e61 Policy Note | 8 August 2025

POLICY PRIORITIES FOR THE ECONOMIC REFORM ROUNDTABLE

e61 Institute

Executive Summary

The e61 Institute is a non-partisan, not-for-profit economic research institute, born from the motivation to push the knowledge frontier to help tackle the big problems facing our society. To do so we combine innovative data with state-of-the-art tools from economics, data science, and statistics to answer the most important economic questions facing Australia.

This Policy Priorities report highlights relevant e61 research, and analysis of potential policy directions, to help inform the Economic Reform Roundtable's stated goals of improving resilience, productivity, and fiscal sustainability. e61's two-page submission to the Roundtable consultation process can be found here.

To achieve these goals, we provide policymakers with recommendations in **four key areas**:

- **Fostering a more dynamic labour market** through removing unnecessary impediments to labour mobility, and focusing on protecting workers not jobs.
- **Better managing the trade-offs involved in the growing formal care sector** by targeting assistance to those most in need and removing impediments to productivity gains in the sector.
- **Improving the efficiency and resilience of the Australian tax system** through broadening the base of income and expenditure taxes.
- **Enhancing the quality and efficiency of government services** through rethinking the State-Federal relationship and encouraging devolution of service delivery to States where better placed.

Policy changes inevitably have winners and losers – there is no silver bullet or win-win reform that achieves fiscal sustainability and productivity improvements without costs. Government must work to understand, transparently communicate and manage these trade-offs. High-quality research can help here.

Decisions made, and processes established, at the Economic Reform Roundtable should not be seen as the end of the work, nor the only work, required to improve productivity and fiscal sustainability. Ongoing effort and commitment by governments at all levels will be needed to succeed in this difficult reform area. Additionally, many of the problems and potential solutions are not fully understood. Future e61 research aims to shed light on some of these key areas, including in business dynamism, skills and education, housing, social policy and overall fiscal policy.

Fostering a more dynamic labour market to boost productivity

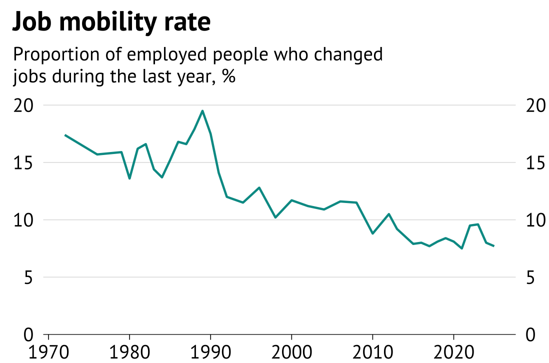
Section summary

Australia's lacklustre productivity performance is partly driven by a decline in labour market dynamism. One clear indicator is the reduction in job switching, which remains near record lows despite a historically tight labour market. To reverse this trend, policymakers should remove unnecessary barriers to job mobility, such as through occupational licensing reforms, alongside the already-announced ban on non-compete clauses. In addition, a greater focus on how the tax and transfer system, rather than the employment system, can support workers insure against risks is needed.

The problem

Australia's economy has become less dynamic over recent decades, with lower firm entry and exit rates, rising industry concentration, and declining labour mobility (Figure 1). A more dynamic economy is critical to boosting productivity and lifting living standards.

Figure 1: Job switching continues to decline

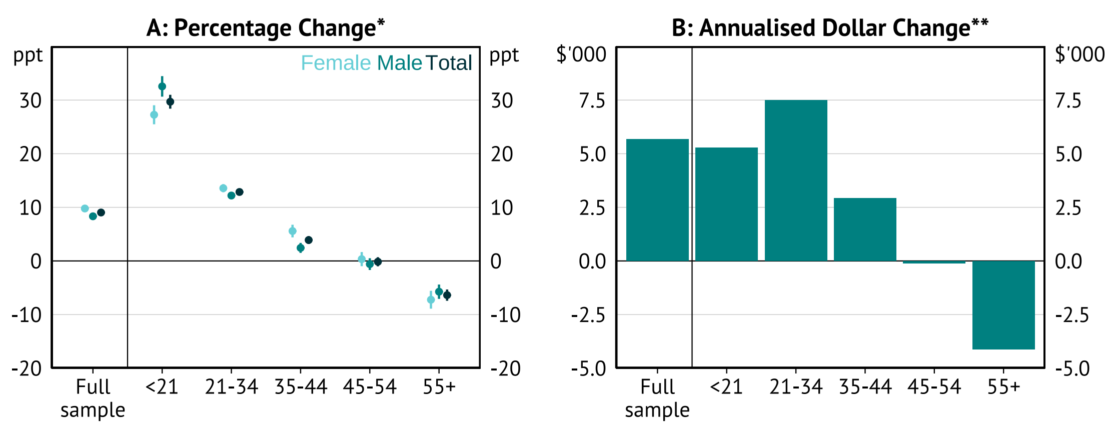


* The job mobility rate is the number of people who changed jobs during the year as a proportion of people who were employed at the end of the year.
Sources: ABS; e61

A key element of a dynamic economy is a flexible labour market, which helps workers find job opportunities that better match their skills and interests. Impediments that restrict workers from switching jobs mean they could be working for firms that underutilise their talents, reducing productivity and wage growth.

Figure 2: Wage gains following job switching

For switchers relative to stayers, by age group



* Panel A presents coefficient estimates from separate regressions. All regressions use STP data from 2020 to 2022 and include Industry x State x Time and SA4 fixed effects.
** Panel B shows the annual median wage gain for job switchers relative to stayers calculated from the estimates in panel A and ABS Employee Earnings and Hours survey data.
Sources: ABS; e61 Institute

These benefits are highlighted in e61 analysis, which shows that workers who switch jobs receive an average increase in earnings of $5,700 relative to workers who do not switch (Figure 2). The largest gains are for workers under the age of 35, highlighting the potential benefits to younger workers.

Despite a tight labour market—where the unemployment rate is at or near full employment—job mobility remains near record lows. This is part of a long-term trend, suggesting that there could be structural barriers to workers switching jobs.

At the same time, Australia has seen a shift towards tighter labour market regulations, making it harder for firms to be flexible with their labour settings. For example, the introduction of the Fair Work Act in 2009 constituted the equal largest tightening of dismissal laws in the OECD. e61 analysis of these changes finds that while they increased job security, they also had unintended consequences – firm productivity declined and worker casualisation increased. This runs counter to the policy principle of protecting workers, rather than protecting specific jobs.

Recent policy decisions—such as the Government's 'same job, same pay' laws—have been in similar vein. This overall tightening of the labour market is shifting the responsibility of economic security from governments (through the existing tax and transfer system) to firms (through the employment system).

Potential solutions

Policymakers should focus on removing unnecessary or inappropriate barriers to job mobility. Banning non-compete clauses for workers receiving under $175,000 annually is a good start. Other options that should be considered are reforms to occupational licensing. These could harmonise occupational licensing differences between States and/or ensure only necessary standards are kept, allowing workers to move more freely between jobs. The Productivity Commission estimates that the latter alone would boost GDP by at least $5.2 billion.

Similarly, reforms that improve recognition of international qualifications and licences should be considered, with the aim of ensuring Australia maximises the positive dividend received from migration and returning citizens. Any policy changes that increase dynamism need to keep in mind support to those who may lose out. The income support system should have a role here, as well as other government supports. By reducing structural barriers and strengthening the safety net, policymakers can foster a more dynamic and productive economy, while managing the trade-offs involved.

Better managing the trade-offs involved in the growing formal care sector

Section summary

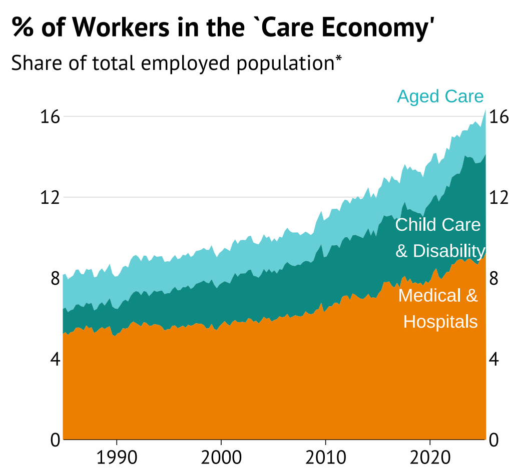
The formal care sector plays an increasingly important role in Australia's economy. Underpinned by substantial government involvement—particularly through the National Disability Insurance Scheme (NDIS)—the care sector provides essential services and enables more informal carers to participate in the paid labour market. However, its rapid expansion has added to Australia's fiscal challenges. As the sector continues to grow policymakers need to carefully manage the trade-offs between care provision and fiscal sustainability, including by acknowledging scarce funding may need to be targeted to those most in need and through efforts to raise productivity in the care sector.

The problem

The care economy is Australia's largest industry, now employing around 16 per cent of workers – growing from 10 per cent in the early 2010s (Figure 3). The growth of the sector has been driven by an ageing population and the rollout of the NDIS. Since the COVID-19 pandemic, the care sector has been the fastest growing part of the labour market, highlighting that it will continue to play a growing role in the economy.

This growth in the formal care sector is underpinned by government intervention and funding, including through the NDIS. The NIDIS is now one of the largest sources of government spending pressures, with expenditure projected to reach 2.3 per cent of GDP in 2035-36, compared to 2.2 per cent for the Age Pension.

Figure 3: Care sector employment



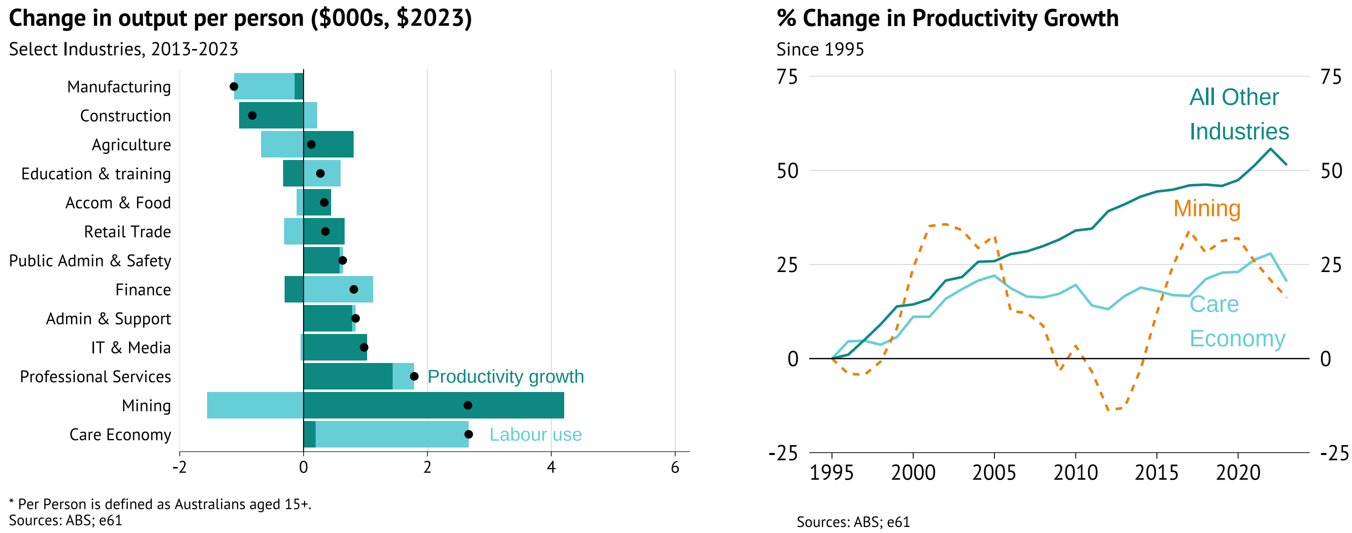
* Note the same worker can be employed in multiple industries.
Sources: ABS; e61

While efforts are being made to cap annual growth in NDIS expenditure at 8 per cent, this target is looking difficult to achieve - in particular once accounting for likely spending elsewhere to secure States' commitments to NDIS reforms. Even if achieved, an annual growth rate of 8 per cent still significantly outstrips growth in the economy and the tax base. And due to capped contributions from the States, the Federal Government shoulders most of these increases. Managing these cost pressures will be critical for overall fiscal sustainability.

Adding to the economic pressures of a growing care sector is that productivity growth in the sector is inherently difficult, and often hard to measure. Many of the services are labour-intensive, including by design through regulated standards, and quality can be hard to improve. As a result, recent growth in the care economy has relied on a large expansion in care workers rather than productivity gains (Figure 4), with e61 analysis showing these workers are largely drawn from other industries rather than from outside the current workforce.

Despite the costs, a formal care sector brings important economic benefits – both direct and indirect. By offering alternatives to informal care, it can enable informal carers, disproportionately women, to remain in or return to the paid labour market.

Figure 4: Sector growth and contributions



Older women are the largest source of informal carers for those with disabilities or health conditions, with around 12 per cent providing this care. Without accessible and affordable formal care services, growing care needs associated with an ageing population would increasingly fall to them. That has the capacity to limit the growth potential of older women's labour force participation, which is an important contributor to overall growth in labour force participation. Unlike men, older women, on average, experience a persistent loss in employment after they become an informal carer. Any proposal to contain the growth of the formal care sector by shifting responsibilities back onto informal carers must grapple with these trade-offs.

Potential solutions

The care sector is only set to expand, driven by the NDIS and demographic trends. Managing this growth will require focusing on how support is best used and finding ways to improve productivity within the sector.

In the immediate future, government spending in the care economy will be driven by the NDIS. Policymakers should consider reforms to the NDIS that acknowledges that funding is scarce and requires some mechanism to target support to those most in need. This could include approaches such as applying a more restrictive eligibility criteria for the types of disability covered under the scheme (in-line with the principle of the 2023 National Cabinet commitment), or exploring the use of household-based means-testing for certain types of participants. The latter is in-line with established principles in government delivery of welfare payments, health funding and education funding, which have also recently been applied to the aged care sector.

The Federal Government could look to also better align incentives for States and Territories by removing all caps on their funding contributions.

At the same time, moves that may assist or incentivise lifting productivity in the care sector would be beneficial. Areas to explore include better tying funding models in the care sector to outcomes (where appropriate), encouraging investments in technology, and supporting the flow of good ideas and efficient practices in the care sector.

Ensuring our tax base is as efficient as possible

Section summary

An ageing economy, more frequent economic crises, and growing public demand for services are all putting upward pressure on government spending. At the same time, technological change and the growing use of tax expenses by government are eroding the tax base. In order to fund government services at the lowest economic cost, principled reform of the tax system is necessary - with broader income and consumption taxes a priority.

The problem

Irrespective of spending choices made, population ageing and rising pressure to invest in defence guarantees that government expenditure relative to GDP will remain historically elevated. Given these expenditure pressures, the question of how to raise the necessary revenue at the lowest cost is more necessary than ever.

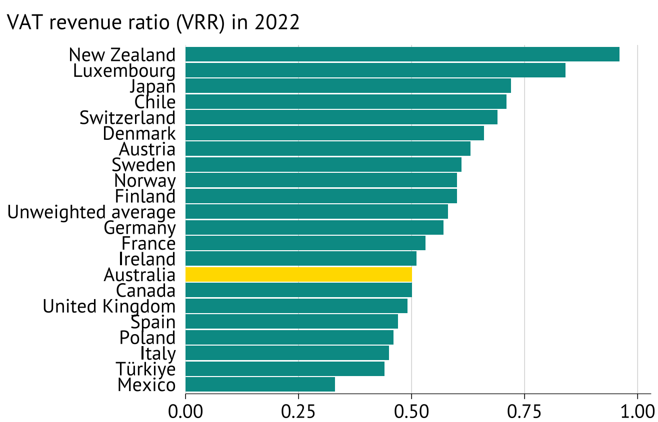
There are two primary revenue bases for the government – consumption expenditure (the Goods and Services Tax, GST) and comprehensive income. Realistically, these are the only taxes that can provide the government with revenue large enough to meet expenses.

Both the income and consumption tax base are currently relatively narrow in Australia – that is they do not apply to all the elements that could be taxed within their base. This affects the ability for these taxes to raise revenue and undermines the equity and efficiency of the tax system by incentivising individuals to change behaviour to reduce their tax liability.

Consumption taxes

For a consumption tax (i.e. GST), the ratio of revenue raised relative to a system that taxes all domestic consumption is 0.5 in Australia, compared to an average of 0.58 in the OECD and 0.96 in New Zealand (Figure 5). This highlights Australia's narrow consumption tax base. At face value this suggests that roughly replicating the New Zealand consumption tax base would double GST revenue, and within part of a broader tax-mix switch could be implemented without sacrificing economic activity.

Figure 5: Australia's consumption tax base is relatively narrow



* VRR refers to the ratio of the revenue raised from the VAT/GST system relative to a flat rate applied to final consumption.
Source: OECD

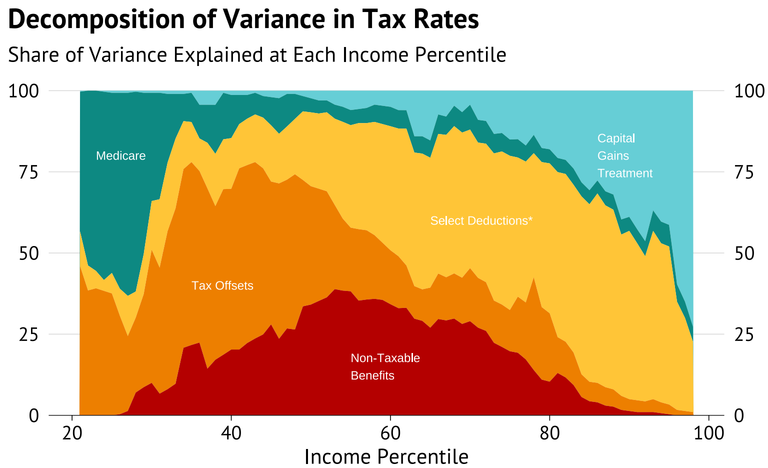
In principle, a broad GST is economically equivalent to a tax on labour earnings plus a one-off tax on existing wealth. This should help alleviate some concerns around distributional consequences of consumption taxes through taxing higher wealth individuals, particularly when combined with a progressive income tax and transfer system. Additionally, when considered over the lifecycle such taxes are largely distributionally neutral according to OECD work.

Comprehensive income taxes

A broad-based comprehensive income tax system treats a dollar as a dollar, irrespective of how it is earned. Viewing this as someone's ability to contribute to government spending, this implies those with the same incomes should pay the same tax (horizontal equity) and those with more income should contribute proportionally more (vertical equity).

However, arbitrary tax-breaks and inconsistent treatment of different ways of earning capital income suggests that the income tax system does not meet these principles, as shown by recent e61 analysis (Figure 6). Work from the Tax Transfer Policy Institute highlights how these distortions are both inequitable and distort people's investment, saving, and work decisions.

Figure 6: Capital gains treatment affect tax rates faced



* Select Deductions refer to the gifts/donations deduction, election expenses deduction, and the lower tax rate applied to voluntary superannuation contributions. The total variance explained above is only the variance explained by these items. As such, some other parts of the tax system that drive variance - for example losses from previous years - are not included here.
Sources: ABS; e61

There are reasons for not taxing capital and labour income in the same way. In principle, the normal return to saving should not be taxed as inflation already erodes returns and saving involves waiting to consume, so taxing capital income composed of these factors could be seen as unfair or distortionary. However, this does not rationalise why Australia taxes the capital gains from owner-occupied property differently from other capital gains, and those gains differently to other capital income.

Additionally, government incentives and expenditures have become increasingly common in the tax base – eroding the integrity of the tax system and making government expenditure less transparent.

Potential solutions

The required revenue for a given level of government expenditure should be raised in the lowest cost way. Tax reform options that support this goal would start by focusing on broadening the consumption and income tax bases.

To this end, policymakers should consider broadening the GST to all final goods and services, with an increase in transfer payments to offset any distributional concerns. Following this, consideration could be given to increasing the GST rate to decrease reliance on other taxes.

Policymakers should also consider changes that broaden the income tax base, in particular the consistent treatment of all capital earnings in the tax system.

Incentive-based tax expenditures, such as the Production Tax Incentives, should be removed from the tax base and forced to face a standard cost-benefit process as an item of government expenditure.

Making our Federation work

Section summary

Responsibilities between different levels of government in Australia are becoming less clear — with blunt Federal policy settings increasingly intervening in State-level service delivery. The growing size of less targeted social transfers in-kind are increasing the cost of service provision, and failing to target those most in need. Devolving responsibility for the provision of these services could help to both mitigate cost pressures and improve outcomes for the most vulnerable.

The problem

The No Worse Off GST deal, NDIS, and growing federal funding of childcare have highlighted growing fuzziness in the different responsibilities of State and Federal governments.

In simple terms, the Federal Government tends to raise revenue using broad instruments and offer relatively broad spending initiatives associated with a strategic policy area. State government is more operational in nature, and offers more bespoke administrative solutions to state specific policy concerns, receiving a large degree of funding from the Federal Government. The difference in revenue raising ability and responsibility for spending at different levels of government is often termed the vertical fiscal imbalance.

This distinction can create conflict when responsibilities—either in the policy setting or in the public's view—are unclear.

Revenue responsibilities

As structured, the demarcation of revenue raising responsibilities makes sense. Federal authorities levy consistent taxation of income and expenditure across States – raising revenue relatively efficiently due to economies of scale in the administration and operation of such taxes. A portion of this revenue is then reallocated to the States to allow them to administer a consistent minimum level of service.

Additional State-level expenditures then rely on State specific taxes – such as stump duty, payroll tax, and in some cases land-value taxes. This structure ensures that the marginal cost of additional spending falls on the States, incentivising them to consider the trade-offs associated with such spending. But the revenue instruments used by States tend to be relatively inefficient. Stamp duty, in particular, restricts housing mobility and has a high marginal effective burden relative to other taxes.

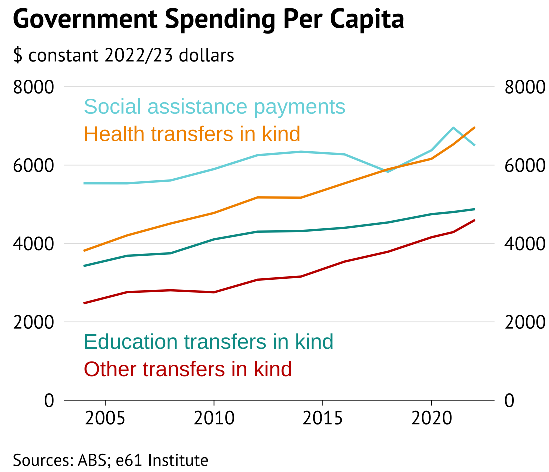
Expenditure responsibilities

Federal and State responsibilities for significant social outcomes—related to health, education, and housing—are mixed. Traditionally, State governments had an administrative and operational role in the provision of services within that state, with the Federal Government offering largely unlinked funding to provide the State the opportunity to prioritise and find efficiencies in its spending decisions.

However, the growing prevalence of social transfers in-kind reflects a willingness by Federal governments to step over the States to meet objectives relating to these policy areas (Figure 7). Given the fiscal instruments available to the Federal Government, these transfers take the form of direct income payments or vouchers for service. However, carte-blanche expenditures of this nature are often an inefficient means to meet these objectives. Recognising this there has also been a growing trend towards providing tied grants to States, providing hypothecated funding for specific purposes.

The increasing centralisation of attributes of service responsibility does encourage harmonisation of services across States, which may be seen as equitable, but also reduces the ability for States Governments to represent the diverse views of their constituents relative to Australia at large. Furthermore, such centralisation undermines the use of State administrative and operational capacity to provide service oversight and market stewardship. Their greater ability to structure and target need in programs may both improve performance and reduce the fiscal cost of such schemes.

Figure 7: Growing prevalence of Federal in-kind spending



Potential solutions

The solution to unclear delineation of responsibilities between Federal and State governments is not further hypothecation of revenue raising towards Federal or State functions, but a clearer demarcation of responsibilities with regards to the most effective administrative function for the task at hand. Policymakers should consider whether devolution of responsibility for particular services, such as childcare, to the States could help to improve service delivery and manage growing fiscal pressures through better using their administrative and operational capacity.

Federal support for States to change their tax mix, such as replacing stamp duty with a land tax (and payroll tax for a cash flow tax), should be considered with potential longer-term impacts on productivity and consolidated budget sustainability.

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