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Australia's marginal tax rates, tax offsets and the Medicare levy

Keldon Pattugalan and David Ellis¹

Australia has a progressive personal income tax schedule with a seemingly simple five rate structure (including a zero rate). Overlaying the statutory tax schedule are more than 40 offsets designed to reduce tax liability for certain taxpayers. These offsets add complexity to the tax system and result in a person's tax liability being determined by several factors, not just their level of income as implied by the statutory schedule.

In this article, we discuss the adverse impacts of high levels of tax system complexity and list the offsets which are available in the personal income tax system. We describe the operation of the low income tax offset and the Medicare levy to illustrate how offsets and other features of the tax system can add complexity and reduce transparency.

1 The authors are from the Tax System Division, the Australian Treasury. This article has benefited from comments and suggestions provided by numerous colleagues, particularly Chris Barron, Aaron Bennett, Conan Brownbill, John Burge, Greg Clark, Anna Dawson, Amy Little, Daniel Nethery, Ed O'Halloran, David Parker, Greg Pinder, Sam Reinhardt, Mathew Toohey and Sean Vittadello. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

Since the introduction of income tax at the federal level in 1915, Australia has had a progressive personal income tax schedule.² The earliest income taxes in Australia took the form of 'continuous income taxes', where each successive pound of income was taxed at a slightly higher rate. By the 1950s there were 29 tax rates and a top rate of 75 per cent. By the late 1970s the rate schedule had been stripped back to four rates with a top rate of 61.5 per cent.

Australia now has five published, or statutory, rates (including the zero marginal tax rate), making for a relatively simple rate schedule. However, overlaying the statutory schedule are over 40 tax offsets and the Medicare levy and Medicare levy surcharge. The tax offsets range from those which are claimed by large numbers of tax payers, such as the low income tax offset (LITO) to the relatively obscure (for example, dependent child housekeeper tax offset). Each offset has its own set of rules covering thresholds, withdrawal rates, value and interaction with other parts of the tax system.

The Australia's Future Tax System (AFTS) Review Panel (2009) recommended that tax offsets which alter personal income tax scales for a large number of tax payers, and the Medicare levy, be removed and incorporated into the personal income tax rate scales (Recommendation 5). It also recommended that most other tax offsets be replaced or rationalised in order to remove complexity and ensure that assistance is properly targeted (Recommendation 6). The Panel considered that both tax offsets and the Medicare levy introduce unnecessary complexity into the tax system and that tax offsets are not the most transparent, timely or well targeted mechanism for delivering assistance.

² A progressive tax rate schedule is one where the tax rate increases, at set thresholds, as the taxable amount increases. This has the effect of increasing the average rate of tax paid.

In this paper we list the tax offsets available in the personal income tax system. As an illustration of how the personal income tax schedule can be affected by these offsets, we describe the operation of two of the most widely applicable features of the income tax system – the LITO and Medicare levy (for the 2009-10 income year³). We show that these two features introduce complexity into the tax system and move effective tax rates away from the simple five-rate schedule to a nine-rate schedule which has both increasing and decreasing marginal tax rates.

We begin with a description of Australia's statutory personal income tax schedule and a discussion of the costs, in general, of complexity and reduced transparency in the tax system.

Australia's marginal tax rate schedule

Personal income tax is the single largest source of tax revenue and provides over 40 per cent of total Australian Government revenue collections and over 30 per cent of revenue from all levels of government (ATO 2010).

Australia has a progressive personal income tax system, achieved with a tax free threshold and four rising tax rates above this (shown in Table 1). Progressive personal income tax systems are commonplace throughout the OECD, with all but three of the 32 OECD countries adopting some form of progressivity in 2009 (OECD 2010).⁴

Chart 1 shows statutory and average tax rates over the income range of \$0 to \$200,000 and clearly shows the 'stepped' increases in the statutory rate scale.

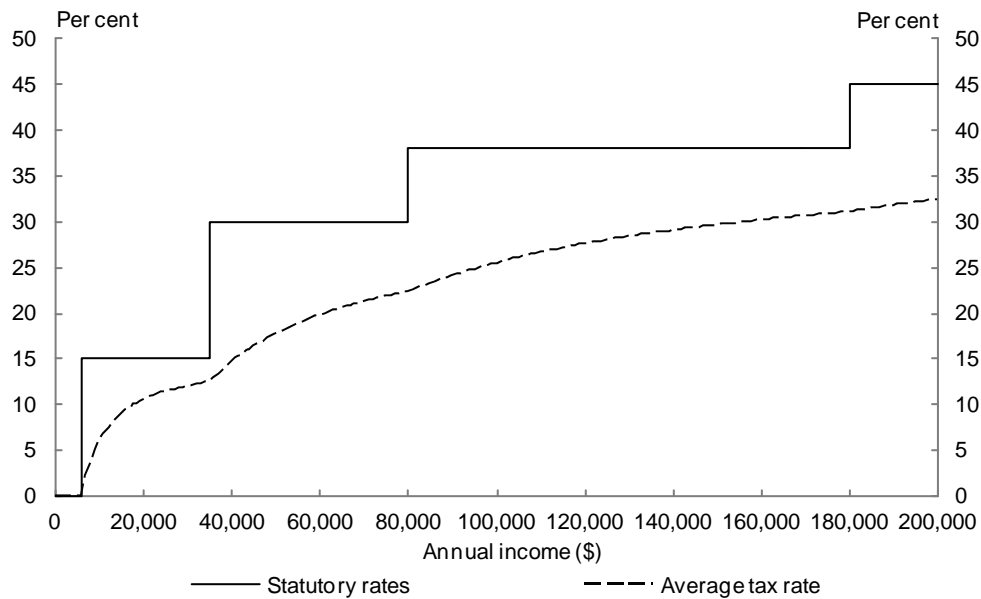
Table 1: Statutory tax rates 2009-10

Statutory	
Income level	Marginal tax rate (per cent)
\$0 - \$6,000	0
\$6,001 - \$35,000	15
\$35,001 - \$80,000	30
\$80,001 - \$180,000	38
Above \$180,000	45

3 As the Medicare levy low-income threshold (discussed later) is usually adjusted and published in May of each financial year, 2009-10 rates are used in this paper to ensure consistency between the statutory tax rates, LITO and Medicare levy. The tax schedules used in this paper are for Australian resident taxpayers only.

4 The Czech Republic, Iceland and the Slovak Republic have flat rates of tax.

Chart 1: Statutory marginal and average tax schedule 2009-10



At this point it is useful to define some concepts used in this paper. **Statutory marginal tax rates** are the legislated personal income tax rates as shown in Table 1. They are the amount of tax paid on each additional dollar earned over a threshold level in the absence of other taxes or transfers. For example, from the statutory rates in Table 1, an individual earning \$35,001 per year has a marginal tax rate of 30 per cent and pays 30 cents of tax on the next dollar they earn. **Effective marginal tax rates** are the amounts of tax an individual pays on an additional dollar of income when all other government taxes, offsets and transfer payments are taken into account. Finally, **average tax rates** are the total amount of an individual's tax divided by their total income.

Transparency and complexity

In a recent address, the Secretary to the Treasury noted that '... the [Australia's Future Tax System] review panel identified the complexity of the tax and transfer system as one of the key areas that posed a challenge to the equity, efficiency and sustainability of the tax system.' (Henry 2010).

While there is no single, universally accepted measure of complexity, making it difficult to determine actual levels, a large amount of complexity can create difficulties for those who interact with it.

A high level of complexity in the personal income tax system can reduce its transparency, making it difficult for individuals to understand its impact or respond to

intended incentives. Dunstall and Reeson (2009) argue that when faced with complexity or uncertainty, individuals delay or avoid making decisions, choose (less than optimal) defaults and are more likely to follow misleading advice.

A highly complex tax system can create costs for taxpayers attempting to understand it. Individuals may be eligible for a number of offsets, depending on their characteristics and personal situation, not all of which are automatically applied. This provides opportunities for some taxpayers to pay less tax than similar individuals if they have greater knowledge of the tax system or the resources to acquire it, such as through engaging a tax agent.

Rather than bearing the costs of trying to understand the tax system, or paying an agent to meet compliance requirements, some individuals may provide inaccurate information, choose not to comply or pay more tax than they are required to. The AFTS Review noted that complexity has its greatest impact on those with the least capacity to deal with it (Australian Treasury 2008).

Holtzman (2007) finds that complexity and a lack of transparency can magnify doubts about a tax system's fairness and decrease public confidence in a country's tax laws and administration. Holtzman explains that if taxpayers do not believe that the tax system is credible, fair and easy to understand, voluntary compliance is likely to decline. Complex tax systems can also make it difficult for policy makers to effectively design policies while avoiding complex and unforeseen interactions between different parts of the tax system.

The AFTS Review Panel (2009) discussed two broad approaches to addressing complexity. The first approach is to address complexity directly through changing the structure of the tax system itself. The second approach involves improving the interface between citizens and the tax and transfer system in order to filter the complexity in the underlying system. An example is the increased use of 'pre-filling' where third party information is provided to the Australian Taxation Office to be included in taxpayers' returns.

These two broad approaches are not mutually exclusive and can be pursued simultaneously. However, it is important to ensure that in progressing the user interface approach sufficient attention is paid to reducing the underlying causes of complexity. Even the best designed system is unlikely to have an unlimited capacity to absorb complexity while maintaining a simple interface for end users.

The Australian tax system includes over 40 tax offsets, all of which have their own rules and consequences. Taxpayers are also required to pay a Medicare levy with complicated phase in arrangements and differential treatment for singles and couples.

Australia's marginal tax rates, tax offsets and the Medicare levy

This introduces complexity and reduces the transparency of the tax system creating higher compliance costs for taxpayers and administration costs for the government.

This paper examines the low income tax offset (LITO) and the Medicare levy (as they affect the majority of Australian tax payers) to illustrate the complexity that can be introduced into the tax system.

Tax offsets

A tax offset is a mechanism for providing targeted tax relief to taxpayers with particular characteristics or particular types of income or expenses. Offsets reduce the amount of tax which a taxpayer is otherwise liable to pay. In contrast, deductions reduce the amount of taxable income on which a taxpayer has to pay tax.

More than 40 tax offsets have been introduced into Australia's personal income tax system by successive governments to provide benefits to particular groups of people.

The purpose of these offsets varies quite significantly, for example:

- The LITO has the effect of increasing the tax free threshold for low income earners only.
- The pension income tax offset and the beneficiary tax offset ensure that tax is not payable by certain taxpayers on transfer payments.
- The mature aged worker tax offset aims to encourage mature aged workers (aged 55 and over) to stay in the workforce.
- The entrepreneurs tax offset aims to provide tax relief to the owners of small businesses with annual turnover less than \$75,000.
- The medical expenses tax offset and the education tax offset reduce the costs of medical expenses and educating children, respectively.

As illustrated above, tax offsets use the tax system to achieve policy objectives such as promoting progressivity, rewarding or encouraging certain types of behaviour or to reducing the costs of certain expenses.

The effectiveness of tax offsets to provide assistance can be limited as they only benefit people with a tax liability. Also, to the extent that tax offsets are not readily understood, and so are not claimed by all taxpayers who are eligible to claim them, their effectiveness can be reduced.

Offsets also introduce complexity into the tax system as they result in a person's tax liability being determined by a range of factors (for example, residential location, age, and living arrangements) other than their level of income. Thus there is a trade off between providing assistance through tax offsets and the complexity that they introduce.

The major tax offsets, their total value to taxpayers and the number of recipients for the 2007-08 income year are shown in Box 1. A list of other tax offsets that are available to Australian taxpayers are in Attachment A.

The low income tax offset

The LITO is the most widely available offset and is effective for all resident taxpayers who have incomes below \$63,750 (in 2009-10). In 2007-08 the LITO was received by around 6.9 million taxpayers (ATO 2010).

The LITO was originally introduced in 1993 as a maximum non-refundable offset of \$150. It has been increased several times since 2003-04 and now provides a maximum non-refundable offset of \$1,350 in 2009-10⁵ for taxpayers with incomes of \$30,000 or less.⁶ This provides lower income earners with a higher effective tax free threshold (\$15,000 compared with a statutory threshold of \$6,000). For incomes above \$30,000, the LITO amount is clawed back (tapered) at a rate of four cents in the dollar until it completely phases out at \$63,750.

The effect of the LITO on the tax schedule is shown in Chart 2. Individuals with incomes between \$30,000 and \$63,750 face higher marginal tax rates than would be the case if only the statutory marginal rates were applied. Chart 2 shows that marginal tax rates rise and fall as income increases, a move away from the 'stepped' scale given by the statutory rates (though average tax rates continue to rise with income).

The LITO reduces transparency as it makes it more difficult for taxpayers to understand what their marginal tax rate is at any given level of income. The statutory marginal rates are readily available on the Australian Taxation Office website; however, the effective rates incorporating the LITO are not.

5 This amount has increased to \$1,500 in 2010-11.

6 In contrast, the tax free threshold has remained at \$6,000 since 2000-01.

Box 1: Major tax offsets (2007-08 income year)

Offset	Value of entitlement (\$million)	Number of recipients
Franking tax offsets	11,381	3,484,210
Low income tax offset	3,714	6,867,635
Senior Australians tax offset	1,239	652,530
Termination payment tax offset	840	145,060
Spouse tax offset	648	401,625
Superannuation contributions tax offset	580	227,280
Mature age worker tax offset	546	1,264,380
Pension income tax offset	495	302,695
Medical expenses tax offset	493	766,095
Private health insurance tax offset ^(a)	259	259,320
Zone and overseas forces tax offset	258	591,910
Entrepreneurs' tax offset	184	397,785
Beneficiary tax offset	149	293,935
Averaging tax offset	130	85,655
First child tax offset	95	175,650

(a) This refers to the amount of the private health insurance rebate which is claimed as a tax offset in tax returns. The majority of taxpayers claim the rebate as a reduction in premiums payable.

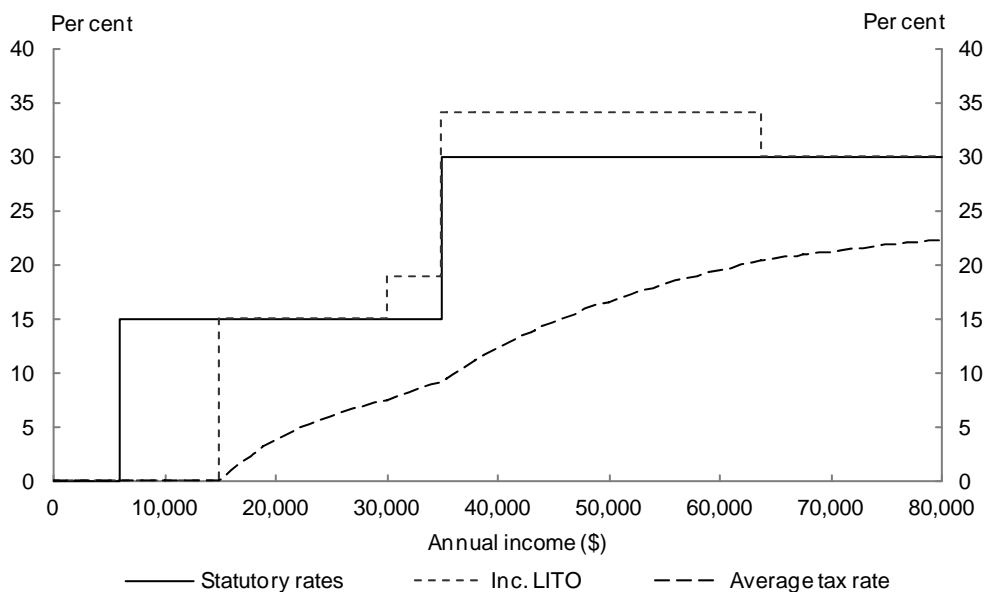
Source: Australian Taxation Office 2010, *Taxation Statistics 2007-08*, Personal tax, Table 14, Part D Tax offset items.

Table 2: Statutory tax rates and effective tax rates including LITO 2009-10

Statutory		Effective rates including LITO	
Income level	Marginal tax rate (per cent)	Income level	Marginal tax rate (per cent)
\$0 - \$6,000	0	\$0 - \$15,000	0
\$6,001 - \$35,000	15	\$15,001 - \$30,000	15
\$35,001 - \$80,000	30	\$30,001 - \$35,000	19
\$80,001 - \$180,000	38	\$35,001 - \$63,750	34
Above \$180,000	45	\$63,751 - \$ 80,000	30
		\$80,001 - \$180,000	38
		Above \$180,000	45

The LITO also interacts with other parts of the tax system. For example, through its interaction with the unearned income of minors, the LITO effectively allows an increase in the amount of unearned income (such as a distribution from a trust) that a minor can receive which is not subject to tax (from \$416 to \$3,333 for the 2010-11 income year).

Chart 2: Effective rates including LITO 2009-10^(a)



(a) Annual incomes up to \$80,000 shown. The marginal tax rates above \$63,750 are unaffected by the LITO.

Medicare levy

The Medicare levy is a levy of 1.5 per cent on all taxable income.⁷ It was originally introduced in 1984 to assist with funding the Medicare system. In 2008-09, the Medicare levy raised around \$8 billion. With the cost of Medicare for 2008-09 at around \$19 billion, the majority of its funding is met from general tax revenues. The following discussion explores the Medicare levy and the complexities that it introduces into the effective tax rate schedule.

Medicare low-income threshold for individuals

The Medicare levy low-income threshold provides an exemption from the Medicare levy for people with incomes below \$18,488⁸, higher thresholds apply for taxpayers eligible for the Senior Australian tax offset and the Pensioner tax offset. To date, the government has increased the Medicare low-income threshold each year in line with CPI growth.

Between \$18,488 and \$21,750 the Medicare levy is effectively shaded-in and collected at a rate of 10 per cent of taxable income. The shade in is effectively a revenue catch-up

⁷ Certain superannuation lump sums are exempt.

⁸ For the year 2009-10.

Australia's marginal tax rates, tax offsets and the Medicare levy

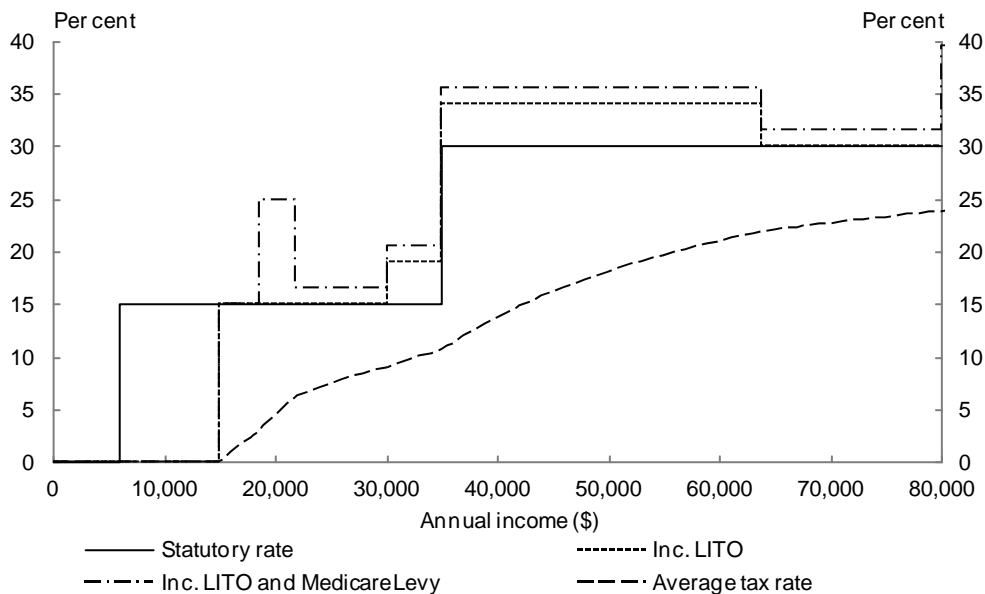
for incomes above the Medicare levy low-income threshold. Once the amount of Medicare levy paid is equivalent to 1.5 percent on all income (at \$21,750), the standard Medicare levy rate applies.

The low-income threshold and shade-in range increases the number, and level, of effective tax rates and decreases the transparency of the marginal tax rate schedule. Table 3 shows the tax rate schedule for a combination of the LITO and Medicare levy for a single individual with no dependants. The LITO and Medicare levy combine to produce nine marginal tax brackets.

Table 3: Marginal rates of tax for an individual with no dependants 2009-10

Statutory		Effective rates including LITO		Effective rates including LITO and Medicare levy	
Income level	Marginal tax rate (per cent)	Income level	Marginal tax rate (per cent)	Income level	Marginal tax rate (per cent)
\$0 - \$6,000	0	\$0 - \$15,000	0	\$0 - \$15,000	0
\$6,001 - \$35,000	15	\$15,001 - \$30,000	15	\$15,001 - \$18,488	15
\$35,001 - \$80,000	30	\$30,001 - \$35,000	19	\$18,489 - \$21,750	25
		\$35,001 - \$63,750	34	\$21,751 - \$30,000	16.5
		\$63,751 - \$80,000	30	\$30,001 - \$35,000	20.5
		\$80,001 - \$180,000	38	\$35,001 - \$63,750	35.5
		Above \$180,000	45	\$63,751 - 80,000	31.5
				\$80,001 - \$180,000	39.5
				Above \$180,000	46.5

Chart 3: Effective rates for a single individual with no dependants 2009-10^(a)



(a) Annual incomes up to \$80,000 shown. The marginal tax rates above \$63,750 are unaffected by the LITO and would simply be 1.5 per cent higher than the statutory rates.

Medicare levy — schedule for couples and those with dependants

In contrast to the statutory personal income tax rates which apply to individual income only, there is a mixture of income treatments for individuals and families for Medicare levy purposes. The levy paid by an individual is determined by reference to their marital status, number of dependants, income, partner's income and, depending on certain conditions, the ratio of these incomes. For example:

Andrew and Rebecca are married with no children. Andrew earns an annual income of \$19,000 and Rebecca earns \$17,000. In this situation Rebecca would not be liable for any Medicare levy but Andrew would pay a levy reduced by a 'reduction amount' from the levy otherwise payable. The reduction amount equals 1.5 per cent of the relevant family income threshold minus 8.5 per cent of the excess of the family income over the threshold (in this case, the reduction amount is \$59.60). The levy otherwise payable by Andrew is \$285 (1.5 per cent of \$19,000) which falls to \$225.40 once the reduction amount is subtracted.

However if Andrew's annual income increases by \$800 to \$19,800, the levy payable is 1.5 per cent of the family income, or \$552 (1.5 per cent of \$36,800).⁹

This example shows the difficulty in identifying which levy bracket the family falls into. It also highlights the distortions created by the shade-in process. The increase in Andrew's income leads to a disproportionate increase in levy payable. A small increase in Andrew's annual income doubles the Medicare levy for which his family is liable.

Table 4 and Chart 4 illustrate the effective marginal tax rates for a person with two children and a partner who earns \$17,000. This shows an underlying nine-rate schedule that is significantly different from the five-rate statutory schedule. In this situation the Medicare levy shade-in 'spike' occurs at a higher income.

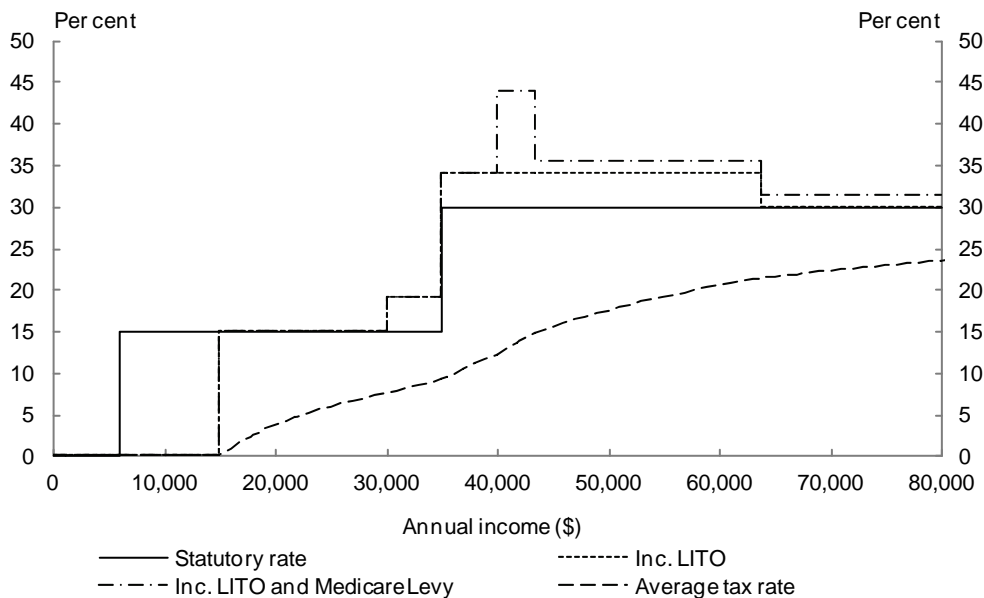
⁹ Refer to *Australian Master Tax Guide 2010*, p 43.

Table 4: Marginal tax rates for an individual with two dependants and a partner who earns \$17,000 per year 2009-10

Statutory		Effective rates including LITO		Effective rates including LITO and Medicare levy	
Income level	Marginal tax rate (per cent)	Income level	Marginal tax rate (per cent)	Income level	Marginal tax rate (per cent)
\$0 - \$6,000	0	\$0 - \$15,000	0	\$0 - \$15,000	0
\$6,001 - \$35,000	15	\$15,001 - \$30,000	15	\$15,001 - \$30,000	15
\$35,001 - \$80,000	30	\$30,001 - \$35,000	19	\$30,001 - \$35,000	19
\$80,001 - \$180,000	38	\$35,001 - \$63,750	34	\$35,001 - \$39,963	34
Above \$180,000	45	\$63,751 - \$80,000	30	\$39,964 - \$43,484	44
		\$80,001 - \$180,000	38	\$43,485 - \$63,750	35.5
		Above \$180,000	45	\$63,751 - \$80,000	31.5
				\$80,001 - \$180,000	39.5
				Above \$180,000	46.5

As with the LITO, the operation of the Medicare levy increases the number of effective tax rates, moving the personal income tax system further away from the relatively simple stepped scale implied by the statutory schedule. The Medicare levy low-income threshold and the use of household income as a unit of assessment for some taxpayers add considerable complexity to the tax system.

Chart 4: Effective rates for an individual with two dependants and a partner earning \$17,000 a year 2009-10^(a)



(a) Annual incomes up to \$80,000 shown. The marginal tax rates above \$63,750 are unaffected by the LITO and would simply be 1.5 per cent higher than the statutory rates.

Conclusion

Australia's statutory personal income tax schedule is overlaid with over 40 tax offsets and the Medicare levy. While these offsets provide benefits to particular groups of people, they add complexity to the tax system. In this paper, we have described the operation of two of the most widely available features of the personal income tax system, the LITO and Medicare levy, to show how they can add complexity and reduce transparency. The operation of the LITO and Medicare levy increase the number of marginal tax rates, creating spikes and a marginal rate schedule which both increases and decreases as income rises.

High levels of tax system complexity can increase compliance and administration costs, undermine public confidence in the tax system and provide opportunities for some taxpayers to pay less tax than similar individuals. Complexity also makes it difficult to easily design changes to the tax and transfer system, or to make changes in isolation. In a complex system, considerations of interactions between a policy proposal and other parts of the tax and transfer system can be as difficult as considerations about the proposal itself.

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ATTACHMENT A: OTHER TAX OFFSETS

Other tax offsets		
Child housekeeper tax offset	Invalid relative tax offset	Student tax offset (notional)
Child housekeeper (with dependent child or student) tax offset	Landcare and water tax offset	Overseas civilian tax offset
Child tax offset (notional)	Life assurance bonus tax offset	Parent/ Parent in law /invalid relative tax offset
Dependent spouse (with child) tax offset (notional)	Lump sum payment in arrears tax offset	Unused annual leave tax offset
Education expenses tax offset	Medicare levy surcharge (lump sum payment in arrears) tax offset	Unused long service leave tax offset
Foreign income tax offset	Sole parent tax offset (notional)	Housekeeper tax offset

Superannuation tax offsets
lump sum from a taxed source for a taxpayer below age 60 but above preservation age
income stream benefit for a taxpayer below age 60 but above preservation age
income stream benefit for a dependant below age 60 of a deceased who died under age 60
income stream benefit from an untaxed source for a dependent above age 60 or for a dependent of a deceased who died above age 60
lump sum for a non-dependant of a deceased
lump sum from a taxed source for a taxpayer under preservation age
income stream for a taxpayer under preservation age (if a disability superannuation benefit)
lump sum from an untaxed source for a taxpayer aged more than 60
income stream from an untaxed source for a taxpayer aged more than 60
lump sum from an untaxed source for a person under age 60 who has reached preservation age
lump sum from an untaxed source for a person under preservation age
spouse superannuation contributions tax offset

Measuring what we do or doing what we measure: challenges for Australia

Dr Ken Henry AC
Secretary to the Treasury

Plenary address to the NatStats 2010 Conference, Sydney, 16 September 2010.

Introduction

Thank you for inviting me to speak here today. This, the second NatStats Conference, provides a great opportunity for those of us who work with statistics to come together, share knowledge and promote the use of statistics to a wider audience.

I would like to start with a quote from the *Report by the Commission on the Measurement of Economic Performance and Social Progress*, commonly known as the Stiglitz-Sen-Fitoussi Report. The Commission's agenda is to seek to improve conventional economic measures to capture better elements of sustainability and wellbeing. It is also providing some sense of the complexities and challenges of seeking these improvements.

The quote from the Stiglitz-Sen-Fitoussi Report reads:

... what we measure shapes what we collectively strive to pursue – and what we pursue determines what we measure.¹

This is an excellent summary statement of what this conference is about.

What we measure, and how we measure it, matters. Our society's values and goals – as well as the challenges that we collectively face – also matter because they are drivers of what we measure.

Hence, the work of the Commission, and related work along similar lines by others, such as the Australian Bureau of Statistics (ABS) and the OECD, is essential reading, especially for policy advisers.

I will start my address today by providing a Treasury perspective on some important trends and challenges likely to affect Australia into the future.

Having outlined those trends and challenges, I then want to explore the importance for policy efficacy of a careful consideration of the links between objectives, conceptual frameworks and statistics. I will be making some observations about how we use statistics, including on the importance of making better use of the data and information that we already have.

Challenges facing the Australian economy

At the risk of understatement, these are remarkable times for those interested in public policy.

1 Stiglitz, J E., Sen, A and Fitoussi J-P 2009, *Report by the Commission on the Measurement of Economic Performance and Social Progress*, Commission on the Measurement of Economic Performance and Social Progress, p 9.

Australia is facing some key economic challenges that are likely to have profound impacts on the economy, and indeed Australian society, for decades to come. These include international developments such as the rise of China and India in an increasingly globalised world; an ageing and growing population; technological change; and climate change.

I have spoken publicly about these trends on other occasions, but it is worth revisiting them today, as we ask ourselves what it is that we should be measuring that might prove of enduring value in shaping the policy debate for some time to come.

These trends are interacting with a set of immediate challenges facing us today as a result of market, social and government failures. Again, these will not be unfamiliar to you. They include:

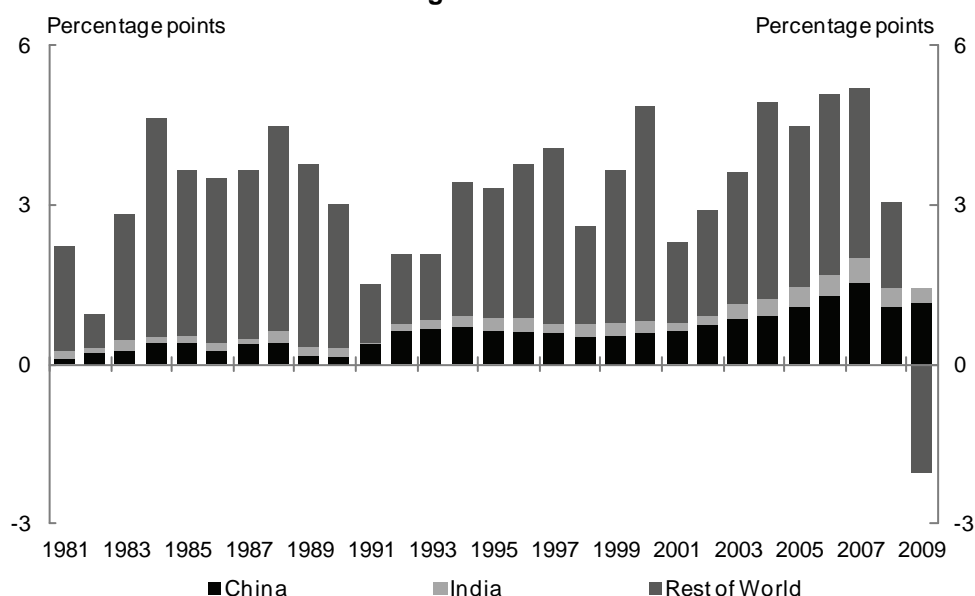
- disincentives and barriers to work;
- areas of entrenched disadvantage, particularly those facing Indigenous Australians and those with a mental illness;
- barriers that prevent scarce resources from being allocated to their most productive and socially valuable use;
- an inefficient, and unsustainable, use of water resources;
- issues in housing affordability, congestion and the liveability of our cities; and
- less than fully developed mechanisms for public infrastructure planning and delivery.

Continuing globalisation and the growth of China and India

Notwithstanding the most serious financial crisis since the Great Depression, the global economy will continue to become more integrated, with increasing cross border trade, more seamlessly interlinked capital markets, increasing technological transfers and more competitive markets for internationally traded goods and services.

The re-emergence of China and India is now one of the key drivers of world economic growth.

Chart 1: The growth of China and India



Source: IMF, CEIC Asia database and Treasury.

Increasing globalisation matters to Australia for a number of reasons.

First, and most dramatically, the resource intensive nature of China and India’s growth, reflecting their stage of economic development, represents a very large shock to the Australian economy.

Australia’s terms of trade, a measure of the average price of our exports relative to the average price of our imports, is at historically high levels. That has obvious benefits for the nation, since it means that our aggregate purchasing power, measured by real wealth or real income, has increased. This is reasonably well understood. Not so well understood is the fact that, increasingly, as mineral resources account for a growing share of exports, our exports deplete our real wealth at the same time as they enhance measured real income. Other impacts of a strong terms of trade are not well understood either. For example, it is not well appreciated that in response to higher terms of trade, there will be a shift in economic activity towards mining and related sectors, with scarce labour and other factors of production being drawn away from other sectors involved in international trade. And there will be distributional consequences, some at a geographical or sectoral scale.

Just one source of the distributional consequences is the impact of higher terms of trade on the relative rates of growth of real wages and the real returns to capital; the latter being favoured.

Secondly, the increasing integration of economies and financial markets is also affecting the potential magnitude, speed and transmission of shocks originating outside of Australia. The recent financial crisis underlines the importance of understanding how international developments may affect the Australian economy.

Thus, our need for statistics extends well beyond what we can produce in Australia.

We have a strong interest in the quality of statistics in numerous countries. In some of those countries, the production of high quality statistics poses a considerable challenge. In China, for example, the task is made difficult by that country's size and diversity, and the fact that it is undergoing major transition. Nobody should be surprised that statistics on the Chinese economy fall short in a number of areas.

Even so, in light of China's growing economic influence, improvements in the quality, coverage, transparency and timeliness of its statistics will be of increasing value globally.

China recognises the importance of improving its national statistics. Progress has been made on many fronts over the years. It is noteworthy that China's National Bureau of Statistics has been working in close cooperation with the OECD and other international organisations to enhance the comparability of its statistics with OECD norms and practices.

As an aside, I might observe that this example serves as a reminder to us that it is easy to take the quality and scope of statistics produced by the ABS and others for granted. It is all too easy, and common, to focus on gaps and errors and lose sight of the strong and well deserved international reputation enjoyed by Australian statistics.

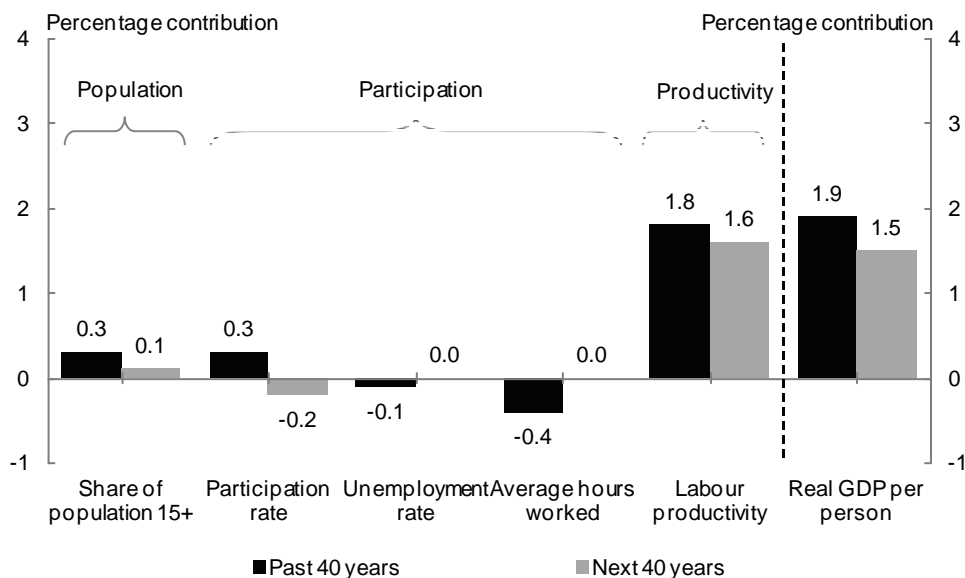
My central point, though, is that in an increasingly globalised world, national statistics have something of the character of a global public good. And, as with all public goods, there is a risk of under-provision.

An ageing and growing population

The projections in the Government's most recent IGR highlighted some of the implications of an ageing population. Ageing is a consequence of a major decline in birth rates in the 1960s and 1970s and increasing life expectancy. The IGR projected that, by 2050, over 5 per cent of the Australian population will be 85 years old or more, compared with around 1.8 per cent today.

That changing age profile is likely to have a negative overall effect on the rate of economic growth.

Chart 2: 3Ps of real GDP per person



Source: Intergenerational Report, 2010.

This impact is illustrated in Chart 2, which decomposes annual GDP per capita growth into the ‘3Ps’ of *population* aged 15 or more; labour force *participation*, including average hours worked; and *productivity*.

The IGR projects that while the share of the population aged over 15 will continue to grow, adding marginally to growth, the change in the age profile of that population will be reflected in lower hours worked per capita because of the falling workforce participation rates.

The IGR explores population developments primarily from the perspective of fiscal sustainability and implications for economic growth as conventionally measured. But the implications of such ageing will clearly be multifaceted.

As you will be aware, public debate has focussed recently on the projected total population. A number of concerns have been raised about the potential positive and negative consequences of an increase in population for the economy, our cities and patterns of settlement, lifestyle and the environment.

Without getting deeply into those debates, it is worth noting in passing that some level of population growth is almost certainly inevitable. Even if net overseas migration were to fall to historically very low levels, we are still likely to experience a sizeable increase in the total Australian population. So these debates are likely to be with us for quite some time. It is clearly in the national interest that such debates be well informed, including by robust statistical analysis.

Technological change

Technological change and innovation, including technological change that has already happened, will continue to transform the economy and peoples' lives.

Innovation is an important source of productivity growth. The productivity projection presented in Chart 2 is not a forecast. It is simply the average experience of the past 30 years. There is scope to do better than that.

Technological change and innovation expands the production possibilities frontier of the economy – that is, it expands what can be produced for a given quantity of capital, labour and natural resources. Production possibilities define our long-run potential. Equally important, and a focus of the next session today, is that we continue to undertake the reforms that make the most of that potential.

As real incomes rise, whether from a stronger terms of trade or technological change, the pattern of consumption is likely to favour what economists call 'superior goods': goods whose consumption increases more than proportionately with income. Such goods include health services and environmental outcomes.

Thus, reflecting again on the IGR, a substantial slice of the fiscal pressures identified there are due to an increased demand for publicly funded health services. Partly, this is a consequence of new technologies. But it is also a consequence of increased demand as real incomes rise.

Technological change and innovation have broader impacts than what might be measured in the National Accounts and budget statements of course. For example, the internet is having profound effects on how we access, intermediate and aggregate information. And it is impacting the development of social and community relationships in interesting, and sometimes challenging, ways.

Climate change

According to the latest IPCC report, it is very likely that, in the coming decades, there will be significant climate change. That change will force adaptation.

The costs of adaptation – again on the scientific advice available to us – are likely to be very large, absent efforts internationally to mitigate climate change.

The means by which we seek to mitigate climate change will also be important. And regardless of how it is done, any significant reduction in greenhouse gas emissions will require a major change in the structure of domestic and international economic activity. But there are more or less damaging ways of achieving any amount of abatement.

How we approach climate change, technological change, population ageing and globalisation will determine our economic performance and, in consequence, our ability to satisfy the material aspirations of future generations of Australians.

But, policy needs to consider broader metrics than this.

Implications of these challenges

Each of the four trends to which I have referred pose a different set of challenges and opportunities. But each will drive pronounced and challenging structural change in the Australian economy.

Structural adjustment will entail costs for some, and transitional change for many.

It will be important to ensure that the economy is flexible enough to adjust. But, at the same time, we will need to protect the most vulnerable and disadvantaged. This will not be easy.

Ensuring we have the correct metrics to identify appropriate policy responses will be crucial to meeting the challenges.

Policy objectives and measures of progress

Many of you will be familiar with the metaphor used to characterise the way economists use data: about the drunk looking for his keys under the lamp post because that is where the light is.

Metrics can influence views as to what policy objectives should be. We know that there are limitations on the availability and quality of data, and methodologies and techniques for turning data into meaningful and useful information. But we should take care not to allow these limitations to become barriers to developing policy.

Returning to the earlier quote, the metrics we use to measure our goals affects the path we take to reach our goals. It is therefore important that we understand the metrics we adopt, and that we appreciate their limitations. A classic example has been the use of GDP as a measure of economic wellbeing or progress.

As the Stiglitz-Sen-Fitoussi report acknowledges, we have long been aware of the limitations of GDP as a measure of progress. Indeed, the co-founders of national accounts – Simon Kuznets and Australian economist Colin Clark – were well aware of their limitations, particularly as a measure of progress.

For example, GDP does not adequately measure non-market production, such as the quality and quantity of government services.

And GDP deals poorly with environmental matters. Of course, GDP is not the only metric available to policy makers.

But, difficulties in measuring the value of market consumption and wealth notwithstanding, in a world with readily available market measures of things like employment and commercial asset values, the lack of similarly accepted measures of the value of the environment creates the risk that society will fail to get the balance right.

The lack of market prices for the flow of ecosystem services and biodiversity means that the benefits we derive from these goods (often public in nature) can be neglected or undervalued in decision-making by private agents and even communities and governments.

Addressing market failures in the allocation of environmental resources is a classic problem of economics, not just one for environmental experts.

Currently, there is a renewed global focus on the valuation of non-market contributions to wellbeing. I would like to mention one stream of work that I find to be of particular interest.

The Economics of Ecosystems and Biodiversity (or TEEB) study, hosted by the United Nations Environment Programme, is an international initiative to draw attention to the global economic benefits of biodiversity; to highlight the growing cost of biodiversity loss and ecosystem degradation and to draw together expertise from the fields of science and economics in developing practical proposals for action.

TEEB released an interim report in May 2008, which provided strong evidence for significant global and local economic losses and human welfare impacts attributable to the ongoing losses of biodiversity and degradation of ecosystems.

The second phase of the study is expected to be completed in October 2010. It is focusing on: developing a framework and methodology for ecosystem valuation; developing 'toolkits' for sustainable development for policymakers at all levels; and raising public and business awareness and access to information and tools for sustainable development and conservation.

I for one am keenly waiting to read their findings and to see what methodological progress they have been able to make in what is a difficult area of measurement.

I am not suggesting that measures of GDP are not useful – GDP remains a useful measure of market production. But confusing market production with progress, or ignoring distributional issues by focusing on aggregate or per capita measures of

production and income, runs the risk of misinforming policy makers. Not only does it provide an inadequate measure of community wellbeing, it can lead to policy decisions that are detrimental to wellbeing.

A sophisticated understanding of 'ends', goals or objectives is extremely important. Just as important is an understanding of 'means': of how we might go about pursuing our goals.

Theory provides frameworks for how we perceive the world and how we might adjust it. Theory provides guidance on how we might move beyond correlation to establishing causation.

But theory without evidence can only achieve so much. Data and theory combine to develop evidence.

Evidence-based policy improves the reliability of advice concerning the efficiency and effectiveness of policy settings and alternatives. Knowing what works, and what does not work, is far better than fumbling around in the dark hoping to find the lost keys. It also means that we can avoid the temptation to look for the keys in the place that happens to be illuminated. Importantly, while data are important, it is information that matters.

Data without theory can be dangerous.

As the words of Einstein remind us,

Not everything that counts can be counted and not everything that can be counted counts.

Data collection should, therefore, be guided by theory. Specifically, data collection should permit the theory to be tested – falsified, if you like.

This is how the evidence base for policy should be developed.

Making best use of available information

Using numbers

Theoretical analysis supported by statistical evidence can be extremely powerful in garnering political and community traction for policy change.

But statistics and metrics can just as easily be misused. Just because a piece of analysis contains numerical support does not mean we ought blindly to trust the analysis.

The way in which statistical information is presented can also affect the public's interpretation of it. The field of behavioural economics provides key insights into how individuals process information at hand.

For example, subjective judgements of risks are influenced by the way in which information is presented. A study of undergraduates at the University of Washington found that anchoring and base-rate neglect affected the magnitude judgement of riskiness.^{2,3}

The study found that students would judge a risk more serious when fatalities were expressed by larger frequencies using larger numbers rather than by smaller frequencies. For example, 1,286 out of 10,000 – a 12.86 per cent mortality rate – is judged as more risky than 24.14 out of 100 – a 24.14 per cent mortality rate.

Consideration as to how information is framed is clearly important when delivering a message.

Who are the users?

When we say 'what we measure affects what we do', it is worth taking a moment to ask who is the 'we'.

It would generally be accepted that an informed community is an important part of a well-functioning democracy – engaging the community in progress measurement strengthens their democratic capacity.

Drawing on Amartya Sen's increasingly influential 'functionings' or capabilities approach – people's capabilities⁴ can be enhanced by public policy, and the direction of public policy can be influenced by the effective use of the participatory capabilities of the public

Public trust in official statistics, general levels of statistical literacy and community engagement determine how powerful metrics are in informing public debate and in underpinning public accountability. These are important also in determining how

2 Yamagishi, K 1997, 'When a 12.86% Mortality is More Dangerous than 24.14%: Implications for Risk Communication', *Applied Cognitive Psychology*, vol. 11, pp 495-506.

3 Anchoring occurs when people make estimations by starting from an initial value that is then adjusted (typically insufficiently) to yield the final answer. Base-rate neglect occurs when people fail to take into account the prior probability of the outcome when processing information (Tversky, A and Kahneman, D 1974, 'Judgement under Uncertainty: Heuristics and Biases', *Science*, vol. 185, pp 1124-1131).

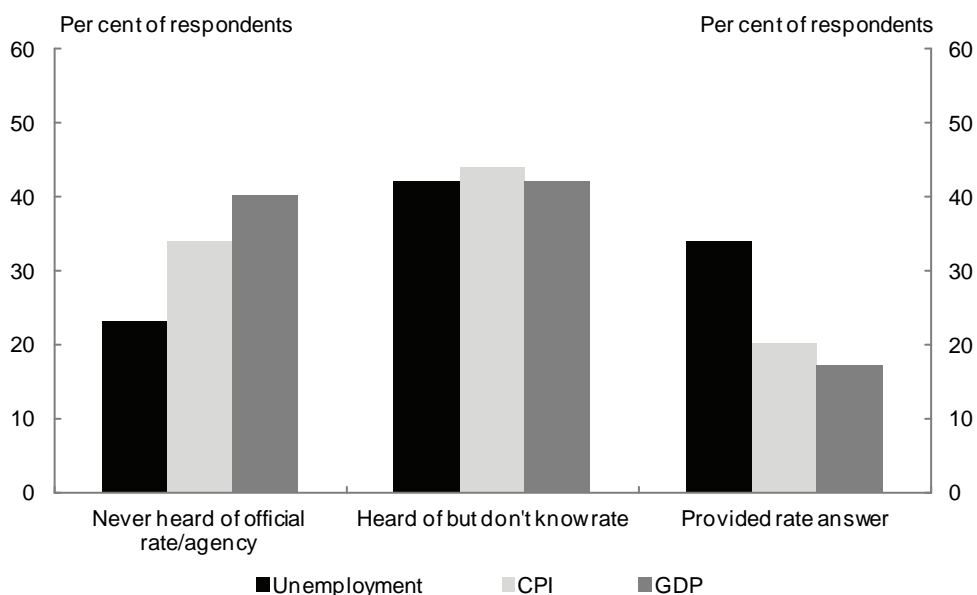
4 Capabilities are the ability of a person to achieve different combinations of functionings – the various combinations of things a person may value and have reason to value doing or being – reflecting the opportunity or freedom to choose a life that a person values (Sen, A 1999, *Development as Freedom*, Oxford University Press, Oxford).

statistics are used to measure progress and in enhancing policy credibility by affirming that what matters really is being considered in policy deliberations.

Even so, there is a sizeable gap between statistical measurements, and citizen perceptions, of socio-economic phenomena – for which there is no single explanation.

Work by the European Commission found that only 46 per cent of Europeans trust official statistics.⁵ If the community does not trust the statistics used to inform decision making, a sense of alienation from, and scepticism towards, political and democratic processes would not be surprising.

Chart 3: People’s knowledge of official measures of economic performance in the USA



Source: Curtin (2007).

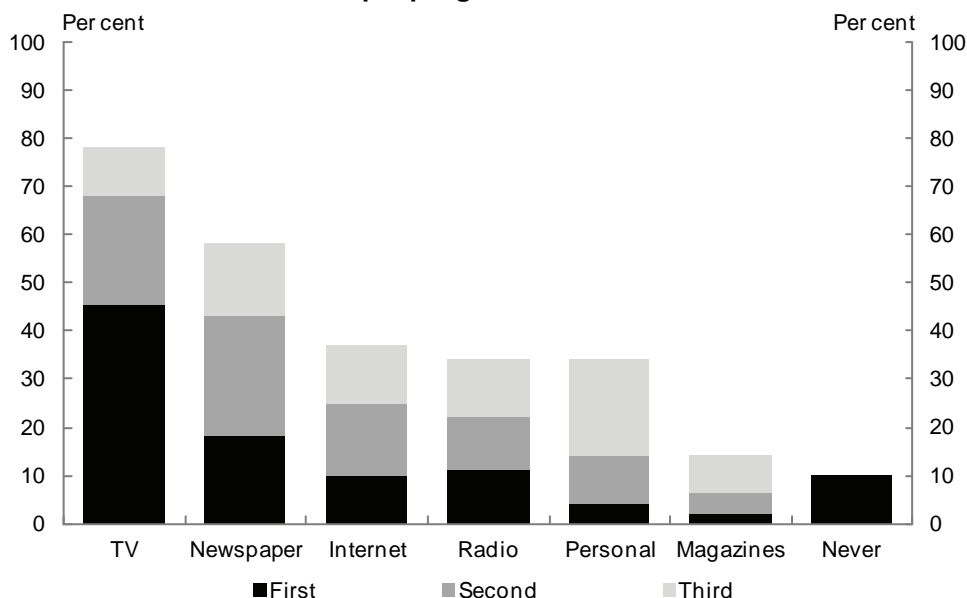
Scepticism aside, basic awareness of statistics is also an issue. A study from the US looking at people’s knowledge of official measures of economic performance found that 40 per cent of Americans had never heard of official GDP data or the source agency, 34 per cent had never heard of the official CPI figures and 23 per cent had never heard of the official unemployment figure.⁶

5 European Commission 2008, Europeans’ Knowledge of Economic Indicators, Special Eurobarometer, April 2008, available at http://ec.europa.eu/public_opinion/archives/ebs/ebs_special_eco_ind_en.pdf.

6 Curtin, R 2007, ‘What U.S. Consumers Know About Economic Conditions’, OECD World Forum on Statistics, Knowledge and Policy, Istanbul.

The role of intermediaries in disseminating information is a key factor influencing both trust and awareness of official statistics – for example, if some people turn to the media as their main source of information, the quality of media is a crucial factor in shaping public debate.

Chart 4: Where do people get information from in the USA?



Source: Curtin (2007).

In the US for example, the study mentioned earlier found that the dominant source of information on economic statistics was television, reported by nearly half of all people surveyed as their first choice, and by nearly three-in-four people among their top three choices.⁷

It is difficult to be optimistic about the quality of the information people get from these sources. While there are some exceptions, much of television and newspaper reporting on economic news, contain little more than a passing reference containing no detail, apart from a one-word summary that the news was ‘good’ or ‘bad’ – or that whilst Joe Bloggs claimed the data were good news, Fred Smith claimed they were bad news. I am therefore pleased to note that the NatStats Awards to be announced tonight include a category for excellence in the use of statistics in the media.

⁷ Ibid.

Sources of data and information

When it comes to sources of data and information, we don't need to reinvent the wheel. A better understanding of how existing measures have been constructed and the appropriate use of these measures can provide rich analysis.

Better exploiting existing knowledge

It is also true that in some cases data exists but access to it is limited. In the report into Australia's Future Tax System (AFTS), the panel argued that data on the tax system should be thought of as a public good and should be freely available.⁸ Currently, unbiased and systematically collected data on the tax system, based on accepted methodologies appropriate for tax policy purposes, are rare and often not available in the public domain.⁹

Data on the transfer system are more readily available than tax data.¹⁰

Research undertaken using social security data has generated many insights that have fed into policy development, including information on the persistence of welfare dependence among specific groups, the 'transmission' of welfare dependence between generations, the responsiveness of different groups to policy changes, and the effectiveness of policies in achieving their intended outcomes.

Data, data everywhere but not a series to use

Data and information can be obtained from a wide range of places, not just official statistical bodies, issues of credibility and quality notwithstanding. A key role of the ABS and other statistical bodies is to set standards in conceptual frameworks for generating data and statistics, not necessarily producing and publishing all data themselves.

Sometimes the emergent pictures from alternate sources are contested, and this is a good thing. Informed public debate about issues that matter ought to be strongly encouraged.

In other cases, credible data exists, but are either overlooked or given insufficient weight.

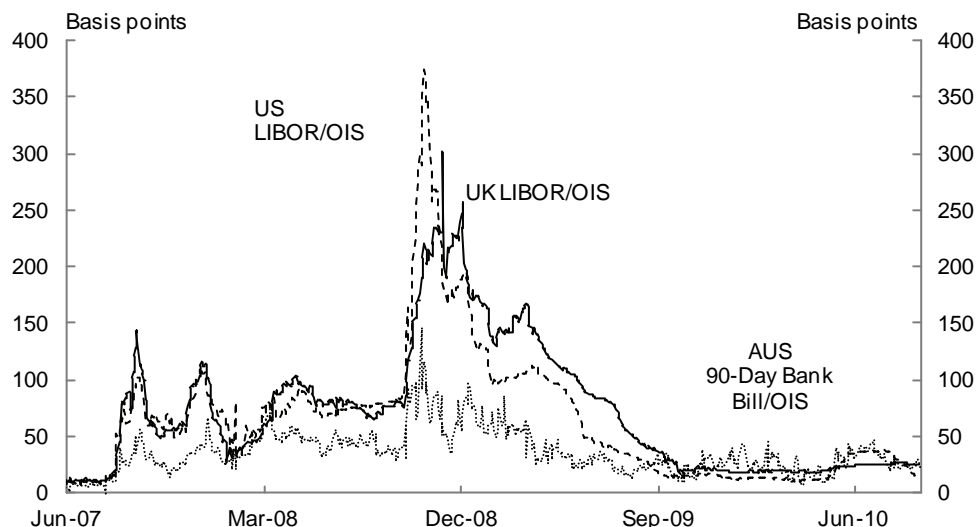
8 Volume 2, Chapter G5.

9 In the past, Australian tax unit record files have not been generally available for research purposes. However, in 2009 the ATO produced and released a confidentialised 1 per cent sample file containing individual tax return information. Over time, expanded availability of this, and similar data for other taxes, would allow deeper analysis of the individual-level effects of the tax system.

10 Confidentiality and privacy concerns are addressed by providing de-identified data under strict terms relating to its use and safe storage.

The global financial crisis provides a case in point.

Chart 5: Financial market data



Source: Thompson Reuters, Treasury.

This chart shows that spreads on financial instruments — a measure of perceived risk — widened appreciably in the second half of 2007.

As the GFC intensified, particularly in the immediate aftermath of the fall of Lehman Brothers, the ‘hard’ data on the Australian economy were still robust. GDP growth was slowing but still positive at over 2 per cent¹¹, unemployment was around 4 per cent and inflation was above target, at around 5 per cent.

Market data were a necessary part of understanding how the crisis was playing out, in advance of the impact being able to be ‘measured’ in the core economic data.

Conclusion

Australia is facing some economic challenges that are likely to have profound impacts on the economy and society for decades to come.

Public policy advisers and statisticians face their own challenges. There is a need for better measures of progress. But investing in better measures of progress will not produce better outcomes if those measures are not widely shared and clearly communicated; and more importantly, if the community does not understand them.

Forums such as this provide a way of reaching wider audiences.

¹¹ September quarter National Accounts, ABS cat. No. 5206.0, 2.3 per cent through the year growth.

Measuring what we do or doing what we measure: challenges for Australia

I would encourage you over the next two days to engage actively and participate fully in the debates and discussions, and give some thought to how you might implement some of the ideas canvassed here.

Thank you.

MySuper — thinking seriously about the default option

Dr David Gruen and Tim Wong¹

This paper was presented by Dr David Gruen, Executive Director (Domestic), Macroeconomic Group, to a Special Session on Superannuation at the 2010 Australian Conference of Economists.

¹ The authors are from Macroeconomic Group, the Australian Treasury. This article has benefited from comments and suggestions provided by Jeremy Cooper and Tony McDonald. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

Over the past year or so, I've had the great pleasure to be a Panel member of the *Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System*, commonly known as the Cooper Review.

In my time today, I would like to briefly outline the thinking behind our recommendations on MySuper and the choice architecture model proposed in the review.²

A decade since the Wallis Report

It has been more than a decade since a review looked into the operation of the super system. The Wallis Report, handed down in 1997, provided a blueprint for regulatory reform of the financial system, including superannuation.

The philosophy underpinning the Wallis Inquiry was an analytical framework rooted squarely in standard neoclassical economics. As applied to super fund members, the starting point was that, on the whole, they should be treated as rational economic agents who know their own business best.

People whose longer-run behaviours diverge from this, because they lack the ability or the desire to obtain the relevant information, are treated as exceptions to the rule.

We can see this from Chapter 5 of the Wallis Report. In describing the case for regulation as a response to information asymmetries, it says:

... consumers are assumed, for the most part, to be the best judges of their own interests.³

In this paradigm, the regulatory approach adopted by Wallis — one that focuses regulation around market conduct and information disclosure — makes sense.

Market conduct rules would prevent system instability arising from failure to enforce or fulfil financial promises and contracts. Disclosure rules would aid and improve the quality of decision making and thereby improve allocative efficiency.

² See Super System Review (2010) for more details.

³ Financial System Inquiry (1997), p 191.

The recommendations of the Wallis Report were consistent with this tenet. Its recommendation on disclosure requirements, for example, said that information provided on financial products should be:

... sufficient to enable a consumer to make an informed decision relating to the financial product.⁴

In this world, you cannot make someone worse off by giving them more information and, by extension, more choices.

This is because an informed individual can always navigate through, and turn down, unsuitable choices.

As such, the logic of this approach to financial market regulation is that people, for the most part, will use the disclosed information, wade through their set of choices and dynamically optimise where and how they should allocate their financial capital.

One presupposition of the logic here is that, given our laws which (for good reason) compel individuals to save through the super system, members will be sufficiently interested in their super to engage in the first place.

However, there is an increasing body of evidence to suggest that, for many people, these assumed behaviours do not apply unequivocally.

The simplifying assumptions that we use — that agents are far-sighted and rational, and make decisions based on standard (time-consistent) preferences — are exactly as the name suggests — stylisations of the real world.

Don't get me wrong. Our standard economic frameworks have played, and will continue to play, a key role in informing policymaking. Indeed, these frameworks have yielded, and will continue to yield, great benefits for Australia.

The salient point here is that standard economic stylisations do not apply to all people, at all times, in all circumstances. Further, market forces do not endow people with a greater capacity to make rational decisions; they merely provide an incentive for them to do so through price signals.

So we should be cautious about relying solely on standard economic theory in an unquestioning way.

We are not always dealing with rational, engaged, dynamically optimising agents — especially in the area of retirement saving. Borrowing an analogy from Richard Thaler

4 Financial System Inquiry (1997), p 34.

and Cass Sunstein, that would be akin to treating people as being able to think like Einstein, store memory like Big Blue, and exercise willpower like Mahatma Gandhi.⁵

Wallis, despite its general approach to regulation, did recognise that there were cases where market failure cannot be avoided — no matter how much disclosure was afforded. In these cases, Wallis argued that some form of paternalism is justified. As the report points out:

... for many financial products, consumers lack (and cannot efficiently obtain) the knowledge, experience or judgement required to make informed decisions ... [this is] a situation where further disclosure, no matter how high quality or comprehensive, cannot overcome market failure.

In these cases, it may be desirable to substitute the opinion of a third party for that of consumers themselves.⁶

Perhaps one way of understanding the differences between the Wallis and Cooper reports is that, rather than treating these cases as ‘exceptions to the rule’, we in the Cooper review considered them to be more widespread — indeed of central relevance when it comes to decisions about retirement savings.⁷

Reflections on behavioural insights

A substantial body of work has emerged in recent decades in the field of behavioural economics.

The behavioural approach has pointed to some of the flaws of standard economics in modelling behaviour and is seeking to better understand and explain people’s decision making by developing tractable models that better fit these behaviours.

While it’s not possible to do this field of research justice in a 20 minute presentation, it is worth pointing to a few of the insights in relation to how people save.

The standard theory would imply that a savings decision is based on a person’s trade-off between consuming today and the risk-adjusted cost of postponing for future consumption, for retirement and for bequest motives.

However, the evidence suggests the standard approach provides only a partial explanation of how people save. For most people, whether to save, and how much to

5 Thaler and Sunstein (2008), p 7.

6 Financial System Inquiry (1997), p 191.

7 Of course, the specific focus of the Cooper Review was on retirement saving and the superannuation system generally, while the Wallis Review examined regulatory issues across the whole financial system.

save, can be a difficult cognitive problem — because of a combination of limited calculation power, along with framing and anchoring biases.

One example is the different impact on saving of a cash transfer presented as a ‘rebate’ or as a ‘bonus’ — even when the amount of money involved is the same.

A well-cited study in the US set up four experiments to examine this difference. The first experiment looked at people’s recollection of how they spent the 2001 US tax rebate when it was presented to them as a ‘rebate’ or a ‘bonus’. The other three experiments looked at how a sample of Harvard graduates reacted to unexpected windfalls, framed differently.⁸

A windfall presented as a ‘bonus’ was more likely to be spent than one presented as a ‘rebate’. These results are interpreted as evidence of a framing bias and probably loss aversion — where people tend to think of ‘bonuses’ as windfall gains (which they are more likely to spend) while a ‘rebate’ is thought of as a recovered loss which they are more likely to save.

Further, the standard theoretical result that more information and choices make people better off — and certainly no worse off — has also been questioned. Large choice sets appear, in some circumstances, to degrade the quality of the decisions people make.

The relevant literature suggests a range of behavioural responses to ‘choice overload’. Choice overload increases the likelihood that people (particularly those with low levels of financial education) will choose a default option, or leads people to pick simpler options regardless of their suitability or, finally, degrades people’s capacity to make optimal decisions.⁹

This evidence highlights the importance of financial literacy, but also the importance of high-quality default options in retirement saving plans.

It also suggests that people can be made better off if choices are framed to ‘nudge’ them towards making optimal decisions. This can be achieved by presenting what would typically be sensible retirement saving choices as simple, easy to understand, default options — but at the same time allowing people to opt out if they decide that the default is unsuitable for them.

Another behavioural effect revealed by the evidence relates to self-control problems, such as procrastination.

⁸ Epley et al (2006).

⁹ For these results, see Agnew and Szykman (2005), Iyengar and Kamenica (2010) and Besedeš et al (2010).

A nice example of this is reported in George Akerlof's and Robert Shiller's wonderful new book *Animal Spirits*.¹⁰ When assistant professors arrived in Harvard in the 1970s, contributions were automatically deposited into their retirement accounts upon arrival. However, these accounts did not accrue interest until the newly minted academics filled out a form declaring how they wanted these funds invested. These forms would have taken no longer than half an hour to fill out.

Marty Feldstein, of all people, observed that most of these assistant professors filled out their forms four or five years later. For Akerlof's wife (Janet Yellen), who was on the staff at Harvard at the time, filling out the form immediately upon employment meant that she is now \$US15,000 better off from the accrued interest.

As a one-time visiting lecturer at Princeton, I can assure you that this sort of thing never happened at Princeton.

College rivalries aside, the point is clear — even highly intelligent, motivated, financially literate people are susceptible to cognitive biases like procrastination. And this remains true even when these biases potentially lead to sizeable financial losses. Unsurprisingly, these observations are not isolated incidents.

Because of these problems, automatic enrolment, compulsion, or the adoption of 'commitment devices' in retirement plans can lead to dramatic increases in employee saving rates.¹¹

The economics profession is in the process of changing its mind about the relevance of these behavioural biases for some aspects of public policy. It is increasingly difficult to sustain policy arguments, particularly about retirement saving, which are dismissive of these insights — especially when those arguments are based on caricatured polarisations between behavioural economists and more 'established' thinking.

The recent work of the Squam Lake Working Group on Financial Regulation provides a compelling example of the economics profession's new perspective. Squam Lake is a group of fifteen US academics that formed in 2008, as the global financial crisis deepened, to offer guidance on financial regulation reform.

10 Akerlof and Shiller (2009).

11 See, for example, Thaler and Benartzi (2004). See also Laibson (1997).

The group is a ‘who’s who’ of US academic economists engaged in financial market research.¹² On some contemporary economic issues – for example, the appropriate macroeconomic response to the global financial crisis – members of this group have markedly different, and strongly held, views.

However, when it comes to retirement savings, and the appropriate features of default options for those who do not make an explicit choice, the group has this to say:

We ... advocate improved default options for defined contribution plans. If employees do not select an alternative, they should be automatically enrolled in their employers’ defined contribution plan. Many participants in defined contribution plans tend to anchor their investment decisions on the default options, as though those are optimal.

... The default options for defined contribution plans should encourage an aggressive savings rate and they should nudge employees toward low-fee, diversified investments.

... High-fee funds argue that their fees are justified by superior performance. A large body of academic research challenges that argument. On average, high fees are simply a net drain to investors. While some investors might gain by selecting successful high-fee funds, the negative-sum nature of the process implies that other investors must lose even more. Most employees saving for retirement are poorly placed to compete in this game. They should not be forbidden from doing so, but disclosure of high fees and a “surgeon general’s warning” are appropriate.¹³

While some of these recommendations have specific relevance to the US, the overall approach shares strong similarities with the Cooper review’s approach to MySuper.¹⁴

MySuper and the choice architecture

It is against this intellectual backdrop that the Cooper review made its deliberations.

12 The members of the Squam Lake Working Group are Martin N Baily, Brookings Institution; Andrew B Bernard, Dartmouth College; John Y Campbell, Harvard University; John H Cochrane, University of Chicago; Douglas W Diamond, University of Chicago; Darrell Duffie, Stanford University; Kenneth R French, Dartmouth College; Anil K Kashyap, University of Chicago; Frederic S Mishkin, Columbia University; Raghuram G Rajan, University of Chicago; David S Scharfstein, Harvard University; Robert J Shiller, Yale University; Hyun Song Shin, Princeton University; Matthew J Slaughter, Dartmouth College; and René M Stulz, Ohio State University.

13 Squam Lake Working Group on Financial Regulation (2009), pp 2, 4, 5.

14 While superannuation contributions in the US are not compulsory, the Squam Lake Group recommend a default savings rate of perhaps 10 per cent of compensation – quite close to the Australian compulsory Superannuation Guarantee contribution.

As is clear from all that has come before, a key driving principle behind MySuper is that, for those people who do not actively choose an option for their superannuation savings, we want public policy to mandate a default option with carefully designed features that we judge will promote the wellbeing of those who use this option.

Crucially, this mandated default option is not imposed on anyone. Freedom of choice is a central feature of the choice architecture model that underpins the MySuper proposal. Actively engaged people can choose a MySuper default option, or they can choose from a potentially wide array of alternative 'choice' options.

The evidence is that around 80 per cent of members of superannuation funds in Australia are invested in the default option in a super fund chosen by their employer or an award. Of that 80 per cent, anecdotal evidence suggests around 20 per cent explicitly choose the default option, with the rest making no active choice.¹⁵

The Cooper Review Panel interpreted this as evidence of significant community disengagement with super. It could also be interpreted as evidence of an anchoring bias, with some treating the default option as a benchmark — regardless of how suitable it may be for them.

However, we also recognised that there are substantial numbers of people in the community who are very much engaged with their retirement savings — both in the decision making and sometimes in the management of their savings.

The idea is not to have a centrally determined option for everybody; nor is it *laissez faire*.

While the system compels people to save into super through the Super Guarantee, the Cooper Review's proposed choice architecture means that people are able to choose between the default option (which must be a MySuper product), or opt for a saving plan with greater choice but greater responsibility.¹⁶

The MySuper component of the proposed choice architecture aims to provide a simple, diversified and cost-effective product. Trustees of MySuper products must comply with a number of requirements which include trustees' duties, the types of fees that can be charged and reporting and disclosure obligations. Trustees would also be

15 See Part One of Super System Review (2010) for references.

16 One prominent industry body argued that 'MySuper will legislate for apathy and disengagement' and 'actively discourage people from engaging with their superannuation'. Putting aside the difficulty of legislating for apathy for even the most accomplished of legislators, the MySuper proposal clearly does not actively discourage engagement. Anyone who does not like the MySuper default options is free to choose an alternative option. Likewise, anyone who wishes to engage with their superannuation will find a whole industry willing and able to help them do so.

required to hold a licence from APRA to offer MySuper products and APRA would have the power to resolve any non-conformity with the criteria.

As you know, the Government, as part of its election commitment Fairer Simpler Superannuation, announced that it plans to implement the Cooper Review's MySuper proposals, with super funds being able to offer MySuper products from 1 July 2013.

As I have argued here, the ideas behind MySuper flow naturally from an evolution in the economics profession's thinking about how individuals make decisions — especially decisions relating to retirement savings, which have long-term but uncertain consequences, in a complex environment in which decision-makers have limited familiarity.

The development of the MySuper proposals, and the associated choice architecture model, has been a challenging and rewarding intellectual exercise that I'm glad to have been a part of.

So I very much appreciate the opportunity extended to me today to outline the thinking behind this particular reform.

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Bank competition in the post-crisis environment

Jim Murphy, Executive Director, Markets Group

Address to the Citi Australia Investment Conference, Sydney, 26 October 2010.

Bank competition in the post-crisis environment

Good morning

I'm delighted to be here today, and I appreciate the initiative of Citi in organising this conference to discuss the issues which affect us all.

Treasury is working to improve Australia's productivity and international competitiveness, and deepen the potential of the economy.

This work focuses on promoting economic growth and supporting employment, ensuring Australia's financial system remains robust and dynamic, and ensuring that regulatory frameworks promote macroeconomic stability and market confidence.

We also monitor and provide advice on the general prudential framework applying to the banking sector, insurers and superannuation funds.

As well, we participate actively in international forums, such as the G20 and Financial Stability Board, to enhance the regional and global financial architecture.

This work gained greater prominence during the global financial crisis.

Putting our work in a broader context, as a central policy agency, Treasury needs to ensure that the long-term challenges facing Australia are not sidelined by the more immediate and urgent issues.

And Australia is facing some significant challenges.

The Government's third Intergenerational Report highlighted some of the challenges in relation to demographic change and an ageing population; economic infrastructure; and climate change.

A safe and efficient financial system will help us meet these challenges.

A safe and efficient financial system is also important from a wellbeing perspective, given the role the financial sector plays in people's lives.

The financial system:

- facilitates payments;
- supports Australians so they can invest and save for retirement;
- enables households to save for, and buy, housing; and
- ensures that capital is allocated efficiently, supporting investment in essential infrastructure.

We also need a safe and efficient financial system because our financial institutions play an essential role in funding the gap between domestic investment and national saving. Our institutions need the confidence of foreign investors that they will service what they borrow.

A safe and efficient financial system is very much about the wellbeing of the Australian community as a whole.

The question Treasury must consider continually is whether the current financial system adequately services all aspects of the community.

For Australia's financial system to be both safe and efficient, it is important that we have competition between providers of financial services, and a sound prudential regulation framework.

As you would all be well aware, the global financial crisis was the most fundamental dislocation in global financial markets in our lifetimes.

While the stability of banking sectors around the world has been very much the focus since we started to emerge from the crisis, it also raised concerns about weakened competition in many jurisdictions.

Australia's financial system has been more resilient than others but, like other countries, we have experienced a change in the competitive dynamics of our banking sector as a result of the crisis.

So I would like to spend some time today talking about the competitive dynamics in Australia's banking sector.

But first, I would like to reflect on the performance of the Australian financial system over the course of the global financial crisis.

The Australian financial system

The strength of our financial system, particularly the banking sector, has cushioned Australia from the impact of the global financial crisis.

Our financial system continued to function well throughout the global financial crisis. Overall, Australia's institutions remained profitable and well-capitalised, and this allowed them to continue to lend throughout the crisis. Even so, intermediated credit from the banking sector became more expensive and subject to tighter conditions.

Some borrowers, particularly large- and medium-sized businesses, were able to raise funds from equity and debt capital markets to supplement their bank funding. Other

Bank competition in the post-crisis environment

businesses, which don't have access to these financing alternatives, have been most affected by the tightening in conditions for intermediated credit.

The strength of our banking sector reflects several factors, including:

- the fact that, in contrast to many of their overseas counterparts, Australian institutions entered the crisis with relatively low exposure to high-risk assets;
- the strength of the equity markets, which allowed banks to raise large amounts of equity in 2009;
- the quality of our financial regulatory system; and
- timely action by the Reserve Bank of Australia and the Government in response to the global financial crisis. In particular, the monetary and fiscal stimulus played a key role in supporting the Australian economy. The Government also introduced guarantees to support Australian institutions' access to funds.

Credit flows over the course of the global financial crisis

At the height of the crisis in 2008, there were concerns that the extreme dislocation in financial markets would mean that Australian institutions would have to ration credit.

But this did not occur to any great extent.

Housing credit continued to grow over the course of the crisis, supported by historically low interest rates, the Government's First Home Owners Boost and lenders' continued appetite for mortgage assets.

In fact, total housing credit grew by 8.2 per cent over 2009.

Credit flows to businesses, though, have fallen. However, taking into account other sources of financing – that is, intermediated credit, equity, and non-intermediated debt such as corporate bonds – businesses' net stock of external funding increased over 2009.

As the price of intermediated credit increased, businesses elected to diversify their funding. This compares favourably with the experience of the early 1990s, when the fall in intermediated credit was not fully offset by increases in non-intermediated debt and equity issuance.

Australia's economy post-GFC

It's Treasury's view that the Australian financial system remains in relatively strong condition, as does the broader economy. The impact of the global financial crisis on the

Australian economy and financial system were well managed by the Government, and economic growth has now broadly returned to pre-crisis levels. Pleasingly, our employment levels have been maintained.

In their latest available half-yearly results, Australia's 'big four' banks reported aggregate headline profits, after tax and minority interests, of almost \$10 billion. This result was about \$1¼ billion higher than in the same period last year, signalling a recovery to pre-crisis profitability.

Another encouraging feature of the banks' latest half-yearly results is that bad and doubtful debt charges have declined markedly. This is the first decline since the financial crisis began, and drove the recovery in profitability.

Changes in consolidation post-GFC

But while Australia's banking system has proved itself to be extremely resilient, it has not been immune from the fallout.

The banking sector has become more concentrated due to mergers, as well as firms either exiting the market or scaling back their operations.

Many non-bank lenders exited the market or significantly scaled back their operations due to the closure of securitisation markets, which constituted the primary source of funding for many of these entities. These competitors were particularly important in driving competition in home loan lending.

Other non-bank lenders have exited the market or significantly scaled back their operations due to constraints in other funding markets. Some of these constraints originated here in Australia, for example, in commercial paper markets. Other funding constraints began in the jurisdiction of their parent companies overseas, restricting the parents' ability to provide capital injections to their Australian subsidiaries.

As well, some foreign banks have exited the Australian market or significantly scaled back their operations here due to funding constraints. These competitors were particularly significant in providing corporate business banking services.

Several smaller Australian banks have also scaled back their operations, largely due to increased funding costs, particularly in wholesale funding markets.

This impact was mitigated by the Government's large deposit and wholesale funding guarantee scheme and the financial claims scheme. Under these schemes, smaller institutions were able to raise deposits and wholesale funding using a Government guarantee.

Bank competition in the post-crisis environment

The home lending portfolios of these banks were further affected by closure of securitisation markets, however the Government's \$16 billion investment in RMBS helped to offset this impact. The business lending portfolios of these smaller banks were also affected by increased impairment rates.

Changes in competition post-GFC

The concentration of Australia's banking sector which occurred during the global financial crisis has altered the competitive dynamics of the sector.

A particular concern is the exit and slower growth of smaller lenders which traditionally relied on securitisation markets for funding. Over the past two decades, these institutions played an important role in driving competition in lending, and reductions in interest margins.

In the short-to-medium term, we don't expect to see competition levels rebounding to their previous highs. Rapid growth in global credit in the lead-up to the crisis led to spreads on a number of financial products narrowing to unusually low levels that did not adequately reflect inherent credit risks.

With the permanent repricing of risk, these highly favourable conditions are unlikely to return. So those lenders which established business models on the expectation that the low cost of credit would continue are likely to experience significant ongoing pressures on their competitive positions.

But we do anticipate that competitive pressures will increase as funding markets continue to recover.

There appears to be some competition between the remaining participants, including the four major banks.

Competition for deposits has intensified, supported by an increased market focus on liquidity. The focus on liquidity has prompted the banks with more wholesale funding to further increase their deposit base.

Corporate bond market

When the crisis began, Australian non-financial businesses seeking access to the bond market were faced with a sharp increase in costs, as spreads jumped.

Subsequently, the stock of corporate bonds outstanding fell for a short time during the crisis as businesses had difficulty accessing the market, and were often forced to turn to the banks for funding.

However, last year, corporates began to again tap the bond market. The proportion of corporate bonds on issue compared with the total Australian non-government bonds outstanding is now close to pre-crisis levels.

Australian corporates have tended to source a larger proportion of their debt from overseas bond markets since the crisis, with only \$32 billion worth of corporate bonds currently on issue being issued domestically, compared to around \$140 billion issued offshore.

We are closely monitoring the development of the domestic bond market, particularly in light of the considerable refinancing requirements over the coming 12 months.

And we are looking to industry to show leadership in harnessing this opportunity.

Initiatives to increase competition

The Australian Government is committed to supporting strong competition in the financial services sector.

Competition is critical to ensuring consumers get the range of services they want, at the lowest possible prices. Ensuring that Australia's financial markets are competitive internationally in terms of safety and innovation also has the potential to draw additional liquidity to Australia. This is vital for the growth of Australia's financial services industry into the future.

We are addressing unfair exit fees and other unfair contract terms.

From 1 July 2010, ASIC has the power to take action against any bank if it charges an early exit fee which is considered unfair or unconscionable to a consumer. Consumers will also be able to challenge early exit fees that are unfair or unconscionable.

The Government has given ASIC these tough enforcement powers by passing two new national laws to protect consumers.

Firstly, the new Australian Consumer Law voids any 'unfair' term in a standard-form consumer contract.

And secondly, the new National Consumer Credit Protection Act gives ASIC further powers to take action on any fee which it considers to be 'unconscionable'.

These reforms will strengthen ASIC's hand in pursuing banks over unfair mortgage exit fees.

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These new powers will also make it easier for borrowers to switch to a competitor offering a better mortgage product. This will no doubt stimulate competition in the mortgage market.

As I mentioned earlier, we are supporting securitisation markets through the Government's investment in mortgage-backed securities. We are also boosting support for competition in the market through deposit tax and interest withholding tax rates initiatives.

The Government will phase down the interest withholding tax rate incurred by financial institutions starting in 2013-14, including local subsidiaries and branches of foreign financial institutions, on most interest paid on offshore borrowings.

We expect that this measure will help support them further in putting competitive pressure on Australia's major banks as offshore borrowings from related parties are a source of funding for some non-major banks.

The Government will also provide savers with a tax discount equal to 50 per cent of the interest earned on deposits held across any bank, building society or credit union up to \$500 from 2012-13, rising to \$1000 in 2013-14.

Because deposits typically represent a high proportion of funding for smaller lenders, the Government expects this reform to help reduce the funding cost incurred to support their mortgage lending business.

Future of Financial Advice

As I'm sure you would be aware, in April this year, the Government announced the Future of Financial Advice reform package.

The reforms are designed to improve the trust and confidence of Australian retail investors in the financial planning sector. More specifically, they are designed to tackle the conflicts of interest that have threatened the quality of financial advice provided to Australian investors in the past.

Key reforms in the Future of Financial Advice package are:

- a prospective ban on conflicted remuneration structures, including commission payments and any form of volume-based payments; and
- a statutory fiduciary duty for financial advisers requiring them to act in the best interests of their clients, subject to a 'reasonable steps' qualification.

The reforms also expand the provision of low-cost simple financial advice, enhance the licensing and banning powers of ASIC, and introduce a product-neutral adviser charging regime for advice.

The majority of the reforms will commence from 1 July 2012.

Conclusion

Ladies and gentlemen, Treasury is working closely with the regulators and industry to ensure that our markets are operating as smoothly and efficiently as possible.

This can often require a high level of fine-tuning, as we balance the interests of both the financial sector and its customers.

Once again, thank you for inviting me to talk with you today.

Key themes from Treasury's Business Liaison Program

As part of Treasury's Business Liaison Program, staff held teleconferences with 12 businesses and industry associations during November 2010.

The feedback from liaison continued the pattern of recent rounds, with strong growth in the resources sector and slower growth in other sectors.

Key themes from Treasury's business liaison program

Trading conditions

The key messages emerging from liaison continued the pattern of previous liaison rounds, with strong growth in the resources sector and a slower recovery in other sectors.

Australia is maintaining its dominance in the supply of metallurgical coal. While heavy rain is affecting supply out of Queensland ports (representing the bulk of the supply of the global seaborne trade), the medium-term outlook for exports remains robust, with ongoing strong demand expected from the Asian region.

Over the longer term, prospects for the LNG sector in Australia are strong.

Consumer spending continues to be restrained, dampening retail sales, in part due to unseasonably cool weather through spring. Retailers remain concerned about the potential for further interest rate increases.

The housing market outlook has cooled, with house price growth relatively flat, and a subdued outlook for building activity. Arrears rates were not expected to rise significantly.

Business credit and investment

Firms in the resources sector are looking to expand capacity through increasing capital expenditure in coming years, with a lumpy investment profile expected. This investment will be import-intensive, with a substantial amount of construction being undertaken overseas.

Planned investment in other sectors is continuing as scheduled following some delays during the global financial crisis, although some firms are waiting to see an improvement in activity before committing to further investment.

Capacity issues

Labour shortages are expected to emerge in the resources sector, as large projects come online. These projects will require highly skilled labour – labour shortages have previously led to technical staff being hired from overseas.

There has been some queuing at Australian ports, although port expansions are on schedule and capacity expansions are underway.

Employment and skills

In the retail sector, overall employment levels remain broadly unchanged since the global financial crisis, and employment turnover is lower. Where there are staffing increases in some locations, they are linked to the opening of new retail outlets.

Prices and wages

Some wage pressures are evident, with wages 'catching up' after wage 'freezes' during the global financial crisis. Concern remains about the level of infrastructure charges in the property sector. While there is the potential for the strong Australian dollar to increase retail competition, it was also noted that the dollar was supporting retailers. Discounting remains prevalent.

Casey: the post-depression treasurer

John Hawkins¹

Casey was a protégé of former treasurer SM Bruce. After assisting Lyons on Treasury matters while Lyons was both treasurer and prime minister from 1932, Casey formally became treasurer in 1935, serving for 3½ years. While not trained as an economist, Casey was very diligent and took an interest in the views of economists. He developed proposals for banking reform based on a Royal Commission. Casey developed a plan for national insurance and shepherded it through parliament, but to his disappointment it was dropped as World War II approached. Casey later gave distinguished service as diplomat, foreign minister and governor-general.



Source: National Library of Australia.

1 The author was formerly in the Domestic Economy Division, the Australian Treasury. This article has benefited from comments and suggestions provided by Selwyn Cornish and Alex Millmow. Casey kept scrapbooks of newspaper clippings during his time as treasurer, now in the National Library's manuscripts collection, which facilitated writing this essay. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

RG or 'Dick' Casey, later Baron Casey of Berwick and Westminster, PC, KGMG, CH and Knight of the Garter, had politics in his blood. He was the son of another Richard Casey, also an MP, whose biography he wrote², and Evelyn Jane Harris, whose uncle had been premier of Queensland and whose father and grandfather had also sat in parliament.

His biographer points to a busy life, serving as 'a British War Cabinet minister, governor and peer, as well as an Australian engineer, company director, soldier, public servant, cabinet minister, diplomat, party chief and governor-general'.³

In all this diverse activity, Casey's time as treasurer has tended to be overlooked. His biographer said of his time as treasurer that 'he left no significant monuments'.⁴ His wife apparently regarded revising the designs on the coinage as his only memorable act as treasurer.⁵ Historians differ in their judgements. The Depression chronicler Boris Schedvin describes him as 'energetic but uninspired in his several treasury capacities'.⁶ More positively, Professor Ross Garnaut rates Casey as one of Australia's best treasurers for securing a faster recovery from the Depression than occurred in other countries.⁷ A contemporary journalist opined 'perhaps no federal treasurer has had such grasp of detail'.⁸

A common view appears to be that Casey was 'a born diplomat and administrator but an indifferent politician', lacking the ruthlessness to seize the top prize.⁹ Casey was 'a dapper ... man about town'.¹⁰ 'His manners were impeccable'.¹¹ By one account he was 'perhaps the handsomest politician in the empire'.¹² But he was no dilettante; once confiding to his diary: 'I am conscious of getting rather more impatient and irritable than I used to be with people who take life as a leisurely business. Life is an urgent vital affair'.¹³ He was an active 'terrifically fit'¹⁴ man, interested in planes which he flew and cars which he drove.

2 Casey (2008).

3 Hudson (1986, p viii).

4 Hudson (1986, p 112).

5 Casey, M (1969, p 63).

6 Schedvin (1970, p 316).

7 *The Age*, 9 May 2005, p 4.

8 (*Melbourne Herald*, 15 October 1938.

9 Bridge, C 'Introduction', in Casey (2008, p 3); Crocker (1987, p 47).

10 Coleman, Cornish and Hagger (2006, p 163).

11 Clark (1987, p 235).

12 UK *Daily Express*, cited in the *Daily Telegraph*, 13 March 1937.

13 Diary entry, 31 July 1941. Casey (2008, p 179).

14 Rodgers, D *Labor Daily*, 22 February 1937.

Casey's early career

Casey was born in Brisbane on 29 August 1890. When he was three the family moved to Melbourne. In 1909 he enrolled in engineering at the University of Melbourne. After a year he left to study at Trinity College, Cambridge, from where he graduated with second-class honours in mechanical sciences.

Returning to Australia, he worked for his father, reporting on mining operations, and studying accountancy at night. In 1914 he enlisted and rose to be Major Casey and was awarded the MC. He returned to Australia after the armistice and took up a career in business, taking over some positions from his father who died in 1919. This in turn led to him joining the National Union, the business backers of the ruling Nationalist Party.

Casey shared with another treasurer, SM Bruce, a wealthy upbringing, schooling at Melbourne Grammar and Cambridge, a passion for rowing and service at Gallipoli. For Bruce, Casey almost became 'the child he never had'.¹⁵

Bruce gave Casey a job as government political liaison officer; effectively Bruce's 'eyes and ears' in London, where he worked with Sir Joseph Cook, another former treasurer and prime minister. Casey wrote regularly back to Bruce.¹⁶ He wrote of the rising influence of economists there, for example, regarding an economic advisory council as a useful model for Australia.¹⁷

In June 1926 Casey married Maie Ryan, a well-connected Melbourne artist then living in London, and they later had a daughter Jane and a son Donn.

From 1928 Casey sought to obtain an informal education in economics and public finance.¹⁸ He conversed with economists from the Economic Advisory Council. He also read books on contemporary economics, but was not impressed, writing to Bruce, 'I have looked through several books on the modern economic position lately, but without any great measure of profit to myself. They seem to be an indigestible mixture of the obvious and the unintelligible'.¹⁹ This view extended to economists in general; 'apart from learning from the economists the basic proven facts of economics and

15 Hudson (1986, p 54). Bruce had rented a house from Casey's parents. They dined together and Casey drafted some speeches for Bruce while he was prime minister. Casey recalled that Bruce often addressed him as 'young fellow' or 'young Richard'. Eventually Bruce asked Casey his age and Casey replied he was in his seventies. Bruce replied 'Heavens alive – then you're not a young fellow at all. I've been wrong all these years!'; *The Age*, 10 January 1973, p 8.

16 The letters are published as Casey (1980).

17 Casey to Bruce, 9 July 1925, reprinted in Casey (1980, p 59).

18 Hudson (1986, p 71).

19 Casey to Bruce, 15 March 1928, reprinted in Casey (1980, p 318).

Casey: the post-depression treasurer

finance, one can with little risk afford to ignore their fancies'.²⁰ He appeared to share the view of economics as the 'dismal science', remarking 'the economic practitioner is like the doctor, more interested in disease than in health'.²¹

Casey also got a useful grasp of the stockmarket, advising Bruce after discussions with bankers, brokers and economists in 1928 that 'a depression of ordinary share prices was probable in the next six or nine months'.²²

His early years in parliament

When Bruce lost the prime ministership he advised Casey to leave London and get into Australian politics, which he soon did.²³ With Bruce's support Casey became the successful UAP candidate for Corio. Unlike most members, who lived in their electorates, the Caseys based themselves in Canberra, where they had horses to ride and a pet emu at their private house at Duntroon. They later moved to a controversial 'resident minister's house' in Yarralumla.²⁴ This gave Casey better access to the public service. Casey 'sat on the doorstep of the Treasury and made their lives a misery – absorbing public finance like a sponge'.²⁵ He cultivated assiduously the economists and statisticians, although concentrating on public finance rather than economic theory.²⁶ He stated his intention to keep abreast of contemporary works on economic affairs.²⁷ He warned 'we neglect the education of our youth in economics'.²⁸

In 1932 he repeatedly called for the creation of a federal economic advisory council, representative of the economic subdivisions of the community, and later a federal prices board.²⁹

In September 1933 Casey became assistant minister (treasurer) as Lyons found the workload of being treasurer and prime minister increasingly onerous. Casey worked long hours and added chairman of the Loan Council to his responsibilities. In 1934 he

20 Casey to Bruce, 23 August 1928, reprinted in Casey (1980, p 319).

21 Casey to Bruce, 25 July 1929, reprinted in Casey (1980, p 544).

22 Casey to Bruce, 23 August 1928, reprinted in Casey (1980, p 396).

23 Edwards (1965, p 87). Hudson (1986, p 72) suggested Casey could have stayed on in London under Scullin, for a few years, but chose not to do so.

24 Langmore (1997); Millmow (2007).

25 Cited by Hudson (1986, p 86).

26 Hudson (1986, pp 86, 98).

27 Letter to the economist R Hawtrey, 19 June 1933, cited by Millmow (2010, p 152).

28 Casey (1933a, p 35).

29 Hudson (1986, pp 87-8); Millmow (2010, pp 126-7). See Casey (1932, p 28) and his speeches collated in Casey (1933b, pp 41,44 and 68).

presented to cabinet detailed papers on public finance and unemployment, although they had little impact.³⁰

Unusually for his side of politics, he worried that 'the profit motive, if exercised without proper regard for the public interest, will kill the present system'.³¹ Perhaps reflecting his engineering background, he was less averse to the concept of economic planning than most of his conservative colleagues.³²

Casey presented the 1935 budget, despite Treasurer Lyons being in the House. He announced a small cut in the special tax on income from property and foreshadowed further reductions in what he called 'a severe form of emergency taxation'.³³

Treasurer

Casey was formally appointed treasurer in October 1935. After the 1937 election he was also responsible for development and scientific and industrial research.

Budgets and taxation

In his first budget speech as treasurer, Casey exulted 'it is a great satisfaction to be in a position to present a budget which has so many happy features'.³⁴ He was pleased to present proposals for cuts to taxes, including the abolition of the special property tax, reductions in income tax and a lower rate and increased exemptions for sales tax. Pensions were increased. Casey also took pride in the marked drop in unemployment. Concerned about Australia's dependence on natural resources leaving it vulnerable to global economic fluctuations, Casey hoped to build up the manufacturing sector.³⁵

Casey opposed the use of taxation for redistributive purposes; 'the punitive use of taxation would be destructive of the system of private enterprise and individual initiative'.³⁶

Casey provided the cabinet with an extensive brief on the budget each year.³⁷ He would get exasperated at the lack of rigour and organisation in cabinet discussions.³⁸

30 Hudson (1986, p 93).

31 1936 remarks cited by Hudson (1986, p 92). Crocker (1987, p 43) calls Casey 'not an unqualified admirer of the capitalist system'.

32 Hudson (1986, pp 100, 212).

33 *Hansard*, 23 September 1935, p 51.

34 *Hansard*, 10 September 1936, p 44.

35 Millmow (2010).

36 *Adelaide Advertiser*, 27 August 1936.

37 Weller (2007, p 66).

38 Weller (2007, p 66).

Casey: the post-depression treasurer

He later commented 'a budget tends to be a conflict between politics and economics in which politics nearly always wins'.³⁹

In his 1937 budget speech, Casey proclaimed that 'the present level of prosperity is higher than it has ever been'.⁴⁰ He spent a good deal of the speech listing the tax cuts made under the Lyons governments but regretted no more could be offered on this occasion due to the need to increase defence spending.

Casey opened his 1938 budget speech by referring to the 'wide fluctuations and instabilities experienced in many important overseas countries' and contrasting it with the 'appreciable economic advance' domestically.⁴¹ Unusually, the treasurer did not just discuss estimates for the current year but looked forward to the prospective deficit 'with further liabilities for defence, national insurance and invalid and old-age pensions'.⁴² This led to the need to raise income taxes, sales tax, land tax and excise duties.

Consorting with economists

Casey continued to keep abreast of contemporary academic work on economics. He took a close interest in Roosevelt's 'new deal', visiting the USA in 1937.⁴³

Casey built up the economic expertise available compared to previous treasurers. He appointed an economics graduate, Ian Potter, as his personal secretary and the brilliant Roland Wilson as his economic adviser; 'besides knowing all the economic nonsense ... has a good head, good judgement and general balance'.⁴⁴ He also took an interest in the Commonwealth Bank's economists, interviewing Nugget Coombs for a post as Melville's assistant.⁴⁵ The increasing role for economists attracted some favourable comment overseas, with Australia called the 'utopia of practical economists' and the land where 'the plans of the Economic Men have been put in place'.⁴⁶

Casey did not go as far, however, as wanting economists with him in parliament: 'It is often said that there should be more ... economists in public life. That is quite wrong ... we in politics should display honesty of purpose, ordinary horse sense and

39 Diary entry, August 1953, cited in Hudson (1986, p 224).

40 *Hansard*, 27 August 1937, p 261.

41 *Hansard*, 21 September 1938, p 16.

42 *Hansard*, 21 September 1938, p 26.

43 Casey (1937).

44 Casey to Bruce, 20 February 1935, cited by Millmow (2010, pp 169-70).

45 Rowse (2002, p 73).

46 Goodwin (1974, pp 235-7). See also Millmow (2010, pp 21-22, 156).

fair-mindedness. These bread and butter qualities are not the prerequisites of any profession.⁴⁷

He became gradually more Keynesian. By 1936 Casey declared 'we are all expansionists', arguing it was matter of degree.⁴⁸ In 1937 Casey said 'expand public works in depression and contract them in better times was the broad advice given by economists', with which he agreed.⁴⁹ It has been claimed that 'the first threads of comprehensive economic management in Australia came with the 1939-40 budget, which put into circulation the Keynesian technique of estimating the inflationary gap ...'.⁵⁰

Banking and monetary policy

The Royal Commission on Banking was established with terms of reference drawn up largely by Casey.⁵¹ It followed the appointment of similar inquiries in Britain, Canada and New Zealand.⁵² After several months' consideration, Casey reached across the aisle to appoint former Labor minister (and future treasurer) Ben Chifley to it, viewing him as a moderate Labor voice with an interest in finance. Professor Mills was appointed as the main economist on the Commission, possibly because he had not already publicly stated his views on the issues before it.⁵³ Most of Australia's leading economists appeared before the Commission, some at great length.⁵⁴ Broadly, the Commission supported a counter-cyclical monetary policy and private banks being required to place deposits with the Commonwealth Bank. This fitted with Casey's desire to 'tackle the conversion of the Commonwealth Bank into a real central bank'.⁵⁵

In 1938 Casey asked the Commonwealth Bank and private banks to report to him on the Commission's recommendations. In November 1938 he introduced a bill to amend the *Commonwealth Bank Act*, setting up a mortgage bank and giving it some minor powers to supervise private banks. Casey wanted the private banks to hold deposits

47 *Brisbane Sunday Mail*, 9 August 1936.

48 Millmow (2010, p 177).

49 *The Age*, 24 September 1937.

50 Millmow (2010, p 3).

51 'To inquire into the monetary and banking systems at present in operation in Australia, and to report whether any, and if so what, alterations are desirable in the interests of the people of Australia a whole, and the manner in which any such alterations should be effected.'

52 Scullin had initiated a parliamentary debate calling for such an inquiry in March 1933. Casey was initially 'horrified' at the idea but later conceded it 'may even possibly do some good'; Sutherland (1980, pp 26, 29).

53 Sutherland (1980, pp 40-41). Sir John Phillips, the Commission's assistant economist, suggested to Sutherland that another factor was that Mills was 'likeable, fair and gentle'.

54 Hytten was a witness for five days; Millmow (2010, p 210). The inquiry is described in Giblin (1951, pp 212-226) and Sutherland (1980).

55 In a 1932 letter cited by Hudson (1986, p 102).

Casey: the post-depression treasurer

with the Commonwealth Bank and assigned Wilson to develop a Trading Banks Bill in 1938, but Cabinet first deferred it, then watered it down and finally let it lapse.⁵⁶

National insurance

At the 1937 election, Lyons promised to introduce a national insurance scheme, combining elements of health insurance and superannuation, a policy Casey as treasurer had been developing and advocating.⁵⁷ Casey put immense effort into the project.⁵⁸ The legislation included benefits for sickness, old age and widowhood. It passed through parliament in July 1938, but employers (and even some members of the government) opposed it and concerns were expressed about administrative difficulties. Unlike the 1928 proposals, this time the Labor party opposed the compulsory contributions. As the expenses of a second world war loomed, the government became even less keen on it. Lyons instructed Treasury to abandon the scheme. Casey's role in its abandonment is unclear.⁵⁹

Politics

When Lyons died in April 1939, the leadership was thought likely to fall to Casey, Hughes or Menzies.⁶⁰ But instead of lobbying furiously for it, Casey joined the Country Party leader Page in unsuccessfully calling for Bruce to return.⁶¹ In the leadership ballot, Casey was eliminated and Menzies defeated the septuagenarian Hughes.

Other interests

In 1937 the Caseys attended the coronation of George VI. While in England they bought a Picasso, believed to be the first Picasso oil painting to be brought to Australia. Casey and Maie both became licensed pilots and sometimes flew themselves between Melbourne and Canberra.

56 Coleman, Cornish and Hagger (2006, p 164).

57 In February 1936, Casey had taken a submission to cabinet on it and suggested a British expert be invited to Australia. Casey met with European experts while in the UK in 1937. In his election campaign that year he called the plan 'one of the most progressive that had ever been advanced'; *Geelong Advertiser*, 7 October 1937.

58 Hudson (1993).

59 His biographer notes that Casey gave contradictory accounts about whether it was his or Lyons' initiative to drop the scheme; Hudson (1986, p 105). Contemporary press reports suggest Casey supported the scheme almost to the end and it was dropped due to pressure from the Country Party and doctors. On one account, Lyons said of Casey's support for the scheme 'He talked us into this. I could see the difficulties. I never wanted it ...'; Millmow (2010, p 251).

60 An interesting conjecture is that some believe that had Lyons been able to speak when visited on his deathbed by the governor-general, he would have advised that Casey be called as his successor; Bridge (2004, p 478).

61 *Argus*, 17 April 1931, p 1. To his credit, Casey also spent time looking after the needs of the Lyons family; Lyons, E (1972, p 125).

His subsequent career

In April 1939 Menzies decided to take the treasury portfolio himself and Casey was shifted to minister of supply and development.⁶² In 1940 Menzies sent Casey as Australia's first ambassador to Washington, many said to exile a rival, where he encouraged the US to enter the war against Germany. Casey subsequently served as a British minister in the Middle East and then as governor of Bengal, before returning to Australia as federal president of the Liberal Party. He also took on the role of public intellectual, writing books. He argued for faster population growth, improved infrastructure and a greater role for the Australian government in the housing market.⁶³ Casey maintained some interest in economics, meeting with Keynes and circulating memos.⁶⁴

Casey returned to parliament at the 1949 election, now representing the outer Melbourne seat of La Trobe. He became minister for supply and development, and then works and housing. From 1951 to 1960 Casey served as foreign minister.

Casey warned of the emerging inflationary pressures in the early 1950s and wanted a stronger policy response, including an appreciation of the exchange rate. Unimpressed with the Treasury's expertise, he wanted an economic secretariat to service cabinet.⁶⁵

In 1956 he was defeated by Holt for the deputy leadership of the Liberals, effectively ending his ambition to become prime minister. He received a life peerage when he stood down from parliament in 1960 and as Baron Casey served as governor-general from September 1965 to April 1969. He was the 1969 Australian of the Year. After a retirement in which he seemed frustrated by the lack of activity, and following a car accident in 1974 from which he never fully recovered, Casey passed away on 17 June 1976.

62 A possible reason is that Menzies wanted to be able to offer the treasurer's job readily to a Country Party member if the coalition was reformed; *Herald*, 25 April 1934 and *Sydney Morning Herald*, 26 April 1934.

63 In Casey (1949, p 4) he doubted Australia would double its then population of 7½ million by the end of the 20th century, which he regarded as 'much too slow'.

64 His diary entry for 16 July 1941 records 'J M Keynes called and had good discussion. He describes his attitude as being optimistic on economic possibilities and not so optimistic on probabilities' and called him 'one of the world's great people'; Casey (2008, p 175).

65 Hudson (1986, p 213).

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What's new on the Treasury website

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

What's new on the Treasury website

Publications

JEFG Report — March 2008

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1884>

To help inform public discussion and debate, Treasury has decided to release reports of the Joint Economic Forecasting Group (JEFG) Committee, after a period of 2½ years, starting with the March quarter 2008 Report.

The JEFG Committee consists of Treasury, the Reserve Bank of Australia, the Department of the Prime Minister and Cabinet, the Department of Finance and Deregulation and the Australian Bureau of Statistics.

The committee meets three times a year to discuss the domestic and global outlook. A JEFG Report is prepared by Treasury in consultation with the other partners and is provided to the Treasurer, the Prime Minister and the committee members. The report provides Treasury's assessment of the domestic and global outlook, including its revised economic forecasts.

Attitudes to Superannuation

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1885>

In early 2009 the Government commissioned empirical research into community attitudes and values toward superannuation. On 24 October 2010, the Assistant Treasurer announced the outcome of this research.

Treasury Annual Report 2009-10

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1893>

The *Treasury Annual Report 2009-10* outlines performance against outcomes, programs and performance information contained in the *Portfolio Budget Statements 2009-10* and *Portfolio Additional Estimates Statements 2009-10*.

Australia's Future Tax System Review — Release of supporting information

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1895>

On 28 October 2010, the Treasurer voluntarily released additional material underlying the AFTS review. This additional material is available on the AFTS website:

http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/commissioned_work.htm

Freedom of Information (FOI) requests for the Treasury Incoming Government Briefs

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1875>

On 24 September, the Treasury published on its website the information released under FOI in relation to the brief prepared for a returned Labor Government (referred to as the Red Book). Following this, the Treasury received a request for an internal review of the decision not to release certain sections of the Red Book. This request was considered, taking into account the weight given to public interest, the passage of time and subsequent events, including public disclosures, since the original decision.

The Treasury has now amended the earlier published documents to include the further material released under the internal review.

Speeches

Presentation by Mr Jim Murphy to the Abacus 2010 Regulatory Affairs Conference

<http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1897>

This address was delivered by Mr Jim Murphy, Executive Director — Markets Group, to the Abacus 2010 Regulatory Affairs Conference on Monday 18 October 2010.

What's new on the Treasury website

The Context and Drivers for State Tax Reform

<http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1908>

This speech was given by Dr Ken Henry to the Committee for Economic Development of Australia (CEDA) – The Tasmanian State Tax Review, on Friday 19 November 2010 in Hobart.

Sustainable Economic Policies — Viable Outcomes for All Stakeholders

<http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1913>

This speech was given by Tony McDonald to the CPA Australian Mining and Energy Conference on Thursday 25 November 2010.

Consultations

The following consultations are open for public comment:

- Options Paper – Regulation of tax agent services provided by financial planners.
- Discussion Paper – Improving the integrity of public ancillary funds.
- Discussion Paper – Improving the operation of the anti-avoidance provisions in the income tax law.

Sources of economic data

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

International economy

Output, current account balance, interest rates and consumer price inflation	OECD Main Economic Indicators
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National accounts

Components of GDP, contributions to change in GDP	ABS cat. no. 5206.0
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Incomes, costs and prices

Real household income	ABS cat. nos. 5204.0 and 5206.0
Wages, labour costs and company income	ABS cat. nos. 5204.0, 5206.0, 5676.0 and 6345.0
Prices	ABS cat. nos. 6401.0 and 5206.0
Labour market	ABS cat. no. 6202.0

External sector

Australia's current account, external liabilities and income flows	ABS cat. nos. 5368.0, 5302.0 and 5206.0
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Past editions of *Economic Roundup*

Details of articles published in recent editions are listed below:

Issue 3, 2010

IGR 2010: challenges and priorities for Australia

Tax reform: opportunities and challenges

Forecasting in the eye of the storm

Estimating the structural budget balance of the Australian Government

Key themes from Treasury's Business Liaison Program

Joseph Lyons: the Tasmanian treasurer

Issue 2, 2010

Fiscal policy and the current environment

The Australian financial system — emerging from the global financial crisis

The value of the environment

An overview of transport investment and government policy

China: growth, urbanisation and mineral resource demand

Tax expenditure considerations for owner-occupied housing

Disparities in average rates of company tax across industries

Key themes from Treasury's Business Liaison Program

James Scullin: depression treasurer

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

