another part of the gap. In nearly all OECD countries, principals in disadvantaged schools report greater shortages of materials and suitable staff than their peers in advantaged schools. But the gaps in Australia are wider than in any comparator country (Figure 8.3).

8.1.3 Spending

Australia is often described as a big spender on school education relative to other countries. It is just not true.

508. Based on OECD conversion of 30 PISA points to 1 year of learning (Thomson et al. (2017, p. 45)).

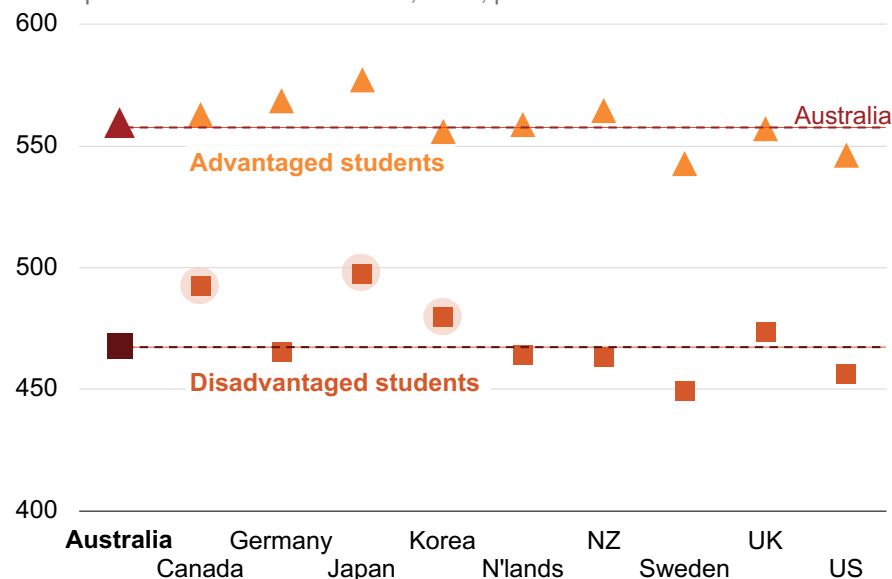
509. Canada's small equity gap might be partly explained by its high non-participation rate (16.5% of its students are not represented in PISA) compared to Australia (9.4%) or Germany (4.2%). But Canada is doing something right: the UK and US have similar non-participation rates to Canada but bigger equity gaps.

510. OECD (2018j).

511. Bonnor (2019).

Figure 8.2: Australia's disadvantaged students do substantially worse in science than their peers in Canada, Japan or Korea

Mean performance in PISA science, 2015, points

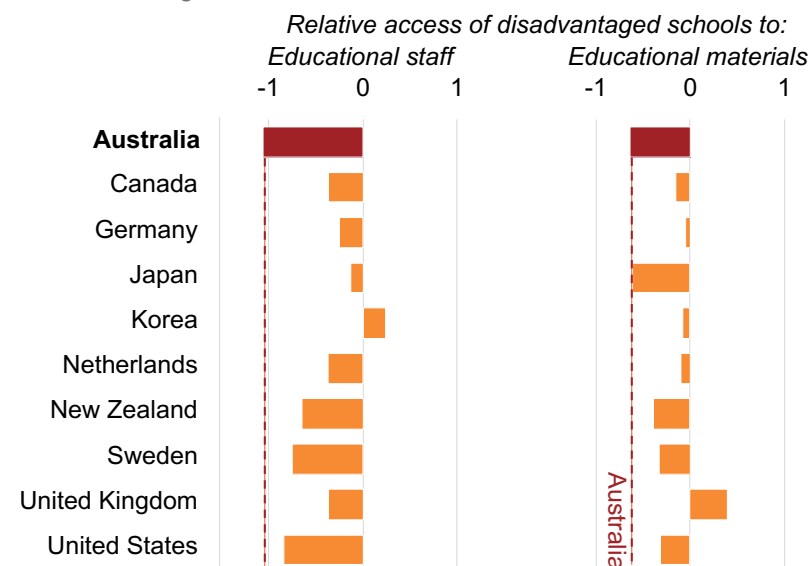


Notes: Disadvantaged students are those in the bottom quartile of the PISA index of economic, social and cultural status (ESCS) in each country. Advantaged students are those in the top quartile of ESCS.

Source: OECD (2018j, table 2.1).

Figure 8.3: Australia's disadvantaged schools have worse access to educational staff and materials than in any comparator country

Difference between advantaged and disadvantaged schools on the OECD indices of shortage of educational staff and materials, 2015



Notes: The charts show the difference in access between disadvantaged and advantaged schools, i.e., a negative number means that disadvantaged schools have worse access to educational resources than advantaged schools. The OECD index of shortage of educational staff summarises school principals' agreement with four statements about whether the school's capacity to provide instruction is hindered by a lack of and/or inadequate qualifications of the school staff. The index of shortage of educational material summarises school principals' agreement with four statements about whether the school's capacity to provide instruction is hindered by a lack of and/or inadequate educational materials, including physical infrastructure.

Source: OECD (2016b, Table I.6.13).

Table 8.1 compares total spending per student as a percentage of GDP per capita (spending here includes both public and private, as well as Commonwealth and state government school spending).⁵¹² On this metric, which accounts for wealth and population, comparator countries spend on average 9 per cent more than Australia (24.7 per cent versus 22.7 per cent). Korea – a strong performer in PISA – spends almost half as much again (33.2 per cent). The lowest spender in the comparator group is the US (21.9 per cent) – a country Australia does not seek to emulate on school education. Australia spends only fractionally more than the OECD average, which is dragged down by Mexico (16.5 per cent) and Turkey (14.8 per cent).

Excluding private spending, Australian governments spend less taxpayer money per school student than any comparable country as of 2015 (see Figure 8.4). On average, governments in comparable countries spend 20 per cent more per student than Australia. Meanwhile, Australia's private spending per student is nearly twice as high as comparator countries.⁵¹³

Real government funding per student has risen materially over the past three years. Yet many Australian schools continue to be funded at less than the target levels, and government schools will remain below their target funding levels indefinitely under current policy settings.⁵¹⁴ If funding rose further to fully fund all schools according to the current funding formula, total spending per student would rise to about 25.7 per cent of GDP per capita.⁵¹⁵

512. The Commonwealth is the majority funder of non-government schools, and the states are the majority funders of government schools.

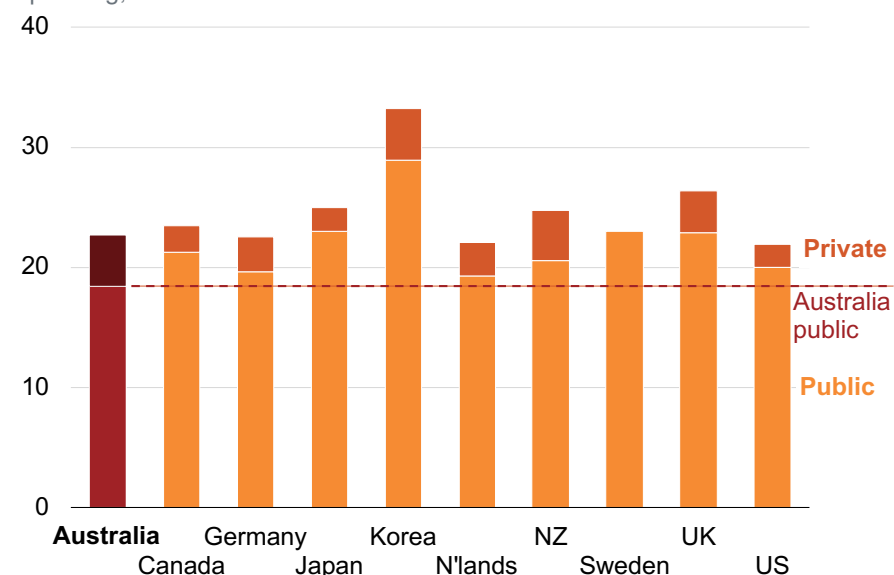
513. Nearly one fifth of Australia's total spending on school education is private spending. The OECD average is closer to one tenth (OECD (2018i, Table C1.5)).

514. Goss (2019).

515. In 2015, the average school received government funding equal to 89% of its target level of funding, or Schooling Resource Standard (SRS). The SRS is a per-student funding amount that is calculated for each school each year, based on the

Figure 8.4: Australia spends less taxpayer money on school education than comparable OECD countries

Spending per student as percentage of GDP per capita, by public and private spending, 2015



Note: Australia's public spending includes both Commonwealth and state funding.

Sources: OECD (2018i), Grattan analysis.

As Figure 8.5 shows, this would put Australia slightly ahead of comparator countries and other OECD high-performers. Public spending would remain below most comparator countries.

8.1.4 Efficiency

Conceptually, school efficiency measures outcomes relative to resources expended. Table 8.1 gives a very rough indication of efficiency in Australian schools.⁵¹⁶ Compared to similar OECD countries, Australia spends slightly less and does slightly worse. While more could be done to lift productivity (as Canada shows), Australia is not greatly *inefficient*; that is, we are not a big spender for poor results.

But Figure 8.3 suggests that Australia is well below par for ‘distributive efficiency’ (*i.e.* distributing available funding according to student need). This lines up with analysis (by Grattan Institute and many others) that shows that government schools – which educate the bulk of the most disadvantaged students – are typically under-funded, while non-government schools are typically closer to, or even above, their funding targets.⁵¹⁷

Funding disparities have *grown* in Australia over the past decade, despite national bipartisan support for needs-based funding. A recent ABC analysis showed that one in three non-government schools receives more per-student government funding than the median state school with similar students, up from just one in 20 in 2009.⁵¹⁸

students it enrolls as well as its size and location. As discussed in Section 8.2.2, the SRS formula itself needs to be reviewed.

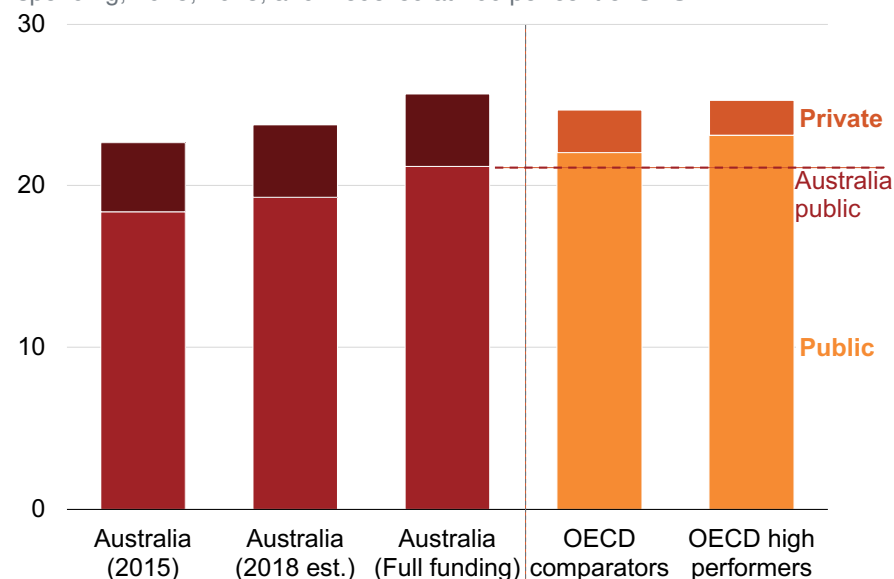
516. Our metric is to some degree a ‘like for like’ comparison because it uses spending as a percentage of GDP per capita, which is a proxy of national wealth.

517. See, for example, Goss et al. (2016). Funding here refers to combined Commonwealth and state government funding compared to the SRS.

518. The ABC analysis took account of student mix (using the Index of Community Socio-Educational Advantage, ICSEA) as well as school size and location (Ting et al. (2018)).

Figure 8.5: Australian governments would not be big spenders even if all our schools were funded at 100 per cent of their SRS target

Spending per student as percentage of GDP per capita, by public and private spending, 2015, 2018, and modelled at 100 per cent of SRS



Notes: In 2015, Australian schools were funded by governments at 89.1% of their School Resourcing Standard (SRS). Since then, governments have increased real funding to about 91.0% of SRS in 2018. ‘Full funding’ means 100% of SRS. The analysis assumes that private funding increased at the same rate as public funding from 2015 to 2018. ‘OECD comparators’ are the nine comparator countries used throughout this report. ‘OECD high performers’ is the average of all OECD countries that performed as well as or better than Australia in PISA in 2015 (averaged across science, maths and reading), with the exception of Ireland which is an outlier on this spending metric with a very high average GDP per capita compared to the OECD average but relatively low wages. The high OECD performers are Belgium, Canada, Estonia, Finland, Germany, Japan, Korea, Netherlands, New Zealand, Norway, Poland and Slovenia.

Sources: OECD (2018i), Grattan analysis.

This should *never* happen under the SRS formula: non-government schools should receive *less* public money than comparable government schools,⁵¹⁹ because parents are expected to contribute through school fees when they make the choice to go private.

If Australia is to get better educational outcomes from the dollars we are spending on schools, a good place to start is to genuinely align funding with need. As the OECD points out, the most equitable school systems are often the best performers.

8.2 What we should do

Most of the big reforms needed to improve school education outcomes are the responsibility of state governments. The Commonwealth's responsibilities are to get school funding right; deliver the Commonwealth components of the newly agreed national reforms; and help to attract more high-achievers to teaching while strengthening incentives for universities to improve initial teacher training.

Of our recommendations, the top three priorities should be:

- Work with the states to move all sectors to a consistent level of funding (against the Schooling Resource Standard) on a consistent timeframe;
- Create a new, independent national evidence institute; and
- Initiate an independent expert review in 2021 of initial teacher education to assess the impact of ongoing reforms and whether additional incentives or consequences are needed to drive quality improvements.

519. Comparability includes school size and location as well as student need.

8.2.1 The big system reforms are mostly the responsibility of state governments

The biggest advances will be made when governments create more 'adaptive' school education systems.⁵²⁰ This means that all stakeholders – teachers, school leaders and education system leaders – track the impact of their actions, critically evaluate the outcomes, and adapt their approach to do better the next time around.

The key to adaptive improvement is to identify and spread teaching practices that maximise student learning and to stop those that don't. Teachers must rigorously track student progress and use the data to target and evaluate their teaching.⁵²¹

To do this, teachers need more support from education systems to assess what students can do and to identify the next instructional steps.⁵²² They need better access to high-quality classroom assessment tools and materials, as well as ready access to the research evidence about what works best. They need better professional development and more feedback from peers.⁵²³ Highly effective teachers should have specialist career paths created for them.⁵²⁴

These workforce reforms would help existing teachers, and attract talented candidates, by further professionalising teaching.⁵²⁵ A related priority is to improve the selection, development and work of school leaders.⁵²⁶

520. Goss (2017).

521. Goss et al. (2015).

522. Goss et al. (Ibid., p. 43).

523. Jensen (2011) and Jensen et al. (2014).

524. Goss et al. (2016, p. 37).

525. Sonnemann and Nolan (2018).

526. A summary of the big reforms in schooling is included in Sonnemann and Goss (2018, pp. 13–16) and Daley et al. (2018c, pp. 61–67). All Grattan reports are available on our website, www.grattan.edu.au.

These reforms are largely the responsibility of state governments, and are explained in more detail in other Grattan publications. The Commonwealth Government should be cautious in intervening in these areas because it may not always be helpful.⁵²⁷

8.2.2 The Commonwealth's role

The Commonwealth should focus on delivering on its existing responsibilities. The Commonwealth already plays a substantial role in school education through school funding, initial teacher education, the national curriculum, national student testing, data collection, and setting national professional standards.

The Commonwealth should get involved in new school reforms only if its proposed action meets three criteria:⁵²⁸

- evidence shows it is a good idea;
- government (at any level) can make it happen; and
- Commonwealth intervention will help, not hinder.

Any new Commonwealth initiatives should help to fill genuine gaps, or take advantage of scale to deliver more productive outcomes.

Consequently the Commonwealth should restrict its new reforms to three areas: get school funding right; deliver the Commonwealth components of the newly agreed national reforms; and help to attract more high-achievers to teaching while strengthening incentives for universities to improve initial teacher training.

527. Sonnemann and Goss (2018, pp. 17–18).

528. Sonnemann and Goss (*ibid.*, pp. 20–21).

8.2.3 Get school funding right, then move on

Australia's long and toxic school-funding wars must end so the nation can move on to other much-needed education reforms.

School funding is in better shape than ever (see Box 3 on the following page), but the Commonwealth needs to take six steps to lock-in consistent, needs-based funding:

1. Implement the National Schools Resourcing Board's (NSRB) new model for estimating parents' capacity to contribute.⁵²⁹
2. Abolish the \$1.2 billion Choice and Affordability Fund.
3. Commission the NSRB to review the SRS formula.⁵³⁰
4. Renegotiate the national school funding agreement to prevent state governments from including depreciation, or reclassifying existing regulatory and transport expenditures, as contributions to their share of funding towards the SRS.
5. Require the NSRB to monitor how education systems allocate the funding that is given to them in a lump sum.⁵³¹

529. The current Government plans to transition to the new model by 2020. The model is based on recommendations by the Chaney review (Chaney (2018)).

530. The 2011 Gonski review recommended more work on the SRS base funding and loadings, but it never happened. Significant questions have been raised about the basis on which the SRS standard was set (Justman and Ryan (2013, pp. 5–6)).

The SRS formula should be reviewed within the forthcoming indexation review as a priority. There must be sufficient resources devoted to this aspect of the review.

531. Education systems include state education departments, Catholic systemic schools, plus a few smaller systems in the independent school sector. Under the national SRS, state systems can take a different view of how best to fund educational need than the SRS formula, but are required to justify their allocation mechanisms.

6. Work with states to move all school sectors to a consistent level of funding (relative to SRS) on a consistent timeframe.⁵³² In some states, government schools are on average much further behind their national SRS target than non-government schools.

8.2.4 Deliver the newly agreed national school reforms

A new national approach was agreed with all states and territories in the *National School Reform Agreement 2018*.⁵³³

It identifies eight national reforms to be implemented over the next five years.⁵³⁴

1. Create national learning progressions in key domain areas and general capabilities;
2. Create opt-in online assessment tools to help teachers track the learning progress of their students;
3. Review senior secondary pathways into work, further education and training;
4. Develop a national strategy to analyse future workforce needs;
5. Strengthen initial teacher accreditation;
6. Introduce a national Unique Student Identifier;
7. Create a new independent national research body; and

532. States should retain some freedom to set their funding levels, so long as total funding is consistent across all sectors within each state as a proportion of SRS.

533. As of February 2019, Victoria had signed only a temporary agreement (Department of Education and Training (2018a)).

534. These build on the findings of the 'Gonski 2.0' review (Gonski et al. (2018)). Gonski 2.0 articulated a high-level vision for school education. Most of its recommendations relate to state governments; only a few relate to direct Commonwealth reforms.

Box 3: A brief recap on school funding

The first Gonski report in 2011 laid the foundation for national needs-based funding via the creation of the Schooling Resource Standard (SRS). But it was deemed too costly to fully implement.

Labor's 2013 Education Act included many good elements but was hampered by the requirement that no school lose a dollar. It thus failed to lift most schools to 100 per cent of SRS, while continuing to *increase* funding for overfunded schools.

The Coalition's Australian Education Amendment 2017 improved on the 2013 Act. For the first time, funding will be reduced to overfunded schools. Commonwealth funding will be consistent across states and territories. And a new National Schools Resourcing Board (NSRB) will review key elements of funding.

The NSRB's first review proposed a new and better parental 'capacity-to-contribute' model for non-government schools, based on family income rather than where parents live. But in accepting the NSRB model, the Coalition also introduced a \$1.2 billion 'Choice and Affordability Fund'. This was a backward step, subsidising low-fee private schools even when parents can afford to pay their way.

Labor has committed to build on the 2017 Amendment and invest \$14 billion more in public schools. Under Labor's policy, Commonwealth funding would rise to 22.2 per cent of SRS, compared to the Coalition's 20 per cent. Despite these improvements, neither party's policy will fully fund all schools. Unless that changes, public schools will continue to be under-funded relative to non-government schools.

8. Improve national data quality, consistency and collection, to improve the national evidence base.

These are sensible and useful reforms; most are within existing areas of Commonwealth responsibility, help to fill genuine gaps, or take advantage of scale. A key priority should be to set up the independent national evidence body, given its potential to strengthen the research base in school education.⁵³⁵

Importantly, the new national approach – done co-operatively – would avoid the Commonwealth dictating or mandating what state governments should do in areas of state responsibility.

While the National Agreement is a step in the right direction, it is accompanied by new bilateral agreements with each state which pose two key risks.

First, the bilateral agreements could create a lot of new red tape. State governments must report annually to the Commonwealth on their progress towards their education plans in the agreement.⁵³⁶ Reporting on state government outputs should be kept to a minimum.

Second, it is possible that a heavy-handed future Commonwealth Government could deem a state government as non-compliant – and withhold access to school funding – if the state failed to implement the reforms agreed in the bilateral agreements. Such a large financial threat may create a perverse incentive for state governments to stick to commitments even when there is good reason to deviate. The new

535. The national evidence body should help to lift the standards for scientific evidence, and produce more randomised controlled trials and quasi-experimental studies. The national body should work closely with the network of state-based education research institutions and help ensure better national coordination of major research efforts, and to avoid duplication and gaps. Discussed further in Sonnemann and Goss (2018, pp. 24–25).

536. Clause 53(b) of the National Agreement provides that states need to report to the Commonwealth on progress in state actions in the bilateral agreements.

bilateral agreements should include clear standards on what constitutes ‘compliance’, with flexibility where justified.

8.2.5 Help to attract more high-achievers to teaching

In Australia, not enough high-achievers are attracted to teaching. Only about one in four students offered a place in undergraduate teaching based on their Australian Tertiary Admission Rank (ATAR) had an ATAR of 80 or more, compared to one in two across all courses.⁵³⁷

Attracting more high-achievers would help raise the quality of teaching.⁵³⁸ People with good academic skills are more likely to make good teachers.⁵³⁹ A 2014 study found countries with teachers who have high academic skills tend to perform better in international maths and literacy assessments.⁵⁴⁰ High-performing school systems attract many high-achieving students to apply for initial teacher education, and then select the most promising candidates.⁵⁴¹

Encouraging more high-achievers to become teachers will require a range of reforms to the job itself, including to pay and conditions, as well as other initiatives that help to lift the status of teaching to make it a more desirable career choice. Most of these reforms are state government responsibilities, but the Commonwealth can contribute through its role in regulating and funding initial teacher education.

537. Department of Education and Training (2018b).

538. Discussed in Sonnemann and Nolan (2018).

539. While the evidence is mixed, on balance it suggests teachers’ prior academic performance is a good indicator of whether they will go on to become great teachers. High-achievers tend to deliver better results on standardised tests and also do better in on-the-job performance reviews (Rockoff et al. (2011), Boyd et al. (2008) and Dobbie (2011)).

540. Hanushek et al. (2014).

541. Singapore, South Korea, and Finland invest heavily in screening candidates. Prospective teachers are assessed on their prior academic ability, as well as traits such as dedication to teaching.

Specifically, the Commonwealth should push for a higher ATAR requirement of about 80. This would help to raise the prestige of teaching, and send a signal to young people that teaching is a socially valued career.⁵⁴² It would be unlikely to lead to teacher shortages overall, because most entrants to initial teacher education are admitted through non-ATAR routes, university transfers, or via post-graduate education.⁵⁴³ A higher entrance requirement would need to be carefully introduced to avoid exacerbating any existing teacher shortages in specific subjects or regional areas. But this is not a reason to hold back from a higher ATAR requirement.

8.2.6 Provide better initial teacher education

The Commonwealth should play a bigger role in improving the quality of initial teacher training given that it funds university providers. Since a major review in 2014, the Commonwealth has tightened course accreditation requirements, and since 2017 teaching graduates must pass a national literacy and numeracy test. In future, providers will need to ensure all pre-service graduates pass a new teaching performance assessment that assesses the practical skills and knowledge of pre-service teachers.⁵⁴⁴ The 2018 National School Reform Agreement identified ‘strengthening the initial teacher accreditation system’ as a continued national priority.

But more needs to be done. There appear to be few direct consequences for universities who produce poor teaching graduates who do not pass the literacy and numeracy test or the new teaching performance assessment, and it remains to be seen whether the new performance assessments will set high standards that are consistent between universities.

Any new Commonwealth intervention in initial teacher education requires careful thought; it can have unintended consequences. The Commonwealth should commission an independent expert review to advise on the progress and effectiveness of current reforms. The review should also consider whether tougher sanctions against poorly performing universities are needed, such as caps on student places, greater transparency on student pass rates, or performance-based funding of initial teacher education courses. The review should be done in 2021 rather than immediately, to allow adequate time for the teaching performance assessment to be implemented. The review should seek substantial input from state governments and the non-government school sectors.

542. One large-scale US study of high-achievers found that prestige was an important factor in their career choice, and that teaching rated poorly on this aspect compared to their chosen professions (Auguste et al. (2010, p. 27)).

543. We estimate that fewer than 15 per cent of all new applicants to teaching would be likely to be rejected under such a policy. Most candidates who entered teaching in 2016 did so through non-ATAR based admission or using post-graduate academic records (AITSL (2018)).

544. The Teacher Education Ministerial Advisory Group (TEMAG) was established in 2014 to advise on ways to improve the preparation of teachers in Australia. Since then, the Commonwealth Government has made several changes to increase the rigour applied when accrediting ITE programs.

9 Higher education

9.1 Where we are

A decade ago, Australia set a target of 40 per cent higher education attainment for 25-34-year-olds by 2025.⁵⁴⁵ On OECD figures, that goal was achieved by 2017 (Table 9.1), giving Australia an attainment level that is mid-range among the comparator countries and similar to Japan and New Zealand.

Although there is a substantial attainment gap between the highest rate (South Korea) and the lowest (Germany), all these comparator countries have mass higher education systems. In most cases, attainment is still growing (Figure 9.1 on the next page). Common cultural and labour market changes are driving demand for higher education, and a wide variety of funding systems have in practice met that demand.⁵⁴⁶

Australia's 2017 attainment rate is a product of both migration and higher education policy. Counting only people whose attainment is linked to higher education policy, Australia was at the lower end of the attainment range in 2017 – 35 per cent of 25-34-year-old citizens and 32 per cent of people born in Australia.⁵⁴⁷ But these rates will increase significantly over the coming years.

9.1.1 Demand-driven funding increased student numbers

Between 2008 and 2017, annual domestic commencing bachelor-degree student numbers at public universities increased by 45 per cent to nearly a quarter of a million.⁵⁴⁸ In 2016, 41 per cent of Australian

Table 9.1: International scorecard for higher education

	Attainment of a bachelor degree or above, age 25-34, 2017	Part-time enrolment rate in post- secondary education	Tuition fees charged by universities to domestic students
	%	%	USD PPP 2015
Australia	40	42	5,526
Canada	36	18	4,969
Germany	31	13	0
Japan	40	8	8,411
Netherlands	45	17	2,409
New Zealand	41	44	4,506
South Korea	48		8,419
Sweden	36	46	0
United Kingdom	44	25	11,797
United States	37	38	4,216

Notes: See Appendix A for notes and sources.

545. DEEWR (2009, p. 12).

546. Cantwell et al. (2018). For funding differences see OECD (2018i, chapter C).

547. ABS (2017e).

548. Department of Education and Training (2019a).

19-year-olds were enrolled in higher education, up from 31 per cent when the 40 per cent target was set.⁵⁴⁹ These younger cohorts will drive up attainment rates in the 25-34-year-old age group as they complete their courses and enter their careers.

Australia's late-teenage participation rate increase was due to 'demand-driven' funding of bachelor-degree places in public universities. Historically, Australia's higher education system has been 'supply-driven'; the government decided how many student places it would fund. But this supply constraint was eased between 2008 and 2011, and then abolished between 2012 and 2017, so that universities could meet demand. In those years, universities were paid a 'Commonwealth contribution' (tuition subsidy) for an unlimited number of bachelor-degree students, except in medicine. Enrolments boomed from 2009 to 2014. Total teaching grants paid to universities reached a record \$7.1 billion in 2017, a more-than 50 per cent real increase since 2008.⁵⁵⁰

9.1.2 The number of domestic undergraduates may well decline

These boom years are now over. With new limits on government spending and weak demand, the number of domestic students is likely to decline in the next few years.

In December 2017, to save money, the Government froze its grants for bachelor-degree places at 2017 levels for two years.

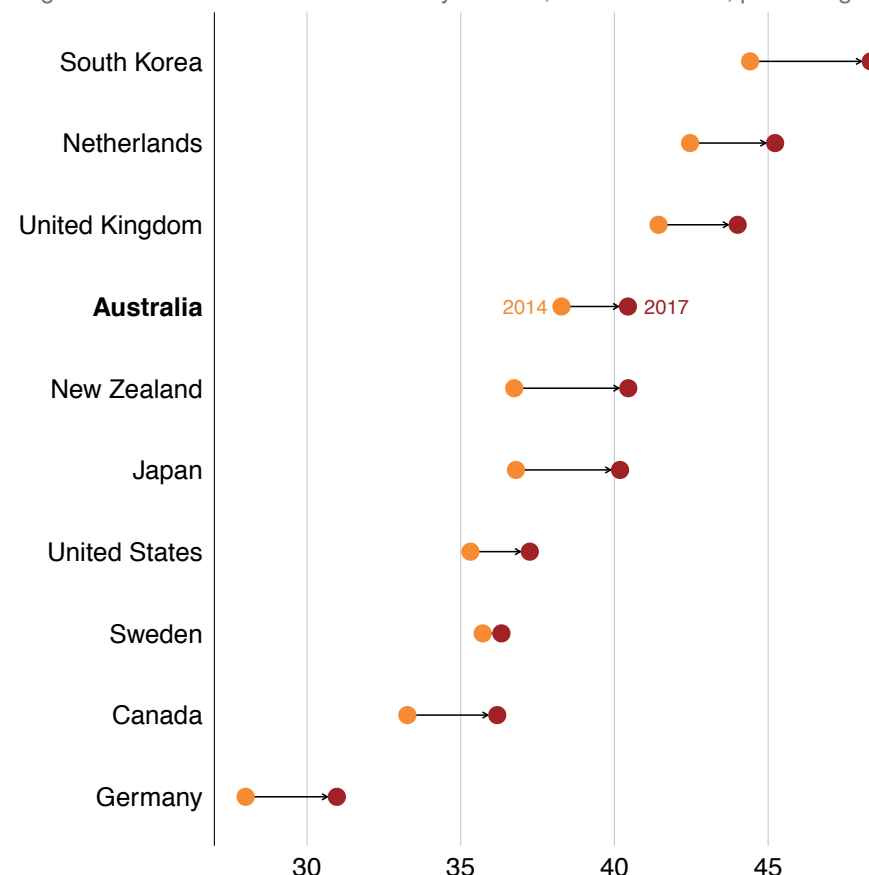
From 2020 to 2022, maximum grants will increase in line with population growth for universities that meet performance criteria. On the Government's estimates, the increase will be just over 1 per cent

549. A. Norton et al. (2018a, p. 22). This is a count of 'domestic' students, which includes Australian citizens, New Zealand citizens resident in Australia, and permanent residents.

550. See Section 9.1.5.

Figure 9.1: Australia has mid-range but increasing higher education attainment

Higher education attainment of 25-34-year-olds, 2014 and 2017, percentage



Notes: Higher education attainment includes bachelor, master and PhD-level qualifications. See additional notes in Appendix A.

Source: OECD.Stat (2019).

per year.⁵⁵¹ This is below inflation, so total grants for most universities under current policies will decline in real terms until 2022.⁵⁵²

Government grants average about 60 per cent of total university funding for domestic bachelor-degree students, although on a per-student basis the government's share of the funding rate varies from less than 20 per cent for law or business to more than 70 per cent in agriculture.⁵⁵³ Students pay the rest through price-capped student contributions. These are unaffected by the public funding freeze.

Because of student contributions, some universities might maintain or increase their student numbers. Universities have often taken students at less than the full funding rate.⁵⁵⁴ Additional students often cost much less than the average amount.⁵⁵⁵ When courses have spare capacity, more students can be enrolled with little extra expenditure.

Despite this potential for student-contribution-only enrolments, some universities may maximise their average per-student revenue and reduce their student intake. If they do, the number of student places could drop significantly between 2017 and 2022. Universities that win performance funding could reduce their student places by more than 5 per cent and still receive their maximum grant. Universities

without performance funding could receive their maximum grant despite reducing student places by nearly 9 per cent.⁵⁵⁶

Exactly how funding considerations will affect medium-term enrolments is hard to predict. Universities will make their own decisions, which may vary between faculties. But the pro-growth incentives of the demand-driven system are clearly gone, and under plausible scenarios universities will supply fewer student places in the future.

On the demand side, fewer people are applying for university. Applications declined by 3.3 per cent between 2017 and 2018.⁵⁵⁷ Enrolment data shows that commencing domestic undergraduate numbers fell by 1.8 per cent for first semester 2018 compared to 2017.⁵⁵⁸ Early reports of applications for 2019 suggest another decline in demand.⁵⁵⁹

Demand fell in 2018 mainly because of fewer applicants aged 20 or older. Some potential mature-age students may be taking advantage of a strong employment market, and will enrol later when jobs are harder to find. But there could be a longer-term aspect to the fall in mature-age demand. Demand-driven funding created more opportunities to attend university straight after school (Section 9.1.1). With aspirations for higher education satisfied at this point, the potential mature-age higher education market is smaller than it was before demand-driven funding.⁵⁶⁰

551. Population aged 18-64. The Government's estimate is 1.1 per cent to 1.2 per cent growth in the years from 2020 (Department of Education and Training (2018c, p. 11)).

552. A small number of universities have been allocated additional student places. Their total funding will increase in real terms.

553. Commonwealth and student contributions for each field (A. Norton et al. (2018a, p. 62)).

554. A 2002 government review document noted that enrolment above the fully-funded level had increased from 3.25 per cent in 1996, to 8.34 per cent in 2001 (Department of Education, Science and Training (2002, p. 20)). A part-payment for these students had been introduced in 1997.

555. For average costs by discipline see Deloitte Access Economics (2017, pp. xxii–xxiii). These are usually below the funding rate.

556. For more detail on how this works see A. Norton (2019a, pp. 4–6).

557. Department of Education and Training (2018b).

558. Department of Education and Training (2018b); and Department of Education and Training (2018d).

559. A. Norton (2019b).

560. Ibid.

9.1.3 Under current policies, participation rates could fall again in the 2020s

The number of 18-year-olds is not expected to grow much for the next few years (Figure 9.2), so school-leaver demand for higher education should be stable. But from 2022 the children born during the mid-2000s baby boom will start finishing school. A decade from now there will be 50,000 more 18-year-olds than today. At current participation levels, 20,000 additional school leavers will look for a university place, equivalent to the domestic undergraduate intake of three average-size universities. Under current policy the higher education system, with an incentive to decrease rather than increase student places, will not meet this demand. If current policies stay in place, from the mid-2020s a lower proportion of school leavers will complete higher education than today.

Participation rates would decline more in the faster-growing states.⁵⁶¹ In Tasmania, on ABS estimates, there will be 5 per cent more 18-year-olds in 2029 than today. But in Victoria and Western Australia there will be 20 per cent more 18-year-olds in 2029 than today.⁵⁶²

Fewer student places would affect low socio-economic status communities the most. Because universities mostly select students on past academic performance, and young people from lower socio-economic backgrounds on average do less well at school, poorer students will be more likely to miss out, as they did the last time the number of student places decreased.⁵⁶³

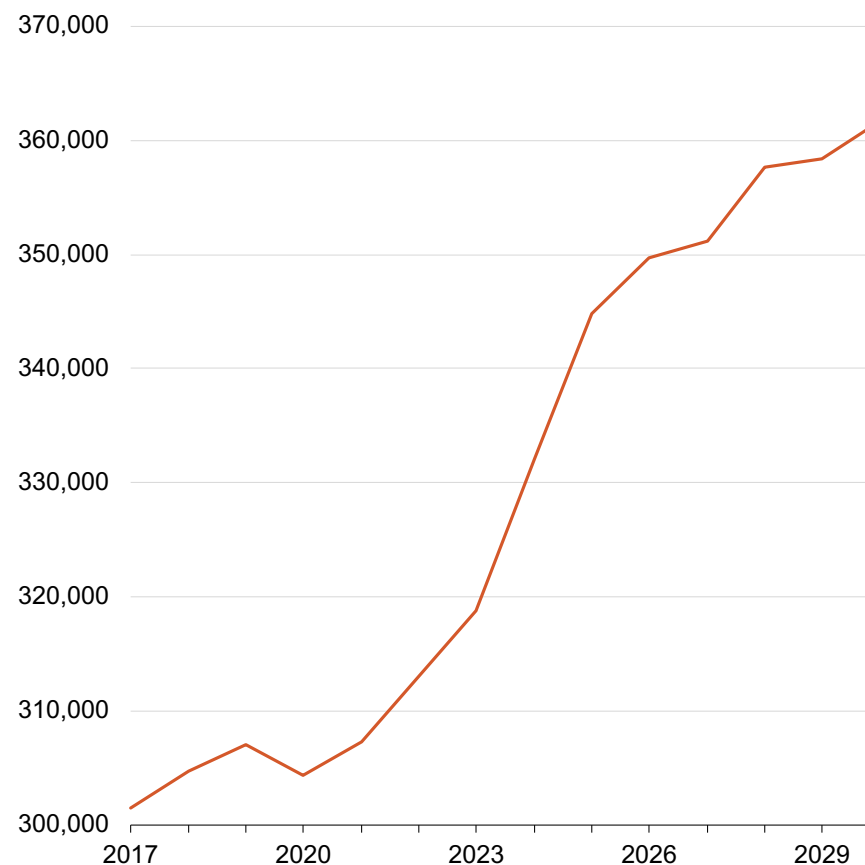
561. The Government is canvassing increasing the maximum grant faster in regions with more population growth (Department of Education and Training (2018c, p. 12)). However, anything less than the sum of CPI and population growth is likely to lead to falling participation rates.

562. ABS (2018j, series B).

563. A. Norton (2016, p. 199).

Figure 9.2: School-leaver demand for higher education will increase in the mid-2020s

Estimated number of 18-year-olds in Australia



Source: ABS (2018j).

9.1.4 Despite recent improvements, some student outcomes are below past levels

Not all students complete their degrees. With growing enrolments, the proportion of students not returning after first year increased from 12.3 per cent in 2009 to 14.3 per cent in 2016 (although it has decreased since 2014).⁵⁶⁴ Completion rates at six years after enrolment are trending down.⁵⁶⁵ About a quarter of commencing undergraduates will not complete a degree.

For students who do finish their degrees, employment prospects have deteriorated. With unfortunate timing, growth in graduate numbers coincided with the end of the mining boom, and a falling number of professional jobs for young people. Since then job numbers have recovered and employment rates soon after graduation have improved, although not to their previous level.⁵⁶⁶ For young graduates in some fields, a quarter or more are doing sales, administrative or service jobs that don't need a degree.⁵⁶⁷

9.1.5 Commonwealth outlays on higher education are high

As both population and higher education participation rates rose, higher education outlays increased (Figure 9.3). Tuition subsidy spending reached \$7 billion in 2016 and is likely to remain around that level in real terms under current policies.⁵⁶⁸ HELP loans are available to both government-supported and full-fee students. Total lending in 2018 of \$6.4 billion was slightly down on 2017 in real terms (Figure 9.3) but is expected to increase in 2019.⁵⁶⁹

564. Department of Education and Training (2018e, table 15.1.).

565. Department of Education and Training (2018f, table 2.).

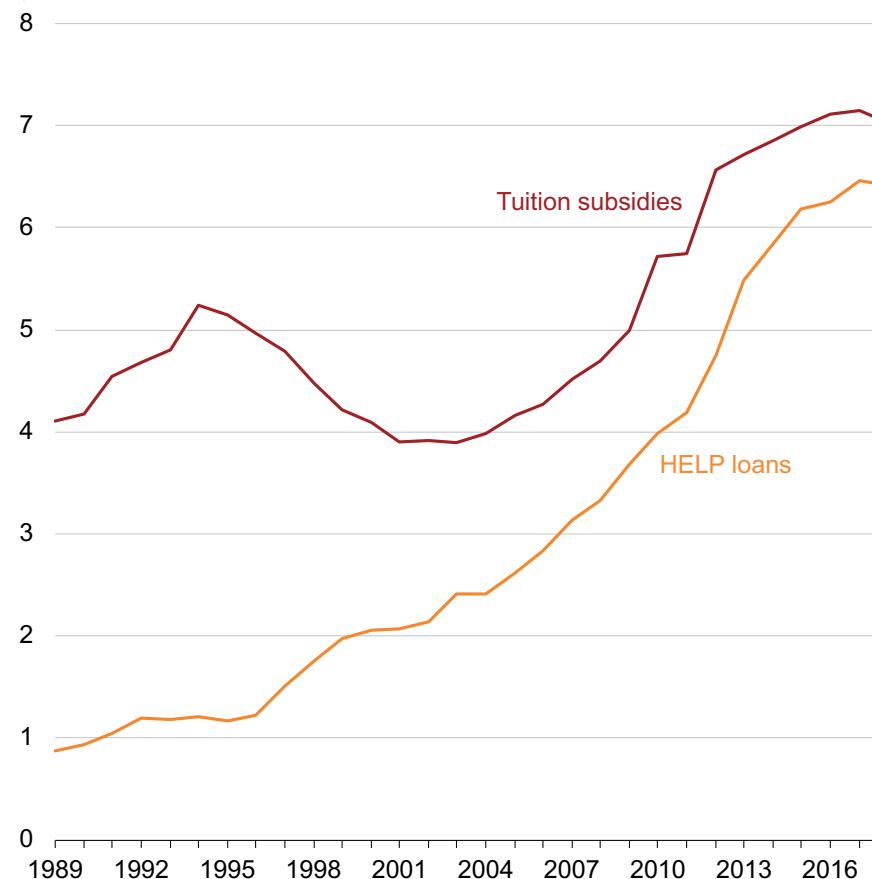
566. A. Norton (2019c).

567. A. Norton et al. (2018a, chapter 10). Young graduates aged 25-34.

568. Department of Education and Training (2019b, p. 41).

569. A. Norton et al. (2018a, p. 50); data supplied by the Department of Education and Training.

Figure 9.3: Commonwealth teaching outlays remain near record levels
\$2018 billion



Notes: Tuition subsidies are Commonwealth Grant Scheme payments 2005-2018, operating grants minus HECS charges in previous years. HELP loans include all lending to higher education students, including to students outside the public university system. Vocational education lending is excluded. CPI adjusted.

Source: Department of Education and Training (2015), data supplied by the Department of Education and Training.

As HELP lending has increased, HELP costs have become a more significant policy issue. The Government expects this year's lending to generate \$1.2 billion in future costs through interest subsidies on outstanding debt and debt it does not expect to be repaid (doubtful debt).⁵⁷⁰ As of 30 June 2018, total outstanding HELP debt was \$60 billion, but valued in the Government's accounts at less than \$40 billion, principally due to doubtful debt.⁵⁷¹

9.2 What we should do

Restoring demand-driven funding can be done without legislation and should be the first priority in higher education for whoever wins the 2019 federal election. The Tertiary Education Quality and Standards Agency could quickly put more pressure on universities to better monitor student groups at high risk of not completing their courses. Other changes to reduce student attrition and financial risks need legislation, but the policy goals are not highly controversial.

More students should be encouraged into vocational education in the next term of government, rather than taking bachelor-degree courses that may not lead to high-skill jobs. Better advice to prospective higher education students could improve their choices. Career information can be increased over the next few years, although a broad cultural preference for higher education cannot be reversed easily. Improving funding arrangements for vocational education involves complex negotiations with state governments, as well as additional Commonwealth funds, and would take longer.

Reforms to the HELP loan scheme would reduce total higher education costs, lessening future fiscal risk from returning to demand-driven

higher education funding and extending loans to more vocational education students. But disagreements over HELP's purposes make it the most difficult reform recommended in this chapter.

9.2.1 Restore and improve the demand-driven system

Restoring the demand-driven system would let the university system respond to population growth. This can be done administratively by revising university funding agreements. If it wins the election, Labor promises demand-driven funding from 2020, although teacher-education courses may be excluded unless universities increase entry requirements.⁵⁷²

A better balance with vocational education

Growth in higher education participation coincided with a decline in vocational education, especially in the major cities (Figure 9.4). Some students who chose higher education may have had more employment opportunities with a vocational education qualification. Skills shortages are much more common in the technical and trades occupations served by the vocational education system than the professional occupations requiring university degrees.⁵⁷³ The recent Joyce review of vocational education presented survey evidence that nearly half of school-leavers aspiring to a job that needed a vocational education were planning on getting a bachelor degree.⁵⁷⁴

Capping higher education places or funding is not the solution to this problem. Pushing young people into courses by cutting off their other options is not a solid basis for committed careers in those fields.

570. Department of Education and Training (2019b, p. 47).

571. Department of Education and Training (2018g, p. 167). This high write-down is partly due to the now-abolished VET FEE-HELP scheme for vocational education students.

572. Plibersek (2019a) and Hunter (2019). Excluding teacher education from demand-driven funding would require a legislative instrument that could be disallowed by the Senate.

573. Department of Jobs and Small Business (2018).

574. Joyce (2019, p. 85).

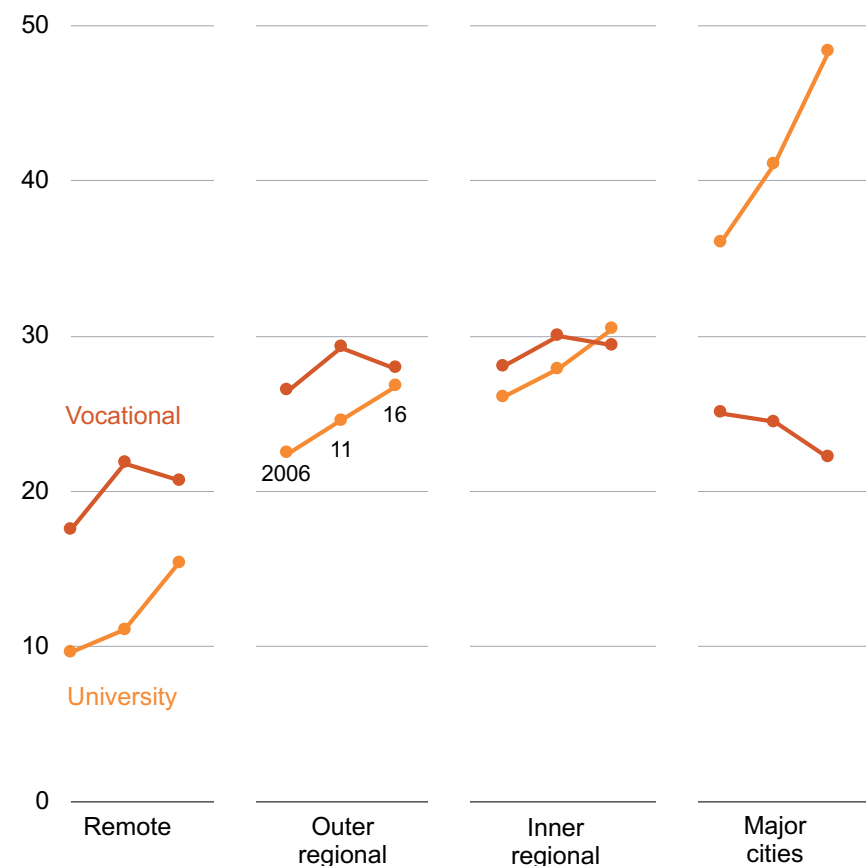
Change requires clarifying the education required for jobs, persuading young people that there are good jobs linked to vocational education, and removing obstacles to them choosing vocational education.

In the 2019-20 Budget, the Government announced a new National Careers Institute to improve careers advice for young people and others. Increasing the profile of vocational education is one of its aims.⁵⁷⁵ The Opposition also wants improved career advice that puts 'appropriate value' on vocational education.⁵⁷⁶ Such initiatives could help rebalance tertiary education at low cost.

Funding differences between vocational and higher education are also an issue. From a student perspective, government financial incentives often favour higher education over vocational education.⁵⁷⁷ In higher education, students can defer all their tuition charges through the HELP income-contingent loan scheme. In vocational education, funding arrangements vary significantly between states and courses. Some courses are free, and tuition fees are typically lower than in higher education. But when fees are charged, loans are unavailable or limited to a fixed amount, which may be less than the cost.⁵⁷⁸

Labor promises a major review of post-secondary education, which would examine funding issues. State-based initiatives are already increasing the number of free vocational education courses.⁵⁷⁹ But many courses still have upfront charges which may deter potential vocational education students. However, the VET Student Loans system should only be extended cautiously. Its predecessor VET FEE-HELP scheme was widely rorted. And vocational education leads

Figure 9.4: Vocational education attainment and enrolment has declined
Qualification attainment or enrolment at age 21 by home location at age 16, percentage



Notes: Vocational attainment is at Certificate III level or higher. Enrolled in vocational education is attending a TAFE or other technical education institution. University includes other higher education providers.

Sources: ABS (2009), ABS (2012) and ABS (2017c).

575. Department of Education and Training (2019c).

576. Plibersek (2019b).

577. A. Norton (2018).

578. Department of Education and Training (2018h).

579. NSW Government (2019); and TAFE Victoria (2019).

to some low-earning occupations, which means that a relatively high proportion of student loans will never be repaid.⁵⁸⁰

Better protections for higher education students

A Grattan Institute report, *Dropping out: the benefits and costs of trying university*, argued that attrition is not always wasteful. Neither students nor universities know enough before admission to predict with certainty who will complete a course. Some trial and error is a necessary part of the selection process. Many students benefit from time at university even when they don't complete a course.⁵⁸¹

But policy changes could reduce the costs of non-completion. Under current practices, students are not warned of the factors that put them at high risk of not completing their course. The biggest factor is studying part-time.⁵⁸² Australia has high rates of part-time tertiary education study compared to other OECD countries (Table 9.1 and Figure 9.5).⁵⁸³

Part-time study gives students flexibility and for some people is the only way they can acquire a degree. From this perspective, the easy availability of part-time study gives Australia a high-opportunity tertiary education system. But at best fewer than 30 per cent of bachelor-degree students who continuously enrol part-time will finish a degree (part-time students who convert to full-time improve their chances).⁵⁸⁴ Part-time students are much more likely than full-time students to work more than 30 hours a week and to have family

580. A. Norton and Cherastidham (2016, pp. 14–15).

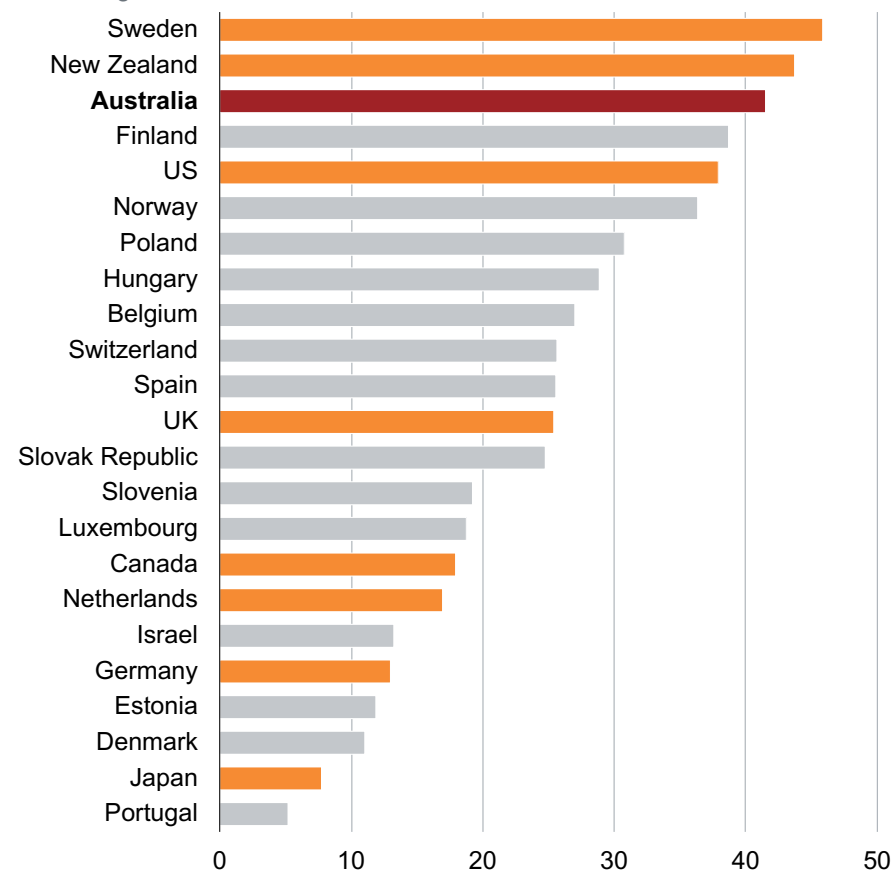
581. A. Norton et al. (2018b).

582. Cherastidham et al. (2018, chapter 2); A. Norton et al. (2018b, p. 34); and Department of Education and Training (2019a).

583. In Australia, students in vocational education are much more likely to study part-time (66 per cent) than students in higher education (33 per cent): ABS (2017c).

584. A. Norton et al. (2018b, p. 34).

Figure 9.5: Australia has high rates of part-time tertiary study
Percentage



Note: This chart includes both vocational and higher education.

Source: OECD (2018i).

responsibilities.⁵⁸⁵ To finish a course requires not just academic ability; it requires time and energy as well.

Current public policy does little to manage the risks of part-time study. Prospective part-time students are not told that fewer than one in three will get a degree. If they knew this risk, they may study full-time or decide against university. The Tertiary Education Quality and Standards Agency should monitor attrition for part-time students, rather than just institution-level attrition, as it does now.⁵⁸⁶ This would put pressure on universities to pay more attention to how they admit and monitor part-time students.

Many students are unaware that they can avoid paying for courses or subjects that they no longer want to take. Students usually have three or four weeks after teaching starts before they are charged or incur a HELP debt. To avoid paying, students must drop subjects prior to a 'census date'. A Grattan Institute survey found that fewer than 40 per cent of students surveyed understood the census date's significance; the others were unaware of it or confused it with some other university date.⁵⁸⁷ As a result, some students needlessly incur HELP debts.

More should be done to increase students' understanding of this 'try before you buy' period. The census date's name should be changed to clearly signal its financial significance. All universities communicate the date to students, but only some do so in ways that students notice and understand, such as by phone calls or text messages.

Universities should also check that students are engaged and on track with their studies, before charging them for second semester. In recent years nearly 6 per cent of commencing bachelor-degree students failed every subject in their first year, raising questions about whether they

were still studying at all, or if so whether they were receiving realistic advice about their prospects.⁵⁸⁸ There are precedents for requiring universities to monitor student progress. Vocational education providers and non-university higher education providers must verify that their students are 'genuine'.⁵⁸⁹

9.2.2 Reduce higher education costs

Demand-driven funding is expensive for governments. Other university funding systems, including the one put in place by the Coalition for 2018-2022, contain costs by limiting enrolments or total grants to higher education institutions. Tuition charges can finance expanded enrolments while containing public expenditure. With tuition charges, the available public funds can be spread across a larger number of students. All countries with significant student fees have mid-level or high education attainment rates in their 25-34-year-old cohort (Table 9.1 and Figure 9.6 on the following page).

Although some countries with free higher education also have high attainment rates, the countries with lower attainment all have free or cheap higher education.⁵⁹⁰

To keep the demand-driven system in place, in 2017 the Government planned to reduce Commonwealth contributions, partly offset with increased student contributions. The Senate rejected this plan, triggering the freeze on total funding. If demand-driven funding returns, the cost of educating the large baby-boom cohort reaching university

585. Ibid. (p. 28).

586. Ibid. (chapter 7).

587. Ibid. (p. 48).

588. Ibid. (p. 43).

589. Ibid. (chapter 6).

590. Higher education attainment at the lower end of the OECD range is not necessarily a sign of policy failure. The economic structure of a country may make other qualifications more suitable. 'Over-education', as measured by workers self-reporting more education than required for their job or observed as holding a higher level of qualification than is typically required for their job, is a common feature of developed country labour markets.

age in the mid-2020s may put proposals for reduced Commonwealth contributions to finance more student places back on the policy agenda. This would be preferable to another freeze.

Reforms to the HELP loan scheme can also limit the Commonwealth Government's costs by increasing the level of repayment. A Grattan Institute report recommended reducing the initial income threshold for beginning HELP debt repayment and requiring other debtors to repay more each year.⁵⁹¹ The Government is reducing the initial threshold from \$56,000 in 2017-18 to \$46,000 in 2019-20. But upper repayment thresholds have been increased, meaning that from 2019-20 most debtors earning between \$60,000 and \$95,000 a year, or about half of all repaying debtors, will have lower annual repayments. Because of this, the Government's repayment threshold reforms may not significantly improve HELP's long-term financial position.⁵⁹² Reducing the upper thresholds would remedy this problem.⁵⁹³

Recent debates on HELP reveal disagreements over what it should achieve. A substantial constituency believes HELP should make higher education free except for people who financially benefit from their degree, such as by earning average weekly wages or more. During most of HELP's history, the initial threshold has been high. For governments, a high repayment threshold is costly, because many people are exempted from repaying.

On another view, HELP is one of the government's policies to manage financial risk and smooth income. The risk to be managed is financial hardship, not earning less than a high income. The level of hardship protected against should link to other government social security

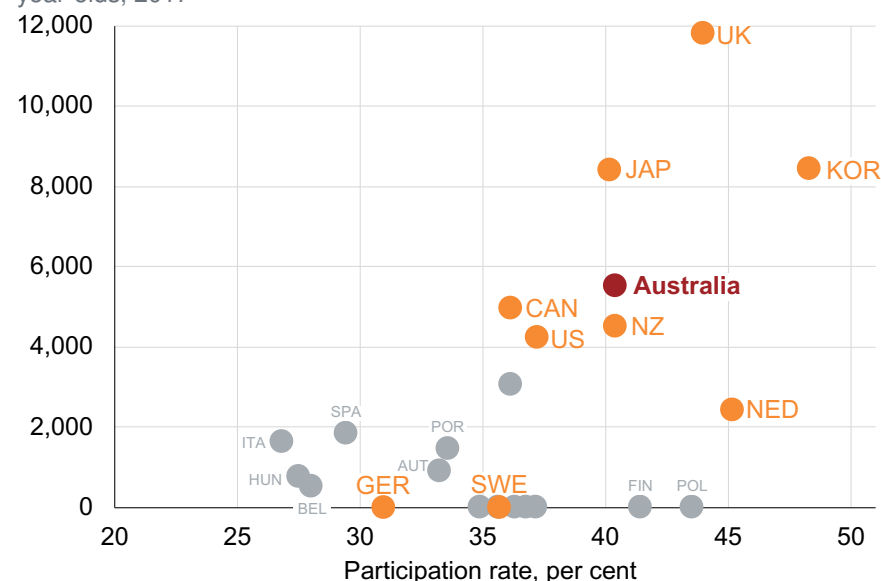
591. A. Norton and Cherastidham (2016).

592. A. Norton and Cherastidham (2018).

593. The original Grattan proposal was that HELP debtors pay progressively higher rates at 6 per increments from the first threshold. The legislated version had these 6 per cent increments except for the second threshold, which was 15 per cent higher than the first.

Figure 9.6: Countries with high student fees also have high student attainment

Student fees (USD 2015 PPP) and higher education attainment for 25-34-year-olds, 2017



Notes: PPP is purchasing power parity. Fees are for public universities, except for Japan and South Korea where most students attend private universities. US figures are average net prices paid by students in public universities, after receipt of scholarships and other support. In the US, fees vary widely and many students pay much more than the figure reported. UK fees have only been at the levels shown since 2012 and people aged 25-34 in 2017 would mostly have paid fees of one-third or less of those reported in the figure, at a similar level to Canada or the US. From 2018, New Zealand began moving to free tertiary education.

Sources: OECD (2018i), with additional data sources listed in Appendix A.

programs.⁵⁹⁴ This points to an initial threshold in the \$40,000s, but also to a possible link with household income. Debtors in high-income households would be obliged to repay their HELP debt even if their personal income was below the threshold, while debtors in low- and middle-income households with dependants could earn higher amounts than now before having to repay their HELP debt.

Focusing HELP on risk management and income smoothing would provide a clear rationale for ending the current provisions for writing off the debt held by deceased estates. Although this is a small current expense – \$6.5 million in 2017-18 – it is a major reason why \$1.2 billion of 2019-20 HELP lending is unlikely to be repaid. The deceased estate debt waiver is poorly-targeted social assistance. Grattan analysis shows that much of the eventually written-off HELP debt will be held by people in high net-wealth households.⁵⁹⁵ Their adult children are the main likely ultimate beneficiaries of writing off HELP debt.

A more effective HELP repayment system would make it easier to extend income-contingent loans to vocational education students other than the diploma students eligible for VET Student Loans. A high initial repayment threshold makes it difficult to use income-contingent loans for vocational education, because too many borrowers would never repay.⁵⁹⁶ Broader access to student loans would reduce the financial bias against vocational and in favour of higher education.

594. A. Norton and Cherastidham (2016).

595. A. Norton and Cherastidham (2014).

596. A. Norton and Cherastidham (2016).

10 Retirement incomes

10.1 Where we are

Overall, Australia's retirement incomes system is serving us well. Most retirees today feel more comfortable financially than younger Australians who are still working.⁵⁹⁷ Retirees today are less likely than working-age Australians to suffer financial stress such as being unable to pay a bill on time.⁵⁹⁸ Across the income distribution, people typically have enough money to sustain the same, or a higher, living standard in retirement as when working (Figure 10.1).

The incomes of future retirees are likely to be substantial relative to their pre-retirement incomes. Our modelling shows that, even after allowing for inflation, the average worker today can expect a retirement income (or 'replacement rate') of at least 89 per cent of their pre-retirement income – well above the 70 per cent benchmark endorsed by the OECD and others (Figure 10.1).⁵⁹⁹

Australia also scores well in international comparisons of the adequacy of retirement incomes (Table 10.1). Australia ranks 6th out of 36 countries for replacement rates for low- and middle-income earners.⁶⁰⁰

597. M.E. Bank (2018, Figure 10).

598. Daley et al. (2018b, Figure 3.3).

599. The results of the Grattan Retirement Income Projector have been updated since Daley et al. (Ibid.) to reflect the ATO 2015-16 sample file and recent methodological improvements. See: Coates and Emslie (2019).

600. The OECD defines low- and middle-income workers as those earning no more than half the average full-time mean income (\$41,000 a year). Half of all working Australians earn less than \$55,432, so the OECD's definition is closer to a middle-income worker in Australia. The OECD also ignores voluntary super and non-super savings that are substantial for wealthier workers (Daley et al. (2018b, pp. 53–54)). Therefore the OECD's replacement rates for Australia vary substantially from those included in Figure 10.1.

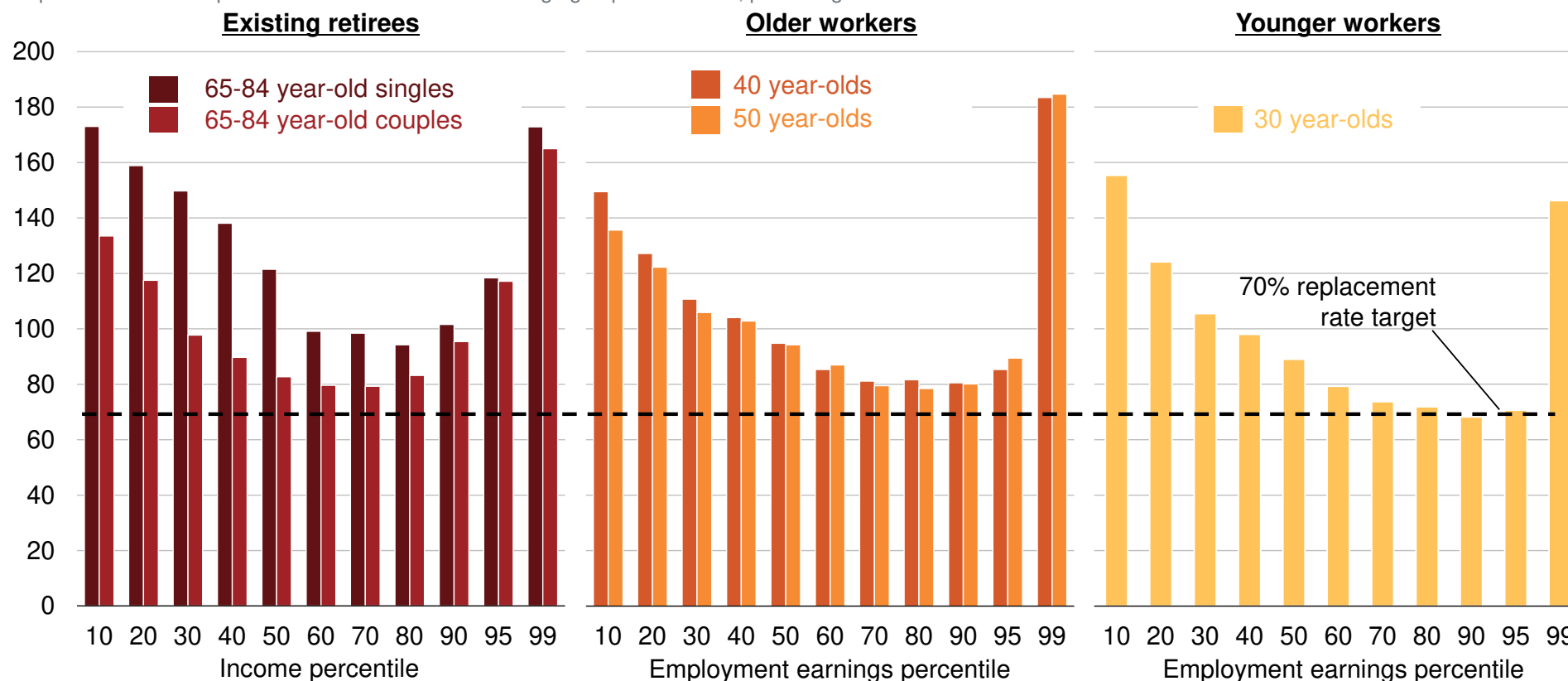
Table 10.1: International scorecard for retirement incomes

	Retirement income: low-middle income earners	Operating expenses of private pension funds	Total projected spending on pensions 2055 or latest year available
	% of pre-retirement earnings	% of total investment	% of GDP
Australia	95	0.78	3.7
Canada	95	0.37	6.9
Germany	66	0.21	12.6
Japan	79		9.5
Netherlands	105	0.12	7.9
New Zealand	101	0.56	7.2
South Korea	64		6.3
Sweden	62		7.4
United Kingdom	84	0.21	8.3
United States	97	0.35	5.9

Notes: See Appendix A for notes and sources.

Figure 10.1: Existing retirees, older workers and younger workers of all incomes can expect an adequate retirement income when compared to their pre-retirement incomes

Replacement rates of pre-retirement income for various age groups in 2015-16, percentage



Notes: Replacement rates for existing retirees are based on disposable household incomes for households with a household head aged 65-84 in 2015, relative to disposable income for households with a household head aged 45-64 in 1995, adjusted for inflation to \$2015-16, where disposable income includes head of household and their partner, but not children. Replacement rates for older and younger workers are calculated based on average projected disposable income during their whole of retirement, compared to average projected income in the last five years of working life, CPI deflated, based on the Grattan Retirement Income Projector as reported in Daley et al. (2018b, Figure 1.2, Figure 1.3). Older and younger worker scenarios are based on existing policy settings, including the 67-year retirement age and the 12 per cent Superannuation Guarantee. The income distribution for 'existing retirees' includes all households, whereas those for 'older workers' and 'younger workers' includes only those who submit a personal income tax return, and therefore misses many of those in the bottom 10 per cent by lifetime earnings such as recipients of Newstart, the Disability Support Pension or the Parenting Payment. But those missed in GRIP are likely to have very high replacement rates in retirement because the Age Pension exceeds their pre-retirement income.

Source: Daley et al. (Ibid., Figure 1.2) updated to reflect more recent data and methodological improvements to the Grattan Retirement Income Projector.

Australia is only 30th out of the same 36 countries for replacement rates for high-income earners – but replacement rates calculated by the OECD underestimate the adequacy of retirement incomes for high-income earners,⁶⁰¹ since they ignore non-super savings that are substantial for high-income earners and assume that retirement incomes should grow in line with wages, whereas people's spending needs typically fall in retirement.⁶⁰²

The OECD's benchmark of poverty⁶⁰³ implies that Australia has a relatively high proportion of older Australians (23 per cent) living in poverty compared to the OECD average of 13 per cent (Table 10.1). But there are a number of issues with the OECD measure. Small changes in reality produce apparently very different outcomes, calculation of the benchmark rests on arbitrary definitions of equivalisation, it does not take into account draw-downs on savings outside superannuation, it does not adequately account for the relatively high rates of home ownership among older Australians (Figure 10.2),⁶⁰⁴ and it ignores the fact that very few Australians are materially below the benchmark.⁶⁰⁵

Australia's retirement incomes system delivers these results at lower cost to government than in most other 'rich world' countries.

601. The OECD calculates replacement rates for a worker earning full-time mean income, or \$82,114 a year in Australia in 2016. Less than one in four working Australians earn this much, and so this benchmark is closer to a 'high income' standard.

602. Daley et al. (2018b, pp. 28–34, 53–54).

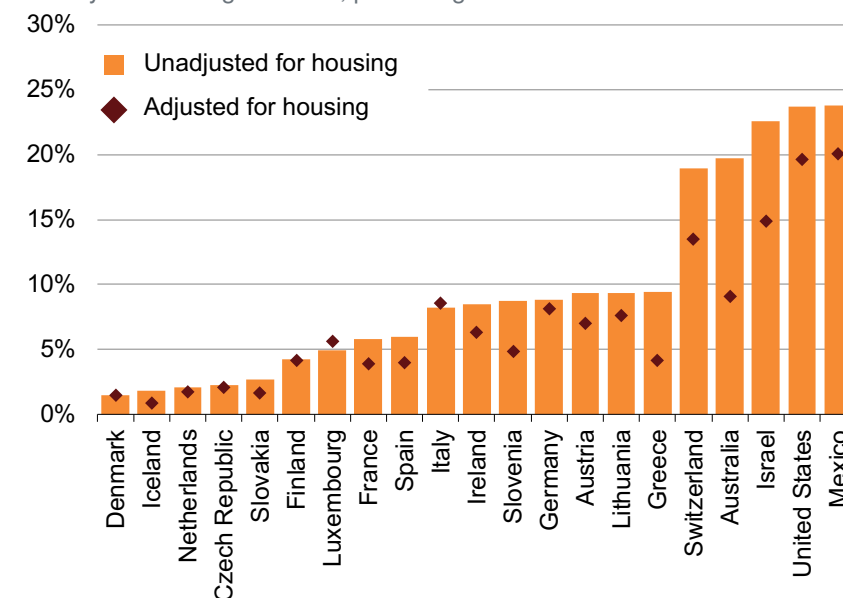
603. The OECD defines the old-age poverty rate as the share of the population aged 65+ who have household disposable incomes below 50 per cent of the population-wide median, adjusted for household size.

604. Daley et al. (2018b, pp. 38–39). See also CEPAR (2018, p. 23).

605. Since Australia's Age Pension is set close to the poverty line defined by the OECD, a large number of Australian retirees cluster close to the benchmark, and so the *depth* of old-age poverty in Australia is relatively low; older Australians in poverty have average incomes only 18 per cent below the poverty line, compared to an average of 23 per cent across the OECD (OECD (2019e)).

Figure 10.2: The poverty rate among Australian seniors falls dramatically once adjusted for housing

Poverty rate among over-65s, percentage



Notes: Poverty line defined as 50 per cent of median household equivalised disposable income using the OECD square root equivalisation scale. Incomes are adjusted for housing by adding in imputed rents.

Source: LIS (2019).

Comparatively tight targeting of pension payments via income and assets tests means Australia spends just 4.0 per cent of GDP on pension benefits (including disability and other pensions), compared to the OECD average of around 9 per cent (Figure 10.3).⁶⁰⁶ And unlike most countries, Australia's spending on public pensions is expected to fall by 2055 (to 3.7 per cent of GDP).⁶⁰⁷

But Australia's retirement incomes system faces some big challenges.

It does not always work for **low-income Australians who don't own their home** in retirement. Senior Australians who rent in the private market are more likely to suffer financial stress than homeowners, or renters in public housing.⁶⁰⁸ And this problem will get worse: on current trends home ownership for over-65s will decline from 76 per cent today to 57 per cent by 2056.⁶⁰⁹

While spending on pensions is low, the Commonwealth Government also gives up about \$35 billion a year – or 1.9 per cent of GDP – in **superannuation tax breaks**.⁶¹⁰ Unlike most OECD countries, the budgetary cost of these tax breaks are expected to rise in coming decades to 3 per cent of GDP by 2060.⁶¹¹ The budgetary costs of these

606. OECD (2017d).

607. These projections for 2055 assumed that spending on pensions would fall based on proposals, since abandoned, to cut pensions through indexation reforms and to raise eligibility ages. But other policies have been adopted, including tightening the Age Pension assets test, which will reduce future pension spending, albeit by less than the policies included in the 2015 Intergenerational Report. Other, more recent, projections that account for these policy changes show Age Pension spending (*i.e.* not including disability pensions) falling from 2.7 per cent of GDP in 2017 to around 2.5 per cent by 2038 (Rice (2018, p. 30)).

608. About 25 per cent of renting pensioners reported financial stress in 2015-16, compared to less than 5 per cent of home-owning pensioners. Daley et al. (2018b, Figure 3.3).

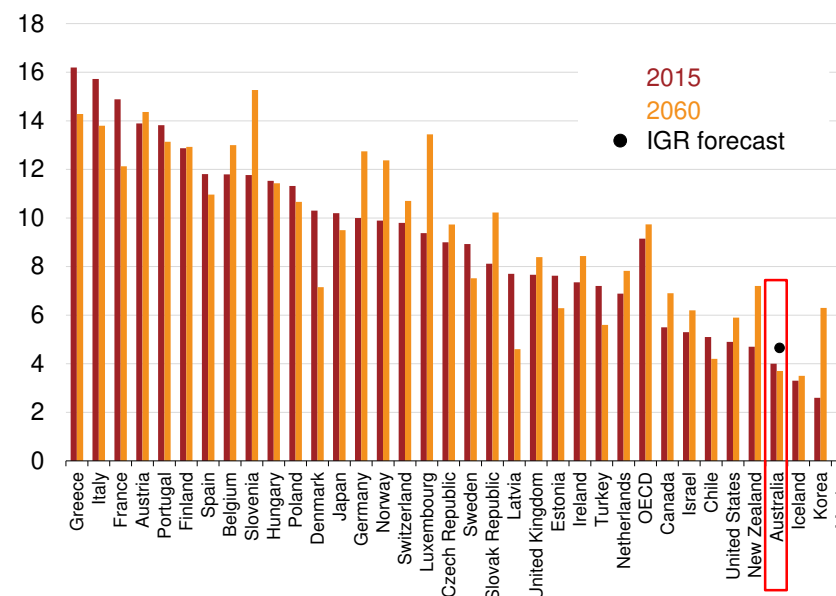
609. Ibid. (p. 62).

610. Daley et al. (Ibid., p. 19).

611. OECD (2018k, Figure 2.7). The future budgetary cost of retirement savings incentives in 2060 varies from 3 per cent of GDP in Australia and Iceland to

Figure 10.3: Australia spends less on public pensions as a share of GDP than other OECD countries

Projected expenditure on public pensions for OECD countries, 2015 and 2060, per cent of GDP



Notes: For Japan, Switzerland, Turkey, Canada, Israel, Chile, the US, New Zealand, Iceland, Korea, and Mexico, the projections are for 2050. For Australia, the projections are for 2055. The OECD 2055 Australian forecasts are based on the 'proposed policy' scenario from the 2015 IGR, which includes changes that increase the pension eligibility age and reduce payment growth. The IGR forecast is based on the 'currently legislated' scenario from the 2015 IGR.

Sources: OECD (Table 7.5 2017e) and Hockey (2015); Grattan analysis.

tax breaks are unsustainable. Half the benefits flow to the wealthiest 20 per cent of households, who already have enough resources to fund their own retirement, and who are unlikely to ever receive the Age Pension.⁶¹²

Australians pay \$30 billion a year in **superannuation fees**, almost 2 per cent of Australia's annual GDP, and more than the \$23 billion we spend each year on energy.⁶¹³ Australian super fees are some of the highest in the OECD (Figure 10.4). Australian superannuation funds charge widely varying administration and management fees, ranging from about 0.5 per cent to 2.0 per cent of assets. The higher-priced funds typically produce worse returns before fees – and therefore much worse returns after fees.⁶¹⁴ The Productivity Commission estimates that at least 1.6 million member accounts are in underperforming funds, eroding nearly half their balance by retirement.⁶¹⁵ Many super funds lack scale: half of all APRA-regulated super funds have assets of less than \$1 billion.⁶¹⁶ And other structural flaws – unintended multiple accounts and entrenched underperformers – also harm the retirement savings of millions of members to the tune of \$3.8 billion a year in extra fees and duplicate insurance premiums.⁶¹⁷

around 1 per cent of GDP in Canada and the US and just 0.1 per cent of GDP in New Zealand.

612. The value of superannuation tax breaks is calculated against a comprehensive income tax benchmark. While some commentators argue that an expenditure tax approach is a desirable structural feature of the tax system, arguments about the best policy for taxing savings should not be confused with questions about how to measure their cost. The income tax benchmark remains the best measure of the cost of tax breaks. In the absence of superannuation, savings would be taxed at rates of personal income tax (Daley et al. (2015a, Box 1)).

613. Daley and Coates (2018a).

614. Minifie et al. (2014, p. 11); Productivity Commission (2018d, Figure 3.20); and Productivity Commission (2018e).

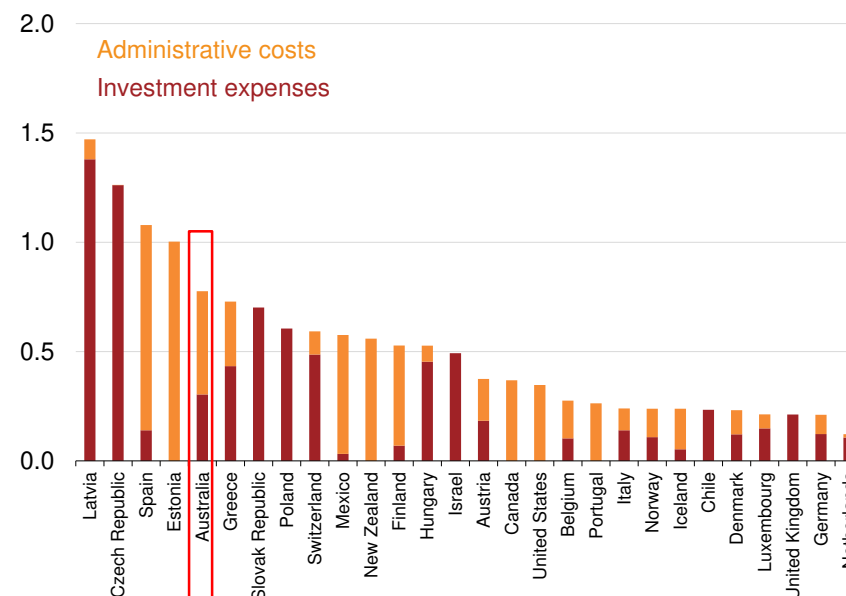
615. Productivity Commission (2018d, p. 2).

616. Ibid. (p. 2).

617. Ibid. (p. 2).

Figure 10.4: Australian superannuation fees are high compared to other OECD countries

Operating expenses of private pension systems in selected OECD countries, 2016, per cent of total investment



Notes: See Appendix A for detailed notes and data sources.

Sources: OECD (Figure 8.9 2017e); Grattan analysis.

10.2 What we should do

The next federal government should as a priority establish an independent inquiry into Australia's retirement incomes system, including the appropriate roles of compulsory superannuation and the Age Pension in providing for Australians' retirement incomes.⁶¹⁸ As part of that review, the Commission should establish a new standard for retirement income adequacy and assess whether Australians of different ages and incomes will meet that standard.⁶¹⁹

Assuming that the review comes to similar conclusions to those that we have reached, The next federal government should abandon plans to increase the rate of compulsory superannuation contributions to 12 per cent. The Commonwealth should also boost the maximum rate of Commonwealth Rent Assistance by 40 per cent to reduce rates of financial stress and poverty among renting pensioners. And the Commonwealth should loosen the Age Pension assets test taper.

To pay for these reforms, the Commonwealth should include more of the value of the family home in the Age Pension assets test and further reform superannuation and age-based tax breaks.

The next federal Government should also adopt the Productivity Commission's recommendations to reduce superannuation fees, particularly by changing the process for allocating new workers to default funds.

10.2.1 Leave the Superannuation Guarantee at 9.5 per cent

Given retirement incomes are already adequate for most retirees, plans to increase compulsory super contributions to 12 per cent, from 9.5 per cent today, should be abandoned.⁶²⁰ The increase would

effectively compel most people to save for a higher living standard in retirement than they enjoy during their working lives. Given typical retiree spending patterns, a 12 per cent Super Guarantee would primarily result in larger bequests.

The Super Guarantee forces people to save while they are working, so they have more to spend in retirement. But there is no magic pudding when it comes to superannuation. Higher compulsory super contributions are ultimately funded by lower wages, which means lower living standards for workers today.⁶²¹

The main beneficiaries from a higher Super Guarantee would be high-income workers, who receive a much larger tax concession than low-income workers and who will receive a relatively small share of their total income in retirement from Age Pension payments. But for most low-income workers, retirement incomes would not rise materially, because lower Age Pension payments would largely erode the increase in income from savings (Figure 10.5 on the next page).⁶²²

Raising the Super Guarantee doesn't just reduce workers' take-home pay. It also hits the Commonwealth Budget. Instead of workers receiving wages that are then taxed at full marginal rates of personal income tax, the extra compulsory contributions to their super fund are taxed at 15 per cent. We estimate that raising the Super Guarantee to 12 per cent could cost the budget \$2 billion to \$2.5 billion a year in additional super tax breaks.⁶²³ Superannuation tax breaks will

618. Ibid. (p. 77).

619. Daley et al. (2018b, p. 5).

620. Ibid. (pp. 85–96).

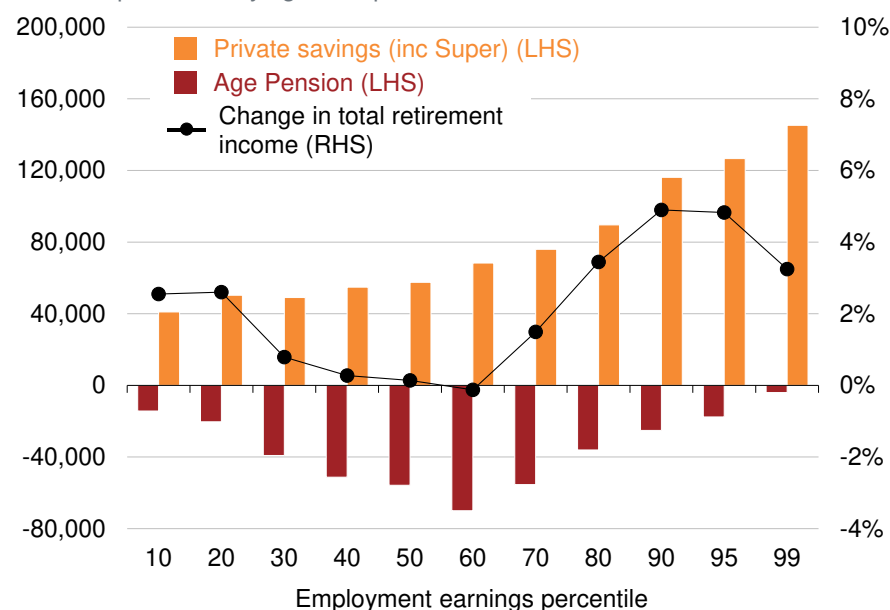
621. Increases to the Super Guarantee Charge are mostly passed through to workers in the form of lower wages (Treasury (2009, pp. 109–110)). Although employers are required to make Super Guarantee contributions, employees bear the cost of these contributions through lower wage growth. This means the increase in the employee's retirement income is achieved by reducing their standard of living before retirement: see among others Freebairn (2007), Keegan and L. Brown (2012), Potter (2016), O'Dwyer (2018), Onselen (2018) and Coates (2019b).

622. Daley et al. (2018b, pp. 89–91).

623. Daley et al. (2018b, pp. 92–93).

Figure 10.5: Raising the Super Guarantee to 12 per cent won't help low-income workers much

Change in total retirement income if the Super Guarantee increases to 12 per cent compared to staying at 9.5 per cent, \$2015-16, CPI deflated

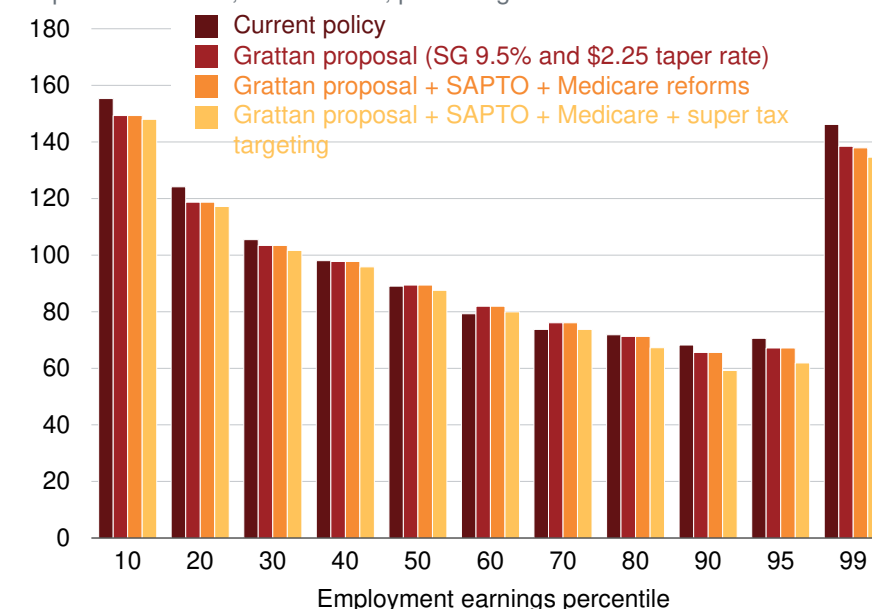


Notes: See Daley et al. (Appendix C 2018b).

Source: Daley et al. (Figure 9.2 *ibid.*), updated to reflect more recent data and methodological improvements to the Grattan Retirement Income Projector.

Figure 10.6: Middle-income earners would benefit more from winding back the pension assets test than increasing the Super Guarantee; high-income earners still have high replacement rates even if tax breaks are wound back

Replacement rates, CPI deflated, percentage



Notes: Results from modelling the retirement income of a person born in 1985, who works uninterrupted from age 30 to 67, and dies at age 92. Retirement savings are drawn down so that a small bequest is left in addition to the home. SAPTO (the seniors and pensioners tax offset) and Medicare levy changes as recommended in Grattan's 2016 report, Age of Entitlement: age-based tax breaks. 'Super tax targeting' includes \$11k cap on concessional contributions, \$50k annual cap on non-concessional contributions, and 15 per cent tax on earnings in the pension phase.

Source: Daley et al. (*Ibid.*, Figure 10.4), updated to reflect more recent data and methodological improvements to the Grattan Retirement Income Projector.

continue to cost the budget more than they save in pension payments until about 2060, according to Treasury analysis in 2013.⁶²⁴ The cumulative increase in Commonwealth public debt from a 12 per cent Superannuation Guarantee would exceed 10 per cent of GDP by 2050.⁶²⁵

10.2.2 Relax the Age Pension assets test taper rate

Instead of raising the Super Guarantee to 12 per cent, government should reduce the withdrawal rate of pension benefits in the assets test from \$3.00 to \$2.25 a fortnight for every \$1,000 in assets. This would lift the retirement incomes of middle-income workers (Figure 10.6 on the preceding page), at much less budgetary cost.⁶²⁶

Before 1 January 2017, retirees with assets above the ‘asset free’ area lost \$1.50 of pension payments every fortnight for every \$1,000 of assets they owned above the asset threshold, or \$39 a year. In 2017 the taper rate was doubled to \$3 of pension lost for every \$1,000 in assets, or \$78 a year, reducing the Age Pension for about 370,000 part-pensioners.⁶²⁷ But the increase in the asset free area boosted retirement incomes for about 170,000 part-pensioners with fewer assets. Overall the package saved the budget about \$1 billion a year in 2017-18.⁶²⁸

624. Daley et al. (2018b, pp. 93–94). Similarly, Rice Warner (2019, p. 9) estimates that increasing the Super Guarantee to 12 per cent would cost the budget around 0.2 per cent of GDP out to 2050, falling to around 0.1 per cent of GDP by the end of this century.

625. Daley et al. (2018b, p. 93).

626. Ibid. (p. 74).

627. About 92,300 part-pensioners no longer qualified for the pension and a further 277,700 had their part-pension reduced. Community Affairs Legislation Committee (2018).

628. Treasury (2015b, p. 169).

But the changes also resulted in an effective tax rate of more than 100 per cent on savings, which is hard to justify.⁶²⁹ Middle-income earners should get at least some reward – in terms of additional income – from savings.

Reducing the taper rate to \$2.25 a fortnight for every \$1,000 of assets would cost the budget \$750 million a year.⁶³⁰ Part-rate pensioners would still face high effective marginal tax rates on the earnings from their savings, but lower than at present.⁶³¹ It would materially boost the retirement incomes of middle-income earners, at much less budgetary cost than planned increases in the Superannuation Guarantee to 12 per cent. In addition, many middle-income earners who have already retired would receive a higher Age Pension than currently.⁶³²

10.2.3 Include more of the value of the family home in the Age Pension assets test

The current rules effectively count only the first \$203,000 of home equity when applying the Age Pension assets test; the remainder is ignored.⁶³³ Inverting this so that all of the value of a home is counted above some threshold – such as \$500,000 – would make pension arrangements fairer without compromising the incomes of retirees, and contribute between \$1 billion and \$2 billion a year to the budget.⁶³⁴ Many Age Pension payments are made to households that have

629. Daley et al. (2018b, pp. 81–82).

630. Ibid. (p. 82).

631. Ibid. (pp. 82–83).

632. Ibid. (p. 83).

633. Ibid. (p. 84).

634. Daley et al. (2018a, pp. 98–99). In principle changes to the Age Pension asset test should also apply to the assets tests for other pensions, such as the Disability Support Pension and Parenting Payment, but reforms to these payments have not been the focus of Grattan work to date.

substantial property assets. Half of the government's spending on age pensions goes to people with more than \$500,000 in assets.⁶³⁵

Reforming the assets test would also encourage a few more senior Australians to downsize to more appropriate housing, although the effect would be limited given that research shows downsizing is primarily motivated by lifestyle preferences and relationship changes.⁶³⁶

Low-income retirees with high-value houses could continue to receive the pension by borrowing against the value of their home⁶³⁷ under recent changes to the Government's *Pension Loans Scheme*.⁶³⁸ If retirees responded rationally, the reform would have no effect on their actual retirement incomes – instead it would primarily reduce inheritances.

This reform also reduces the unfairness of the current system that treats homes and other assets very differently. And it seems unfair that the current system pays welfare to retirees who own homes that many in a younger generation will never be able to buy.⁶³⁹

The impact of the change could be mitigated if the value of owner-occupied housing that is included in the pension assets test was increased only gradually. This would give retirees more time to decide how to respond to the new rules.⁶⁴⁰

635. Ibid. (pp. 98–99).

636. Daley et al. (2018b, p. 84); and Valenzuela (2017).

637. Daley et al. (2018a, p. 99).

638. Changes to the Pension Loans Scheme announced in the 2018-19 Budget may result in a few more retirees drawing down on the value of their home. The Government plans to expand access to everyone over Age Pension age and increased the maximum fortnightly income stream to 150 per cent of the Age Pension rate: Treasury (2018c, p. 175).

639. Daley et al. (2018b, p. 85).

640. Ibid. (p. 85).

10.2.4 Curb superannuation tax breaks

The current superannuation system is expensive and unfair, while substantially widening the gender gap in retirement incomes. Super tax breaks cost a lot – almost \$35 billion a year in foregone revenue, or well over 10 per cent of income tax collections – and the cost is growing fast. Half the benefits flow to the wealthiest 20 per cent of households, who already have enough resources to fund their own retirement, and whose savings choices aren't affected much by tax rates.⁶⁴¹

Curbs to superannuation tax breaks announced in the 2016-17 Budget and subsequently passed with minor amendments are a big step in the right direction, because those affected by the changes are overwhelmingly high-income earners who are unlikely to ever qualify for the Age Pension in retirement.⁶⁴² But even after these reforms, super tax breaks will still flow overwhelmingly to high-income earners who do not need them.⁶⁴³ People in the top 20 per cent of income earners will still receive about half of all pre-tax super contribution tax breaks.

Three reforms would better align tax breaks with the goals of superannuation, while saving the budget about \$4 billion to \$5 billion a year.

First, contributions from pre-tax income should be limited to \$11,000 a year.⁶⁴⁴ This would allow someone earning up to around 1.5 times average full-time weekly earnings to make compulsory super

641. Daley et al. (2015a, Figure 2.4).

642. The reforms included: a new 15 per cent tax on super earnings in retirement for people with super account balances of more than \$1.6 million; a lower annual cap of \$25,000 on pre-tax contributions; a lower income threshold of \$250,000 at which tax on super contributions will rise from 15 per cent to 30 per cent; and a lower \$100,000 annual cap on post-tax contributions (Coates (2018a, p. 27)).

643. Daley et al. (2018b, pp. 97–98).

644. The maximum superannuation contributions base would need to be reduced to \$115,000 so that workers are not compelled to make super contributions upon which they receive no tax concession (Daley et al. (2015a, p. 45)).

contributions (assuming compulsory contributions of 9.5 per cent of annual earnings).⁶⁴⁵ This would improve budget balances by \$1.7 billion a year.⁶⁴⁶ There would be little increase in future Age Pension payments, since the reductions in tax breaks would mainly affect people unlikely to receive an Age Pension anyway.

Second, lifetime contributions from post-tax income should be limited to \$250,000, or there should be an annual cap on post-tax contributions of \$50,000 a year.⁶⁴⁷ It won't save the budget much in the short term, but in the longer term it will plug a large hole in the personal income tax system.

Third, earnings in retirement – currently untaxed for people with superannuation balances below \$1.6 million – should be taxed at 15 per cent, the same as superannuation earnings before retirement. A 15 per cent tax on all super earnings would improve budget balances by about \$2 billion a year today, and much more in future.

Ending franking credit cash refunds, as proposed by the Labor Party,⁶⁴⁸ will have a similar effect to taxing superannuation earnings, but is a second-best option. It erodes some of the benefits of the franking credits system, and artificially disadvantages Self-Managed Superannuation Funds. But it may well be a reasonable second-best policy in a tax system rife with distortions. The decisions not to tax superannuation withdrawals and to increase the effective tax-free

threshold for older Australians have led to wealthy retirees contributing very little to government revenues relative to younger households. Rolling back dividend imputation is a fair way to help improve the budget and reduce the growing intergenerational transfers in our tax system.⁶⁴⁹

Grattan research shows that tightening super tax breaks would largely affect the top 20 per cent of income earners, who are unlikely to ever receive the Age Pension (Figure 10.6).⁶⁵⁰ Replacement rates for low- and middle-income earners would still be adequate after our proposed reforms to super tax breaks, in combination with keeping the Super Guarantee at 9.5 per cent and lowering the Age Pension assets test taper rate. For a median-income earner, the net lifetime replacement rate would decrease from 89 per cent to 88 per cent.

For a small proportion of women with higher incomes later in life, the changes would reduce their catch-up contributions. But the changes would reduce the tax breaks far more for older, wealthier men.⁶⁵¹

10.2.5 Wind back age-based tax breaks

The tax-free thresholds for seniors and for younger people have diverged over the past 20 years. Seniors do not pay tax until they earn \$32,279 a year, whereas younger households have an effective tax-free threshold of \$20,542. This is hard to justify. A retired couple pay about \$4,000 a year in tax on annual earnings of \$70,000 from their assets (assuming their assets outside of super are worth \$1.4 million). Any extra income they draw from a super account is tax-free. By contrast,

645. Daley et al. (2015a, p. 29). People earning more than 1.5 times average weekly full-time earnings are unlikely to receive any Age Pension for much or all of their retirement.

646. Daley et al. (2018b, p. 98).

647. A lifetime cap would be superior to an annual cap in ensuring people with broken work histories are not disadvantaged. But since three-quarters of post-tax contributions are made by people aged over 55, there is likely to be little difference in practice between a lifetime cap or an annual cap (Daley et al. (2015a, p. 54)).

648. Shorten (2018).

649. D. Wood and Coates (2018).

650. Daley et al. (2018b, Figure 10.2).

651. About 69 per cent of men (and 61 per cent of women) in the top 10 per cent of income earners contribute more than \$10,000 a year. Only 234,000 women earning less than \$80,000 make pre-tax contributions of more than \$10,000. In contrast, almost 950,000 men earning more than \$80,000 contribute more than \$10,000 from pre-tax income (Daley et al. (Ibid., p. 100)).

a working couple with both people earning the minimum wage would have the same income of \$70,000 a year but pay tax of about \$7,000 a year. Unlike the retired couple, they probably don't own their own home, and they have little chance of accumulating \$1.4 million in assets, or accruing significant super savings, or owning their home before they retire.⁶⁵²

The Government should wind back SAPTO (the seniors and pensioners tax offset) so that it is available only to pensioners, and so that those whose income bars them from receiving a full Age Pension pay some income tax. Seniors should also start paying the Medicare levy at the point where they are liable to pay some income tax. They would then pay a similar amount of tax to younger workers with similar incomes. This package would improve budget balances by about \$700 million a year.⁶⁵³

These proposed reforms to SAPTO and the higher Medicare levy threshold for senior Australians would have minimal impact on retirement incomes for low- and middle-income earners, particularly the 40 per cent of seniors who receive a full Age Pension (Figure 10.6).⁶⁵⁴ Almost all the impact would be borne by middle- and high-income retirees. Most seniors affected would be wealthy enough to receive no pension at all for most or all of their retirement years. And they would not pay any more tax on their incomes than younger households on similar incomes.

10.2.6 Reduce superannuation fees and lift fund performance

The Government should adopt the Productivity Commission's recommendations to reduce superannuation fees, particularly by changing the process for allocating new workers to default funds.

652. Daley et al. (2016a).

653. Ibid. (p. 3).

654. Daley et al. (2018b, Figure 10.4.).

Under the Productivity Commission's proposals, Australians would be allocated a default super fund only once, when they first started working. Unless they actively chose another fund, new workers would be defaulted into one of a shortlist of 'best-in-show' funds.⁶⁵⁵ They would stay in this fund even if they changed jobs. The shortlist would be developed by an independent expert panel in a way that made funds compete vigorously for access to the default market.⁶⁵⁶ Every four years, this panel would re-assess applications from funds to make the shortlist. Financial planners would be encouraged to recommend funds from the top 10 list. If they did not, they would have to show reasons, under a rule known as 'if not, why not?'.

The Commonwealth should also introduce standards, and encourage regulators to enforce them, to 'cut the tail' of poorly performing super funds. But because this mechanism is inherently much more vulnerable to legal challenge, it should be seen as an additional measure, rather than a substitute for introducing a best-in-show shortlist for default funds.

These reforms would have an enormous impact on retirement incomes. If superannuation returns were 0.5 per cent higher, then the median income earner would have about 4 per cent more income in retirement.⁶⁵⁷ This is larger than the boost to retirement incomes as a result of increasing the Superannuation Guarantee from 9.5 per cent to 12 per cent. Reducing superannuation fees would also produce substantial budgetary savings in the long-term via reduced spending on the Age Pension.⁶⁵⁸

655. Productivity Commission (2018d, p. 2).

656. This is conceptually similar to proposals for a wholesale tender for default funds proposed in Minifie et al. (2014) and Minifie et al. (2015).

657. Daley et al. (2018b, p. 95).

658. For example, Rothman (2012) estimated that if super returns were 1 per cent lower than expected then annual government pension outlays would rise by 0.3 per cent of GDP by 2050. Lifting net returns by the same magnitude (by reducing super fees) could generate similar budgetary savings in the long term.

Grattan's 2018 submission to the Senate Inquiry into the *Protecting Your Superannuation Package* Bill demonstrated that many Australians are paying far too much for insurance cover via superannuation, which is also reducing their retirement incomes.⁶⁵⁹ While the Parliament has passed some elements of this legislation, the remaining provisions dealing with opt-in insurance for under-25s and those with small super balances should be passed at the earliest opportunity.⁶⁶⁰

10.2.7 Investigate raising the pension and super ages to 70

Grattan reports have shown that increasing the super preservation age from 60 to at least 65 if not 70, and increasing the age of access to the Age Pension from 67 to 70, would make more difference in the long term than almost any other reform to economic growth,⁶⁶¹ budget balances,⁶⁶² and retirement incomes.⁶⁶³ Having increased the age of access to superannuation and the Age Pension to reflect substantial increases in life expectancy over the past 30 years, it may be appropriate to index these ages to reflect future increases in life expectancy.⁶⁶⁴

As discussed above (Section 2.2.2 on page 37), given the combination of a very large policy impact, but substantial concerns about unfairness, the Productivity Commission should be asked to investigate the economic, budgetary, and social costs and benefits of gradually raising the age of access to the Age Pension and superannuation to 70 years.

659. Daley and Coates (2018b).

660. Coates (2019c).

661. Daley et al. (2012a).

662. Daley et al. (2012a, pp. 29–32); and Productivity Commission (2015a, p. 2).

663. Daley et al. (2018b, p. 74).

664. Daley et al. (2013b, p. 30).

11 Budget policy

11.1 Where we are

The Commonwealth Budget has been in deficit since the Global Financial Crisis (Figure 11.1). While the budget bottom line is forecast to improve in the next two years, there are substantial medium- and long-term pressures that the government will need to tackle.

Australia avoided the worst of the economic⁶⁶⁵ and budgetary fallout from the GFC. Australia ran fiscal deficits of more than 3 per cent of GDP immediately after the crisis. But this was modest compared to most OECD countries.⁶⁶⁶

Yet other countries have consolidated their fiscal positions more quickly over the decade since the GFC.⁶⁶⁷ By 2016 (the latest OECD data available), Australia's federal deficit was larger than the OECD central government average. The deficit has narrowed more recently, and the budget is now forecast to reach surplus in 2019-20, largely because of strong revenue growth.⁶⁶⁸

Net debt is expected to reach 19.2 per cent of GDP in 2018-19. Australia's debt remains substantially lower than comparable countries,⁶⁶⁹ but it is at its highest level in recent history (Figure 11.2).

665. The economic fallout was cushioned by the government's stimulus package – cash handouts and infrastructure spending (Li and Spencer (2016)) – and the commodities boom led to a huge boost in mining investment (Minifie (2013)).

666. In 2010 the Commonwealth Government had a deficit of 3 per cent of GDP, while OECD countries averaged a deficit of 5 per cent of GDP (OECD (2017f)).

667. In 2016, the OECD average budget position was a deficit of 0.94 per cent of GDP, compared to Australia's deficit of 1.17 per cent of GDP (OECD (ibid.)).

668. Treasury (2019d). The expected surplus is driven by growth in company tax and superannuation tax revenues due largely to higher-than-expected prices for Australian exports such as coal and iron ore, and to companies having exhausted tax offsets since the GFC.

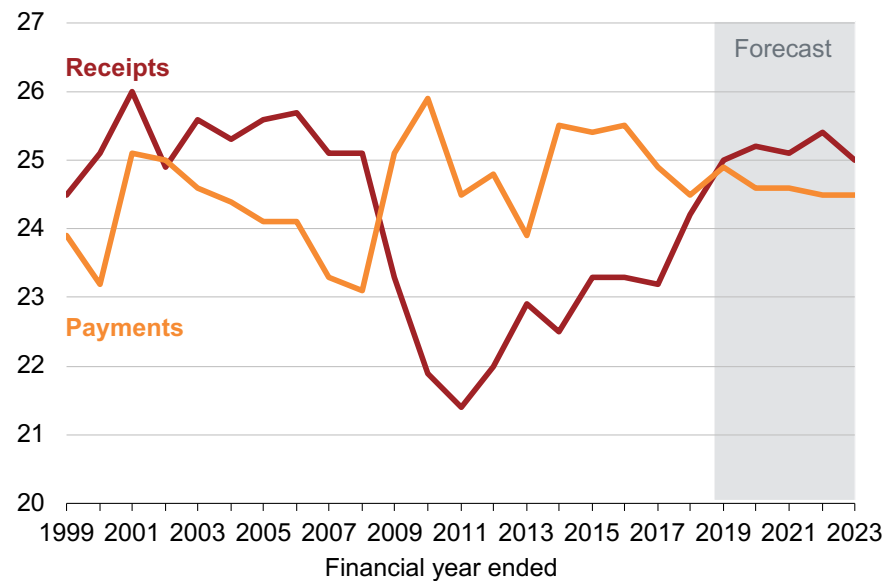
669. Comparisons are only available for gross debt.

Table 11.1: International scorecard for budget policy

	Central government fiscal balance, 2016	Central government debt, 2017	Independent forecasts or assessment of forecasts?
	% of GDP	% of GDP	Yes/no
Australia	-1.2	32	No
Canada	-0.4	39	Yes
Germany	0.4	46	Yes
Japan	-4.6	195	
Netherlands	-1.1	63	Yes
New Zealand	1.3	42	
South Korea	-0.8		Yes
Sweden	1.6	37	Yes
United Kingdom	-2.6	113	Yes
United States	-3.7	89	Yes

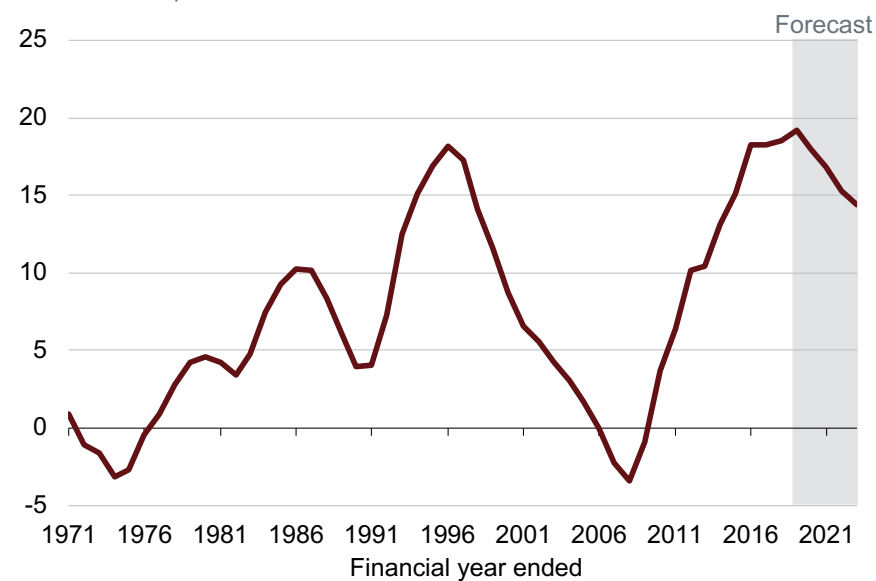
Notes: See Appendix A for notes and sources.

Figure 11.1: The Commonwealth Budget has been in deficit for a decade
Per cent of GDP



Source: Treasury (2019d).

Figure 11.2: Net debt is high by historical standards
Net debt as a per cent of GDP



Source: Treasury (*ibid.*).

High government debt incurs interest and limits future borrowings, reducing the capacity of governments to respond to economic shocks. The Australian economy is particularly exposed because, with interest rates at historical lows, the Reserve Bank can do little more to stimulate the economy. This leaves the Commonwealth Budget as the primary defence in the event of an economic downturn. As the 2015 Intergenerational Report notes: ‘experience suggests that economic downturns occur roughly every decade’.⁶⁷⁰

High levels of debt – if used to fund recurrent expenditure rather than productive investment – are also unfair. They require younger people and future generations to pay for today’s spending. These same people are hit hardest by low wages growth and are already on the hook to pay higher taxes (or accept lower services) as the working-age share of population shrinks (Section 11.1.3).

11.1.1 Bracket creep has done the heavy lifting

Budget consolidation has mainly been a revenue story. Revenues have increased by around 2 per cent of GDP since 2013-14.⁶⁷¹ Most of the growth is in personal income tax collections through bracket creep. Company tax and superannuation tax revenues also grew, because of higher commodity prices and companies having exhausted losses to offset tax.

Spending growth has also been subdued in recent years. Indeed spending growth under this Government has been the lowest of any government in 50 years (Figure 11.3). Policy changes to constrain the growth in transfer payments by tightening eligibility and freezing indexation contributed to lower growth over much of the past decade.⁶⁷²

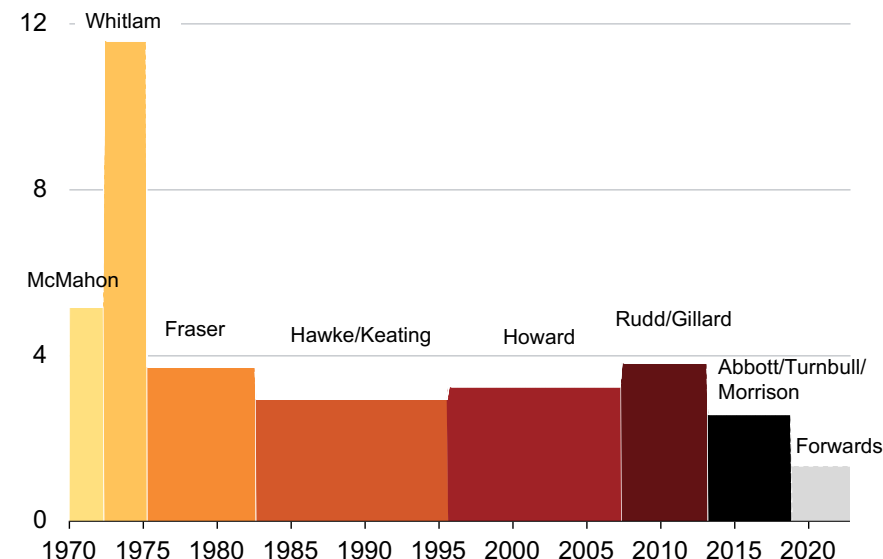
670. Treasury (2015a, p. 50).

671. Treasury (2019d).

672. Examples include new assessment tables for work-related impairment for the disability support pension in 2012, pausing indexation on the thresholds for family payments in 2014, and a doubling of the asset taper rate for the pension in 2017.

Figure 11.3: Spending growth has been constrained by historical standards

Average annual real growth in Commonwealth payments, per cent



Note: Spending growth in cross-over years (years in which government changed hands) are allocated across the governments in proportion to the share of the year in which they held office (to the nearest calendar month).

Source: Grattan analysis of Treasury (2019d).

But over the forward estimates, payments growth is projected to halve. The lack of explicit policy measures to constrain spending make the forecasts of even lower growth difficult to understand.⁶⁷³

Given the point in the economic cycle, the Commonwealth Budget should be in a much stronger position than it is. Under the Government's own fiscal targets, changes in the economy are supposed to be banked to improve the budget bottom line. But less than half of recent revenue windfalls, including from higher commodity prices, have been used to boost the budget position – the rest have been used to fund new spending or tax cuts.⁶⁷⁴

11.1.2 Projections understate the challenge

Continued revenue growth and formidable spending restraint will be required over the coming years to keep the budget in the black and pay down the debt. Three major obstacles stand in the way.

First, short- and medium-term budget forecasts remain highly optimistic – especially about the capacity for spending restraint.⁶⁷⁵ For example, health spending – the third largest expense category⁶⁷⁶ – is projected to grow by only 0.7 per cent per annum over the forward estimates, despite historical growth of 3 per cent per annum.⁶⁷⁷

Payments are projected to fall by 1.5 per cent of GDP by 2029-30 (Figure 11.4). Achieving such a reduction would require significant falls in spending across almost every major spending area, during a period when we know population ageing will increase pressure on many

673. Coates and D. Wood (2018).

674. As at Budget 2019-20. See also D. Wood and Griffiths (2018).

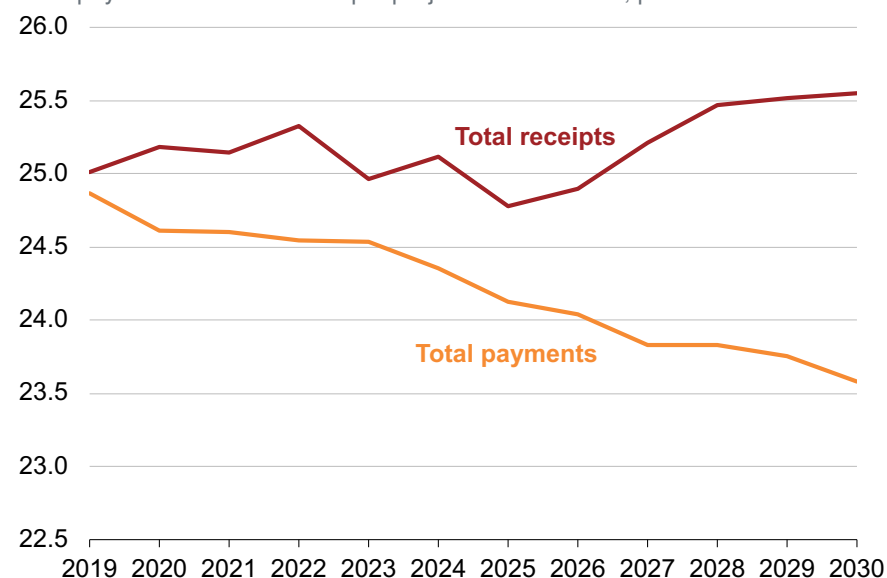
675. Coates and D. Wood (2018).

676. After 'social security and welfare' and 'other purposes'.

677. Financial years ending 2019-2023 (forecast) compared to 2014-2018 (actual); Treasury (2019d) and past Commonwealth Budget papers.

Figure 11.4: The 2019 Budget assumes significant spending restraint over the medium-term

Total payments and total receipts projected to 2029-30, per cent of GDP



Source: Treasury (2019d).

components of spending. The Parliamentary Budget Office estimates ageing will add 0.3 per cent of GDP a year to spending by 2028-29.⁶⁷⁸

Second, if the Government's Personal Income Tax Plan takes full effect it will reduce revenue by upwards of \$35 billion a year over the medium-term, making the task of paying down the debt even more formidable.⁶⁷⁹ And the full budget impacts of several other major policy decisions are not yet known because they fall beyond the four years of

678. PBO (2019); and D. Wood (2019).

679. D. Wood et al. (2019b).

the forward estimates. These include school funding commitments,⁶⁸⁰ and the National Disability Insurance Scheme.⁶⁸¹

Finally, there has been a huge amount of ‘off-budget’ infrastructure spending.⁶⁸² This ‘buy now, pay later’ approach has allowed successive governments to commit about \$50 billion in infrastructure spending over the past decade – including on the NBN, Inland Rail, Western Sydney Airport and the Snowy Hydro share buyback – without any immediate hit to the budget bottom line. With off-budget projects, there must be a ‘reasonable expectation’ that the investment will be recovered over time. But if the numbers on these projects don’t stack up, future taxpayers will be on the hook for today’s bad decisions.⁶⁸³

11.1.3 Challenges around the corner

Longer-term economic challenges – such as an ageing population and climate change – make it all the more important to improve the structural budget balance sooner rather than later.

Long-term forecasts under ‘business as usual’ scenarios suggest improvements in the short-term but a long-term budget blow-out. Without new tax and spending policies to repair the budget, the deficit could reach 6 per cent of GDP – and net debt more than 50 per cent of GDP – by 2055.⁶⁸⁴

The Government has made some difficult choices: the introduction of tax on the income from super balances above \$1.6 million will help

680. Goss (2019).

681. Treasury (2019d).

682. New infrastructure projects can be treated as ‘off budget’ if they occur as equity injections into Public Non-Financial Corporations rather than grants or direct spending. This means that the spending does not affect the government’s bottom line when the project is built, but does so later when interest is paid on debt, net of any dividends (Terrill and D. Wood (2018)).

683. Ibid.

684. Treasury (2015a, pp. xiv–xv).

improve the sustainability of tax concessions for retirement savings – although there is still more to be done (Section 2.2.1 on page 32). Others have fallen by the wayside: the decision to increase the Medicare Levy announced in the 2017-18 Budget⁶⁸⁵ was abandoned in the 2018-19 Budget before it took effect. In 2014, the Abbott Government proposed increasing the retirement age to 70 by 2035, but the change was never legislated and was eventually abandoned by the Morrison Government.⁶⁸⁶

The Government should not rely on historical rates of economic growth to do the heavy lifting on budget repair. Slower economic growth may well be the new normal, and governments should plan accordingly until proven otherwise (see Section 2.1.1 on page 25).

11.2 What we should do

To address the long-term structural budget challenges, the next Commonwealth Government will need to both increase taxes *and* reduce spending. This will require significant budget discipline, so strengthening budget processes, including setting clearer fiscal targets and moving economic forecasting to the PBO would help the government stay on track.

Tax increases and spending reductions are no easy task politically. But the public supports bringing the budget back to surplus. After the 2018 Budget, 56 per cent of Australians surveyed thought more should have been done to reduce the deficit.⁶⁸⁷

Tax changes should raise revenue in the way that generates the smallest drag on the economy. Increasing or broadening the GST, winding back negative gearing and reducing the capital gains tax

685. Daley and D. Wood (2017b).

686. Daley et al. (2018b, p. 53).

687. Essential (2018).

discount would all increase government revenues and improve the tax mix at relatively low economic cost (Section 2.2.1 on page 32).

There is also a case for well-off older Australians to make more of a contribution – well-off retirees pay less tax than working-age Australians on the same income. Chapter 10 outlines proposed changes to superannuation tax breaks, the seniors and pensioners tax offset, private health insurance rebates, the Medicare Levy threshold, and the Age Pension means test.

Spending pressures could be eased by reducing the amount the government pays for pathology and pharmaceuticals under the Pharmaceutical Benefits Scheme (Section 7.2.1 on page 95), doing away with ‘special funding deals’ for schools (Section 8.2.3 on page 109), more rigorous assessment of infrastructure spending (Section 4.2.2 on page 63), and ending wasteful spending on ineffective regional development programs (Section 3.2.2 on page 53).

Better budget institutions can also help strengthen budget discipline.⁶⁸⁸ Two major reforms in the past two decades have improved Australia’s budgeting practices and fiscal accountability: the Charter of Budget Honesty Act 1998 and the creation of the Parliamentary Budget Office (PBO) in 2012. But there is scope for further improvement, as outlined in the following three sections.

11.2.1 Set clear fiscal targets and enshrine them in legislation

Fiscal rules or targets are a useful device for helping governments commit to prudent fiscal policies.⁶⁸⁹

688. IMF (2014a); and IMF (2014b).

689. Pre-commitment can help overcome decision-making bias towards looser fiscal policy, including the political imperatives of election campaigns and short-termism (IMF (2009)).

The Charter of Budget Honesty requires the Government to publish a fiscal strategy statement with each budget in order to ‘*increase public awareness of the Government’s fiscal strategy and to establish a benchmark for evaluating the Government’s conduct of fiscal policy.*’

But in its current form, the Government’s fiscal strategy doesn’t fulfil this objective. Many of the targets are too vague to assess whether the Government has met them – for example, ‘achieve budget surpluses, on average, *over the course of the economic cycle*’, or ‘deliver sustainable budget surpluses building to at least 1 per cent of GDP *as soon as possible*’.⁶⁹⁰

Nor does the Government explicitly report in the budget papers on how it is progressing against its objectives. This appears contrary to the Charter of Budget Honesty⁶⁹¹ and is certainly in contrast to the approach of the government in the years immediately after the introduction of the Charter.⁶⁹² Almost all state governments report progress against their fiscal targets in their budgets.⁶⁹³

Other Commonwealth Government fiscal objectives are in conflict. The Finance Minister recently acknowledged that the Government broke its commitment to bank all budget improvements from changes in the economy. He said this was necessary so the Government could

690. Our emphasis.

691. Section 9(d) of the *Charter of Budget Honesty Act 1998* requires that the fiscal strategy statement specify, for the budget year and the following three financial years: (i) the Government’s fiscal objectives and targets; and (ii) the expected outcomes for the specified key fiscal measures.

692. From the 1999-2000 Budget, fiscal strategy statements included details of progress against each of the government’s fiscal objectives. This explicit reporting stopped in the 2002-03 Budget when the government failed to meet one of its objectives – to keep the tax burden below 1996-97 levels. Since then, reporting against objectives by various governments has been patchy at best.

693. Daley et al. (2018c, p. 10).

meet its objective to maintain the tax-to-GDP ratio at or below 23.9 per cent.⁶⁹⁴

Targets can also be added or removed without notice, at the whim of the government of the day. For example, the 23.9 per cent tax-to-GDP cap was added to the list of fiscal targets in the 2018-19 Budget.

The Commonwealth Government should abandon its current scatter-gun approach to fiscal targets. Fiscal targets should be simple, easy to monitor (*i.e.* it is clear whether or not the target has been met) and aligned with long-term fiscal sustainability.⁶⁹⁵

The best approach would be to amend the Charter of Budget Honesty so the targets are enshrined in legislation. Government should consult (including with the opposition), with an eye to choosing only a small number of simple and measurable targets. For example, the medium-term fiscal target could be to achieve budget surpluses on average over a decade. The government should explicitly report progress on each target in every budget.

11.2.2 Give the PBO responsibility for budget forecasts

Most developed countries now have some type of Parliamentary Budget Office or Fiscal Council, although their responsibilities vary. In many countries, these institutions play a role in assessing government forecasts or publishing alternative forecasts (Table 11.1).

The Commonwealth Government should give Australia's PBO responsibility to produce and publish macroeconomic forecasts that would feed into the government's budget estimates.

Australia's forecasts and projections were systematically optimistic when the economy stagnated, and overly pessimistic when it was going

well.⁶⁹⁶ The excessive optimism of the past decade allowed successive governments to engage in forecast-led denial about the need for budget repair: when the budget is projected to float back to near surplus over the next four years, then it seems less urgent to make politically difficult decisions to improve the bottom line.

Forecasts that are independent of government won't necessarily improve forecast accuracy. Private-sector forecasters demonstrated the same systematic forecast errors as the Treasury over the past decade.⁶⁹⁷ But moving forecasting to the independent PBO would at least remove the question of whether the government is 'cooking the books' to improve its electoral fortunes.

Handing responsibility to the PBO would also improve the transparency around macroeconomic forecasts. Independent fiscal institutions are more likely to publish the assumptions underpinning the forecasts and engage more freely in discussions about significant economic uncertainties – for example, whether current wage stagnation is a structural change or simply cyclical.

Another potential benefit is creating a more orderly budget process. The Office of Budget Responsibility in the UK has noted that since it has taken responsibility for macroeconomic forecasts and monitoring fiscal rules, budget policy measures need to be locked-in at least a week before (rather than the day before) the budget is released.⁶⁹⁸

Concerns that losing responsibility for macroeconomic forecasts would in some way undermine Treasury capability are misplaced. Treasury would retain full responsibility for macroeconomic and fiscal policy advice. Arguably, removing forecasting – a distinct skill-set – would free up resources so Treasury can concentrate on its core remit.

694. Cormann (2018).

695. IMF (2018b).

696. Daley and D. Wood (2017c).

697. Daley (2017, p. 18).

698. R. Hughes (2019, p. 6).

11.2.3 The Commonwealth Government and the states should work together to produce a national IGR

The Commonwealth Government produces an Intergenerational Report (IGR) every five years, to assess the long-term sustainability of Commonwealth policies.

The IGR is an important counterbalance to short-termism in politics. It provides insights into the long-term (40-year) fiscal implications of an ageing population, and highlights the effects of changes in population size, age profile, participation rates and productivity growth on Australia's future standard of living and public finances.⁶⁹⁹

But there is a major weakness: the IGR looks at Commonwealth Government finances only.⁷⁰⁰ Given the strong dependencies between Commonwealth and state budget positions, particularly over the longer-term, the IGR gives at best a partial picture of Australia's fiscal sustainability, and at worst a misleading one.

For example, the 2015 IGR projections assumed that Commonwealth hospital spending would grow in line with inflation and population growth from 2017-18 (*i.e.* real per person spending would be unchanged for four decades).⁷⁰¹ This was in line with the policy introduced in the 2014 Budget (but since amended).⁷⁰² The effect was to make the long-term Commonwealth Budget position look more benign. But given the likely trajectory of health spending,⁷⁰³ the Commonwealth policy implied a rapid increase in state government spending on health and deteriorating state government budget balances – which were not evident in the IGR.

The Commonwealth Government should work with state governments to get agreement for a national IGR that contains long-term fiscal projections across all levels of government. This would make the IGR a more meaningful and useful assessment of the nation's fiscal sustainability.

The national IGR should be produced by the independent Parliamentary Budget Office. Putting the report in the hands of the PBO would remove the risk of the report becoming politicised – a criticism (fairly) levelled at past IGRs.⁷⁰⁴ It would also encourage constructive collaboration between state and federal governments of different political stripes.

699. Treasury (2015a).

700. Wells (2015).

701. Treasury (2015a, pp. 62–63).

702. Treasury (2014, p. 11).

703. Daley et al. (2018c, chapter 10). See also section 1.1.2 of that report.

704. Lyon and Amidharmo (2016); Cowan (2015); and Kirchner (2012).

12 Integrity reforms

12.1 Where we are

Australia is a healthy and well-functioning democracy by global standards. But we are middle-to-bottom among our peers on measures of trust in government, perceptions of corruption, and the transparency and functioning of government (Table 12.1).

There is substantial scope to improve checks on the integrity of Commonwealth Government decision-making.⁷⁰⁵ State governments have led the way with reforms to detect and investigate corruption and to limit undue influence ('soft corruption') by special interests. But the Commonwealth Government has done very little to improve the integrity of its processes in more than a decade.

12.1.1 Trust in government is falling

In Australia – and in many other countries – trust in government is low and falling. In international comparisons, Australia is about middle of the pack on trust (Table 12.1). But Australian cynicism is now at an all-time high – only a quarter of Australians think 'people in government can be trusted to do the right thing' – the lowest since the survey began in 1969 (Figure 12.1).

Widespread loss of trust can make legislating policy change more complex, because it is harder for governments without political capital to enact 'difficult but necessary' reforms. Over time, widespread loss of trust in political institutions can undermine representative democracy.

While there are many causes of falling trust and exasperation with the political establishment,⁷⁰⁶ one is the growing sense that people in

Table 12.1: International scorecard for integrity reforms

	Edelman Trust Barometer 2019	Corruption Perceptions Index 2018	Transparency of government policy making
	<i>% of people who select a positive response</i>	<i>100 = very clean; 0 = highly corrupt</i>	<i>1 = worst; 7 = best</i>
Australia	42	77	5.2
Canada	53	81	5.7
Germany	40	80	5.5
Japan	39	73	5.6
Netherlands	54	82	5.9
New Zealand		87	6.3
South Korea	48	57	3.6
Sweden	46	85	5.5
United Kingdom	42	80	5.6
United States	40	71	5.6

Notes: See Appendix A for notes and sources.

705. A. Brown et al. (2019).

706. D. Wood et al. (2018b, pp. 76–81).

government look after their own interests, or those of powerful groups, rather than the public interest (Figure 12.1).⁷⁰⁷

12.1.2 Commonwealth Government restrictions on special interest influence are weak

Many Australians suspect that interest groups with the resources or connections to lobby or donate to politicians get special treatment. They're right to be concerned – sometimes bad policy is made or good policy is dropped because powerful groups have too much say – and this can have large economic and social costs.⁷⁰⁸

Many other democracies have stronger rules around political donations and lobbying, designed to keep special-interest influence in check. Most OECD countries restrict political donations or expenditure (or both) in some way.⁷⁰⁹ But Australia does not. As a result, there appears to be a lot more private funding in the Australian political system than in other developed nations.⁷¹⁰

Federal political parties rely on a small number of donors for most of their funds. The top 5 per cent of donors contributed more than half of all declared donations to political parties at the 2016 federal election. And a high share of donations came from businesses in industries with the most to gain or lose from government decisions (Figure 12.2 on the next page).

707. D. Wood et al. (2018c); and A. Brown et al. (2019).

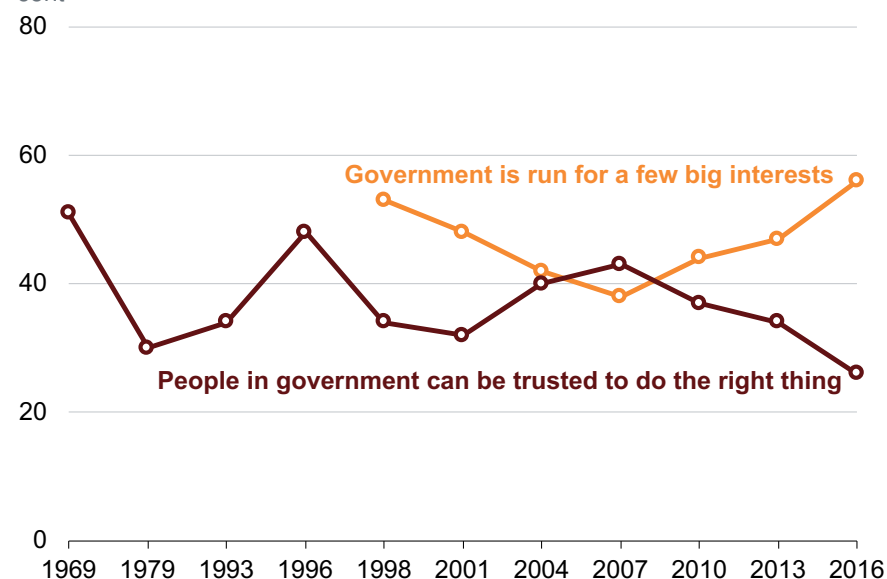
708. D. Wood et al. (2018c).

709. OECD (2016c).

710. Public funding was only 32 per cent of political party funding in Australia at the 2016 election. Private funding from known sources was 26 per cent. The remainder was undisclosed (42 per cent) but if it is largely private donations – which many have assumed – then Australia has remarkably high levels of private funding per person by international standards (D. Wood et al. (2018c, pp. 34–36)).

Figure 12.1: Trust in government is the lowest on record

Respondents who 'agree' or 'strongly agree' with selected statements, per cent



Sources: Cameron and McAllister (2016); see also Markus (2017).

These types of businesses also get more face-time with politicians than other groups⁷¹¹ – compounding the risk of links between money, access, and policy influence.

The Commonwealth Government donations regime often leaves voters in the dark about who donates. The high threshold for declaring donations (\$13,800) combined with the fact that political parties are not required to aggregate multiple donations from the same donor means there is a lot of money we know nothing about.⁷¹² The long lag – up to 19 months – for political parties to disclose the source of their funds prevents timely scrutiny.⁷¹³

The Commonwealth Government is similarly opaque in relation to its contact with interest groups. Only third-party lobbyists are required to list on the Australian Government Lobbyists Register, and Australians are given no information on who Commonwealth ministers meet.⁷¹⁴

Commonwealth ministers give an undertaking not to lobby government for 18 months after leaving office. But the waiting period is an administrative obligation only, it applies narrowly, and there is no penalty for a breach. The UK, US and Canada all have greater transparency and accountability around lobbying activity.⁷¹⁵

711. Commonwealth ministers do not publish their diaries, so Grattan analysed who politicians meet by using the diaries of state ministers in NSW and Queensland. In both states, private interests accounted for more than 60 per cent of senior ministers' external meetings, most of which were with businesses in highly regulated industries (D. Wood et al. (2018c)).

712. 42 per cent of money received by Commonwealth political parties at the 2016 election had no identifiable source (D. Wood et al. (Ibid.)).

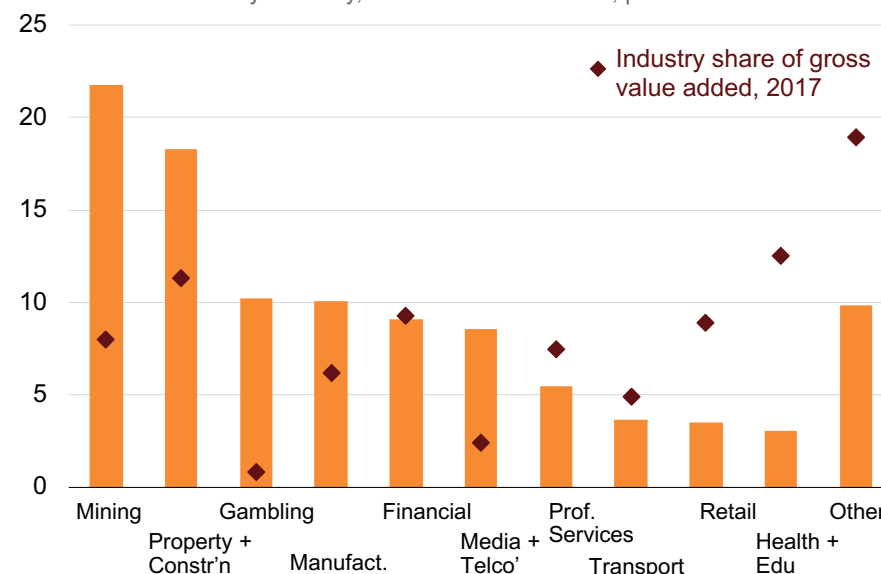
713. D. Wood et al. (2019a).

714. D. Wood et al. (2018c, pp. 18–29).

715. Ibid. (pp. 27–29).

Figure 12.2: Industries with the most to gain or lose dominate corporate donations

Share of donations by industry, 2015-16 and 2016-17, per cent



Notes: Individuals who donated more than \$60,000 have been categorised by industry if publicly available information showed they have financial interests in a given industry. The gambling industry's share of gross value added is calculated as a share of the 'Arts and recreation' sector, although gambling is only a subset of this.

Sources: Grattan analysis of party declarations to the AEC in 2015-16 and 2016-17 (AEC (2018)), and IBISWorld database.

12.1.3 Checks on conflicts of interest are insufficient

The public's trust in politicians has also been eroded by the perception that they don't always act in the public interest. Three quarters of Australians surveyed believe 'people in government look after themselves'.⁷¹⁶

Public cynicism about politicians and their motives is fed by instances of parliamentarians abusing their entitlements⁷¹⁷ and accepting generously paid roles to lobby their former colleagues immediately after they retire.⁷¹⁸

There is also cynicism about the benefits some politicians receive from groups seeking to influence policy. Federal politicians have accepted at least 55 corporate-sponsored overseas trips since 2010, according to analysis by the Australian Strategic Policy Institute of politicians' disclosures.⁷¹⁹ About 68 per cent of federal ministers and shadow ministers have declared corporate-sponsored hospitality (events or travel)⁷²⁰ and 7 per cent have accepted overseas trips sponsored by a foreign government or agency.⁷²¹

716. Cameron and McAllister (2016).

717. In the past five years, two speakers of the House of Representatives and a minister resigned after revelations of car rides to wineries, a helicopter flight from Melbourne to Geelong, and repeated flights to the Gold Coast.

718. A third of registered lobbyists are former government officials and a quarter of all federal ministers and assistant ministers who have left politics since 1990 moved into lobbying roles for special interests after politics (D. Wood et al. (2018c, pp. 20–24)).

719. Clarence (2018).

720. Ministers, assistant ministers, shadow ministers and shadow assistant ministers declared 242 instances of sponsored events and travel, at an average of 2.7 each (D. Wood et al. (2018c, p. 24)).

721. Grattan analysis of all ministers', assistant ministers', shadow ministers' and shadow assistant ministers' declarations, as at August 2018 (D. Wood et al. (Ibid., p. 24)).

Such hospitality can create an actual or perceived conflict of interest. Gifts and benefits can make favoured treatment more likely.⁷²² There are some rules for federal ministers designed to reduce conflicts of interest, but not for other federal MPs.⁷²³ By contrast, all state parliamentarians must abide by a code of conduct (Section 12.1.5), as must all members of the UK Parliament.⁷²⁴

12.1.4 The Commonwealth Government anti-corruption regime is full of holes

Australians are concerned about corruption in politics: in 2018, 85 per cent of voters surveyed thought at least 'some' federal MPs were corrupt.⁷²⁵

Australia has also slipped in Transparency International's Corruption Perceptions Index in recent years.⁷²⁶ The index scores countries on how corrupt their public sectors are seen to be, as measured by surveys of business people, analysts and other experts. Australia is still among the best-ranked countries in the world, but it is the only highly-ranked country to have suffered a significant decline in the index, slipping 8 points between 2012 and 2018 (Figure 12.3 on the following page).

There are major weaknesses in the current Commonwealth regime for investigating corruption in the public sector and political establishment. Several bodies exist with oversight of different parts of the system, but their scope and powers leave significant gaps.⁷²⁷ In particular, half the

722. Axelrod (1986); and Malmendier and Schmidt (2017).

723. Department of the Prime Minister and Cabinet (2018b).

724. Coghill et al. (2008a).

725. This was a telephone poll of 2,218 Australians as part of the Global Corruption Barometer, conducted by Griffith University and Transparency International Australia in May–June 2018 (A. Brown et al. (2018)).

726. Transparency International (2019).

727. A. Brown et al. (2018).

federal public sector is outside the jurisdiction of the Australian Public Service Commission, and no agency is responsible for investigating the conduct of politicians unless a report is made to the Australian Federal Police.⁷²⁸ There is no clear point of contact for members of the public or whistle-blowers to report corruption or misconduct.

The federal anti-corruption regime lacks what every state has – an integrity or anti-corruption commission with scope to investigate suspicious conduct across the whole public sector, including among politicians.

Recognising this, the Government announced in December 2018 that it would establish a Commonwealth Integrity Commission (CIC). This is a step in the right direction, but there are many aspects of the proposal that appear to narrow the scope of conduct that can be investigated or are still unclear.⁷²⁹

12.1.5 The Commonwealth Government is lagging the states

Every Australian state and territory has a stronger integrity regime than the Commonwealth (Table 12.2 on the next page).⁷³⁰

Most states and territories have introduced controls on money in politics – through a cap on political expenditure, or political donations,

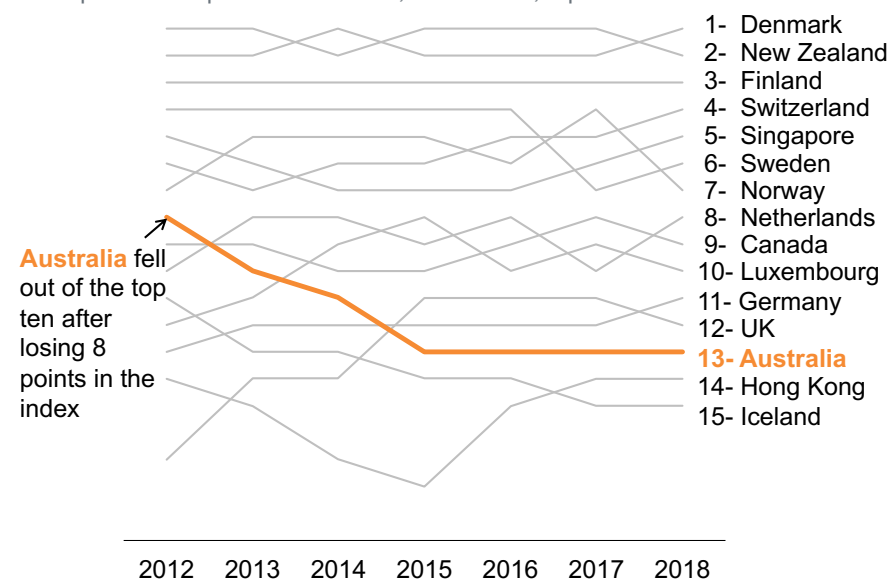
728. For example, the Australian Commission for Law Enforcement Integrity has an Integrity Commissioner, but is currently limited to investigations in the law enforcement arena. The Commonwealth Ombudsman has investigative powers, but investigates complaints made against government departments and agencies rather than the conduct of parliamentarians. The Public Service Commissioner monitors compliance with the Australian Public Service Values and Code of Conduct, but its jurisdiction does not cover parliamentarians. See Appleby (2014) and A. Brown et al. (2018).

729. For example, the proposed CIC would only investigate matters referred by other integrity agencies, leaving a big gap in the federal system; and there is no contact point for tips and information from the public and whistle-blowers. See D. Wood and Griffiths (2019).

730. Daley et al. (2018c, p. 102).

Figure 12.3: Experts say Australia is falling behind on international measures of corruption

Corruption Perceptions Index rank, 2012-2018, top 15 countries in 2018



Notes: The index scores countries on how corrupt their public sectors are seen to be, according to surveys of business people, analysts and other experts. Australia is the only top-ten ranked country to have a statistically significant decline in the index since 2012 (from a score of 85 and a rank of 8th in 2012, to a score of 77 and a rank of 13th in 2018).

Source: Transparency International (2019).

or both. Most state governments are more transparent about their interactions with interest groups – several publish ministerial diaries, some have a more detailed lobbyist register, and most provide much more information on political funding.⁷³¹

The states have also led the way on improving accountability. Every state has an integrity or anti-corruption commission and a code of conduct for members of parliament.

Progress by state governments shows that reforms to boost transparency and accountability in policy making are politically possible and can enhance democratic accountability without creating a substantial administrative burden.

12.2 What we should do

The next Commonwealth Government should improve checks and balances on the influence of special interests and strengthen the accountability of public officials. In particular, it should cap spending on election advertising to reduce the influence of major donors, and boost the transparency of lobbying activity to help keep special-interest influence in check. And whoever wins the election should establish a strong national integrity commission and a code of conduct for all parliamentarians. This would improve accountability and demonstrate real commitment to rebuilding public trust in government.

12.2.1 Cap expenditure on political advertising

Capping political advertising expenditure during election campaigns would reduce the ‘arms race’ between parties and their reliance on major donors.

731. The only state governments to receive a poor rating on transparency are those that adopted the Commonwealth donations disclosure regime (Tasmania and the Northern Territory)(Daley et al. (2018c)).

Table 12.2: States and territories have improved integrity measures, but the Commonwealth lags far behind

	Transparency		Accountability		Limits on campaign finance	
	Score (A: best, E: worst)	Change in past five years	Score (A: best, E: worst)	Change in past five years	Expenditure caps or donations caps?	Change in past five years
NSW	A	↑	A	↑	Both	--
VIC	B	↑	B	↑	Donations caps	↑
QLD	A	↑	A	↑	Neither	↓
WA	C	--	C	--	Neither	--
SA	B	↑	C	↑	Expenditure caps	↑
TAS	E	--	C	↑	Expenditure caps	--
ACT	A	↑	D	↑	Expenditure caps	--
NT	E	--	C	↑	Neither	--
AUS	E	--	D ⁻	--	Neither	--

Notes: The ACT strengthened expenditure caps on parties but weakened caps on third-party political campaigners and removed donations caps, resulting in neutral change. Tasmania has expenditure caps for Legislative Council elections only.

Sources: Grattan analysis of state electoral acts, ministerial codes of conduct, and other sources, Daley et al. (2018c).

Political advertising by other groups, such as unions and industry peak bodies, should also be capped to ensure they cannot ‘swamp’ public debate during election campaigns, at the expense of groups with less money and fewer resources.⁷³²

The cap should be high enough to enable third parties to communicate with voters on policy issues,⁷³³ but not so high as to enable them to drown out all other voices, including political parties.

Some design issues would need to be addressed: establishing how long before an election the cap would take effect, drawing up rules to prevent parties circumventing the limits (including the party in government boosting taxpayer-funded advertisements), and determining appropriate penalties.⁷³⁴

12.2.2 Make political donations more transparent

Three simple changes could make political donations significantly more transparent.⁷³⁵

First, the disclosure threshold should be lowered. At \$13,800 the current figure is well above the amount that an ordinary Australian voter could afford to contribute to support a political cause. A more reasonable threshold would be \$5,000. Donations below this level are unlikely to lead to influence. And such a threshold would still protect the privacy of small donors and minimise the red tape associated with handling smaller donations.

732. D. Wood et al. (2018c, pp. 63–66).

733. Twomey (2015).

734. Twomey (2014) and Joint Standing Committee On Electoral Matters (2011) canvassed some of these issues.

735. D. Wood et al. (2018c, pp. 59–60).

Second, donations from the same donor to the same party, over say \$100,⁷³⁶ should be aggregated and disclosed by the party once the combined total exceeds the disclosure threshold. This would prevent a large donation from being split into many small anonymous donations.

Third, party funding disclosures should be available much sooner. With many states moving to ‘real time’ disclosure during election campaigns,⁷³⁷ it beggars belief that donations could not be disclosed in a similarly timely manner at the federal level.

12.2.3 Publish ministerial diaries

Federal ministers should publish details of all official meetings (in their office and off-site), scheduled phone calls, and events they attend in an official capacity.⁷³⁸ ‘Official meetings’ should include those at which a minister was not present but was represented by a ministerial adviser or advisers. Records of meetings should identify who was present and the key issues discussed.⁷³⁹ To be most useful, ministerial diaries should be published quickly and in an accessible form.

Published diaries would enable journalists and others to see who ministers are meeting – and, perhaps even more importantly, who they’re not meeting. This type of public scrutiny creates pressure for decision makers to think more carefully about who they consult.

Federal ministers and assistant ministers already sign up to a code of conduct which requires that they ‘*ensure that their conduct,*

736. It would be too burdensome to include very small donations (such as the purchase of raffle tickets) in aggregation requirements.

737. There is effectively a seven-day lag in Queensland and South Australia, and 21 days in NSW and Victoria.

738. Queensland, NSW and the ACT already publish ministerial diaries, but could make them more useful and accessible by implementing the recommendations in this section.

739. D. Wood et al. (2018c, pp. 57–58).

representations and decisions as ministers. . . are open to public scrutiny and explanation'.⁷⁴⁰ Publishing ministerial diaries would help ensure they keep this promise.

12.2.4 Broaden the lobbyist register

The Australian Government Lobbyists Register is ineffective in its current form. Its definition of 'lobbyist' is too narrow, there is little incentive to comply, and it relies on politicians to police it.

The register should instead be linked to the sponsored security passes that give holders regular, unescorted access to Parliament House (the 'orange passes').⁷⁴¹

'Orange passes' are granted to people who require 'significant and regular business access' to politicians; this includes the most active commercial and in-house lobbyists. Any lobbyists on the expanded register would be required to comply with the Lobbying Code of Conduct.

12.2.5 Introduce a code of conduct for all parliamentarians

Clear standards around conflicts of interest – as currently exist for federal ministers – should apply to all federal parliamentarians. A code of conduct for federal MPs should at a minimum clarify rules on accepting hospitality, gifts and secondary employment. A broader code would enable the public, media and parliament to hold elected officials to a set standard.⁷⁴²

740. Department of the Prime Minister and Cabinet (2018b).

741. D. Wood et al. (2018c, pp. 58–59).

742. D. Wood et al. (Ibid., pp. 60–61). An example is the Queensland Parliament's Code of Ethical Standards, which is built on the principles of: integrity of the Parliament; primacy of the public interest; independence of members; appropriate use of information; respect for people; and appropriate use of entitlements (Legislative Assembly Of Queensland (2018)).

12.2.6 Administer codes of conduct independently

All codes of conduct for ministers, lobbyists and ministerial staff – as well as any new code that might be developed for all parliamentarians – should be independently administered, to build public confidence that the codes are respected and adhered to.⁷⁴³

An independent body should have an educative role, to help parliamentarians, ministerial staff and lobbyists understand their responsibilities and disclosure obligations.⁷⁴⁴ It should have the authority to investigate potential non-compliance, and the power to make findings and refer breaches when they occur.

A separate ethics adviser should be appointed, to enable current and former parliamentarians to seek advice when they are in doubt.

12.2.7 Establish a national integrity commission

The recently announced Commonwealth Integrity Commission won't help restore public trust in politicians and public officials unless it is better designed, resourced, and supported by other integrity reforms.⁷⁴⁵

At a minimum, a national integrity commission needs to be able to resolve suspicions about serious misconduct. It is unlikely to do so with the limited scope and powers proposed by the Government. Instead, the commission needs to be able to receive tips from the public, media and public officials (including whistle-blowers); to investigate serious misconduct and corruption risks even where they may not ultimately constitute a criminal offence; and to inform the public of the outcome.⁷⁴⁶ Without this broader scope and power, a national integrity commission won't fulfil its intended purpose.

743. D. Wood et al. (2018c, pp. 61–62).

744. It could also play a broader role in professional development, see Coghill et al. (2008a) and Coghill et al. (2008b).

745. D. Wood and Griffiths (2019); and A. Brown et al. (2019).

746. D. Wood and Griffiths (2019).

Appendix A: Metric details

A.1 Economic Development

Gross National Income (GNI) per capita, AUD, PPP, 2017

Sources: ATO (2017) and OECD (2019a) (accessed Jan 2019)

Note: Gross national income (GNI) is defined as gross domestic product, plus net receipts from abroad of wages and salaries and of property income, plus net taxes and subsidies receivable from abroad. This indicator is measured in USD per capita at current prices and PPPs, and adjusted to AUD using average exchange rates for the 2017 calendar year.

Employment rate, per cent, 2017

Sources: OECD (2019f).

Note: Ratio of the employed to the working age population (15-64 year-olds), annual. United Kingdom = Great Britain.

Youth not in employment, education or training (NEET), 15-29 year olds, per cent, 2017

Sources: OECD (2018l).

Notes: NEET = Not in employment, education or training. Young people in education include those attending part-time or full-time education, but exclude those in non-formal education and in educational activities of very short duration. Employment is defined according to the OECD/ILO Guidelines and covers all those who have been in paid work for at least one hour in the reference week of the survey or were temporarily absent from such work. United Kingdom = Great Britain.

Income inequality (P90:P10)

Sources: OECD (2019b).

Note: P90/P10 is the ratio of the upper bound value of the ninth decile (*i.e.* the 10% of people with highest income) to that of the first decile (*i.e.* the 10% of people with lowest income). Although there are known issues with Australian income data at the first *decile*, the tenth *percentile* is more reliable. Income is defined as household disposable income in a particular year.

A.2 Regional Development

Metropolitan population (% of total population)

Sources: OECD (2018g)

Note: Metropolitan areas defined as functional urban areas with a population of greater than 500 000, based on geography of the population's daily commuting patterns.

Metropolitan output (% of national GDP)

Sources: OECD (ibid.)

Note: Metropolitan areas defined as functional urban areas with a population of greater than 500 000, based on geography of the population's daily commuting patterns.

A.3 Housing

Housing (per 1,000 residents aged 20+)

Sources: OECD (2017a, Series HM 1.1)

Note: Housing stock refers to total occupied and unoccupied private dwellings for 2015 for all countries except for the United Kingdom (2014).

Median housing costs (% of disposable income)

Sources: OECD (2017a)

Note: Median housing costs are defined as mortgage burden (principal repayment and interest payments) or rent burden (private market and subsidized rent) as a share of disposable income. Median housing costs are for 2014 for all countries except for Canada (2011) and New Zealand (2017). In New Zealand, Korea and the United States gross income instead of disposable income is used due to data limitations.

A.4 Health

Health care expenditure, per cent of GDP, 2017

Source: OECD (2018m)

Note: Current expenditure on health (all functions), all providers, all financing schemes, as a percentage of gross domestic product.

Life expectancy at birth, total population, years, 2016

Source: OECD (ibid.)

Notes: 2015 data used for Canada.

Out of pocket costs, per cent of household final consumption expenditure, 2017 or latest year

Sources: OECD (2018m) and OECD (2018a)

Notes: 2015 data used for Australia and Japan; 2016 data used for New Zealand and the UK.

A.5 Energy

Residential electricity price, cents per KWh, 2017

Sources: OECD (2018h) and RBA (2018b)

Electricity carbon intensity, tonnes of CO₂e/MWh

Source: IEA (2018)

Notes: Data from 2016. Values may not align with nationally reported emissions intensity due to IEA methodology. This measure uses average carbon content for fuels which varies by source.

Electricity outages, minutes per year

Source: World Bank (2018b)

Notes: Five-year average for the largest business city, except Japan and the US, which are population-weighted two-largest cities. Includes all planned and unplanned outages.

Industry gas price, dollars per GJ

Sources: OECD (2018h), RBA (2018b) and Department of Environment and Energy (2017)

Notes: End-use prices include all the various forms of taxation that affect the final amount spent by end-users. The methodology for the Australian values may be different to the other countries because Australian industry gas prices are not reported in the OECD (2018h) Energy Prices and Taxes report. Australian gas price is the national volume-weighted average. In 2017, the Australian east coast delivered gas price was \$10.08 and the Western Australian price was \$6.97.

A.6 School Education

Spend per student as % of GDP/capita (percentage)

Source: OECD (2018i, Table C1.4)

Note: Total expenditure on educational institutions per full-time equivalent student relative to GDP per capita (2015)

PISA maths 2015 (PISA score points)

Source: OECD (2016a, Figure I1.1).

Notes: Mean score in PISA 2015 Mathematics.

Gap between top and bottom SES quartiles in PISA science 2015 (years)

Sources: OECD (2018i, Table 2.1).

Notes: Translated from PISA points to years of learning using 30 points = 1 year, see Thomson et al. (2017, p. 45).

A.7 Higher education

Higher education attainment rate

Source: OECD (2018i) *Education at a Glance* Figure A1.2.

Notes: Australian data is from ABS *Education and Work* (Cat. 6227.0). Data from other countries is mostly also from household labour force surveys, see OECD (ibid.).

Tuition fees charged by public tertiary educational institutions to national students (USD PPP 2015)

Sources: OECD (ibid.) *Education at a Glance* Figure C5.1. **Notes:**

Tuition fees charged by public tertiary educational institutions to national students, by level of education (2015/16). Some countries have been updated by Grattan Institute and converted to USD PPP 2015 using:

- **Canada:** Statistics Canada. Table 37-10-0003-01. Canadian undergraduate tuition fees by field of study.
- **New Zealand:** NZ Productivity Commission, New models of tertiary education.
- **US:** College Board (USA), Trends in College pricing 2015.
- **Netherlands:** Tuition fees at Dutch universities, <http://studyfinancing.eu/college-guide/education-in-the-netherlands/tuition-fees/>

Part-time enrolment in post-secondary education

Source: OECD (ibid.) *Education at a Glance* Figure B1.3. Part-time enrolment in tertiary education, by age group (2016).

A.8 Retirement incomes

Retirement income: low-middle income earners (% of pre-retirement earnings)

Source: OECD (2017f).

Notes: Calculated using net replacement rates from mandatory (public and private) and voluntary pension schemes. Low-middle income earners are defined as those on 50 percent of average earnings.

Operating expenses of private pension funds (% of total investment)

Source: OECD (ibid.).

Notes: Data cover costs of all pension providers for running pension plans in 2016, unless specified otherwise. Data for Australia, Austria, Canada, Finland, Hungary, Iceland, Norway, Poland, Portugal, Spain and Switzerland refer to pension funds only. Data for Belgium refer to the operating costs of IORPs in 2014. Data for Chile only refer to investment expenses which are borne by pension funds, as administrative costs are borne by pension fund administrators and are not deducted directly from pension funds. Data for Denmark refer to ATP, LD, company pensions, life insurance companies and pension funds held in life insurance companies. Data for Estonia refer to pension funds managing mandatory plans only. Data for Germany refer to Pensionsfonds and Pensionskassen under the supervision of BaFin only in 2015. Data for Greece refer to occupational plans only in 2014. Data for Israel refer to old, new and general pension funds in 2015. Data for Italy refer to contractual pension funds only. Data for Luxembourg refer to pension funds under the supervision of the Luxembourg Financial Supervisory Authority (CSSF) or the Insurance

Commission (CAA) only. Data for Mexico refer to personal plans only. Data for the Netherlands are preliminary and refer to pension funds only. Data for New Zealand refer to 2014. Data for the United Kingdom refer to 2015 and combine investment expenses and administrative costs (breakdown not available). Data for the United States refer to DB plans only.

Total projected spending on pensions 2055 or latest year available (% of GDP)

Source: OECD (2017f).

Notes: Refers to public spending on pensions. Figures are from 2055 for Australia, UK, Germany, Netherlands, and Sweden. Figures are from 2050 for Canada, Japan, Korea, New Zealand, and the USA.

A.9 Budget policy

Central government fiscal balance

Source: OECD (ibid.).

Notes: Reported as a per cent of GDP. Figures are for 2016.

Central government debt

Source: OECD (ibid.).

Notes: Reported as a per cent of GDP. Figures are for 2017 except Japan's, which is for 2016.

Independent forecasts or assessment of forecasts

Source: OECD (2017g).

Notes: Does the country have an independent fiscal institution that assesses forecasts or produces alternative forecasts? Yes/no.

A.10 Integrity reforms

Edelman Trust Barometer 2019

Source: Edelman (2019).

Notes: The Edelman Trust Barometer is a public survey on the trust and credibility of government, media, business and NGOs in 28 countries. Trust in government is reported as the percentage of people who selected a top 4 (positive) response on a 9-point scale. Scores are for 2019 except Sweden's, which is for 2018.

Corruption Perceptions Index 2018

Source: Transparency International (2019).

Notes: The Corruption Perceptions Index scores countries on how corrupt their public sectors are seen to be, as measured by surveys of business people, analysts and other experts. 100 = very clean; 0 = highly corrupt. All scores are for 2018.

Transparency of government policy making

Source: World Economic Forum (2018).

Notes: The 'transparency of government policy making' score is based on the World Economic Forum's Executive Opinion Survey which asks: 'In your country, how easy is it for companies to obtain information about changes in government policies and regulations affecting their activities? [1 = extremely difficult; 7 = extremely easy]'. Scores are for 2017-18.

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