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AUSTRALIA'S EXPERIENCE WITH ECONOMIC REFORM

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This paper has been prepared to inform an officials level workshop at the IMF and World Bank Annual Meetings in Bali, Indonesia in October 2018. The paper will be discussed by Ms Laura Berger-Thomson and a panel including Dr Changyong Rhee, Mr Charles Abel, Dr Mohamad Chatib Basri, Mr Rodrigo Valdés and Mr Nigel Ray.

This paper discusses the factors and circumstances that influenced the course of the Australian economy over the past 40 years. It will discuss challenges Australia faced and events that motivated reform emphasising aspects unique to Australia as a commodity exporting country, geographically remote with a relatively small population.

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INTRODUCTION

The Australian economy has been remarkably resilient over the past 30 years or so. Since the early 1990s recession, the economy has weathered a number of significant shocks well, including the Asian financial crisis in 1997-98, the global financial crisis of 2008-09 and one of the largest terms of trade cycles in the country's history from the mid-2000s to the mid-2010s. This resilience largely reflects the flexibility in the Australian economy, which is a product of a series of macroeconomic and microeconomic reforms by successive state and federal governments that occured over the past 40 years or so.

This paper examines Australia's period of economic reform in a way that intends to be useful both for Australian policymakers thinking about future reform, and for other countries considering their own reform programs, acknowledging their circumstances may be quite different to those in Australia. Like in many other countries, the economic reforms undertaken in Australia have largely focused on opening markets to increased competition, including in the traded, financial and government sectors. These reforms have led to significant structural change. They have transformed a relatively closed and regulated economy into one that is more efficient, flexible and open, and in the process have reduced the size of industries supported by large ongoing subsidies and high tariffs, notably in manufacturing. Despite this, there is good evidence to suggest the reforms have led to an overall rise in living standards, both through raising productivity via supply-side reforms and improving demand management.

The paper begins with a broad overview of the main reforms before examining what they achieved for Australia in terms of economic performance and stability. It then reflects on what insights can be drawn from the way Australia went about implementing these changes, and the factors that contributed to their development and success. In the Appendix, the paper describes Australia's reform period in greater detail through three broad reform waves: macroeconomic stability; microeconomic reform; and monetary and fiscal policy developments.

1. AUSTRALIA'S ECONOMIC REFORMS AND THEIR EFFECTS

For much of the 20th century, Australia's economy was more protected and inward-looking than it is today. Domestic industry was protected from international competition by high tariffs. Iron ore exports were banned until the 1960s. Almost all wages were set by a centralised authority. The Australian dollar was pegged to the British pound and capital flows in and out of the country were tightly controlled. In markets ranging from transport to retail to dairy, the government dictated business operations such as pricing, opening hours or output. The country's biggest bank was government owned, as were a raft of state-based banks, the monopoly telecommunications provider, the biggest airline, and power, water and gas utilities. In the financial sector, foreign banks were barred from operating in Australia and domestic banks were limited by government regulation on how much they could lend and at what interest rate.

The Australian economy of 2018 looks very different. Tariffs are among the lowest in the world. Most workers' wages are determined at the enterprise level. Australia has a floating exchange rate and an open capital account. Public ownership of trading companies or utilities is uncommon, and only in a few markets is the government involved in setting prices. Commercial banks decide how to allocate credit and face competition from foreign institutions. And, though it plays a less managerial role in the private economy, government continues to provide core public services such as universal school education and health care.[2]

This transformation of the Australian economy occurred through a range of reforms implemented through three waves — best understood in thematic rather than chronological terms. The first wave largely comprised reactive reforms aimed at improving macroeconomic stability. These changes were concentrated in the 1970s and early 1980s, although financial reform continues through to today. Reforms in the second wave were conducted in a more premeditated fashion and were largely aimed at raising the efficiency of the domestic market. This effort began in earnest in the late 1980s and was particularly intensive during the 1990s. The third wave focused on the government sector, particularly through measures to improve fiscal sustainability and revise tax and spending policies. Though more prominent since the 2000s, changes of this type have occurred throughout the reform period. The Reform Roadmap in the Appendix presents a snapshot of the Australian reforms between 1970 and 2018.

First wave of reforms

Australia's first wave of reform began with the deregulation of the financial sector from the 1970s and included the floating of the exchange rate. In the face of rising capital inflows and the growth of non-bank lending, authorities battled to manage a fixed exchange rate, a controlled capital account and domestic monetary settings. The initial response was to unwind some banking controls and partially free up the exchange rate by introducing a crawling peg. But following a government-commissioned independent review of the sector at the end of the decade, a decisive shift occurred in 1983 with the decision to float the Australian dollar and remove capital controls. Soon after, foreign banks were permitted to enter the Australian market. Financial sector reform has provided a range of benefits. The floating exchange rate has been critical to Australia's economic resilience over recent decades (Chart 1). And after some missteps – notably a credit bubble during the late 1980s – financial deregulation eventually delivered gains including reduced borrowing costs (Chart 2). But financial reform has not stayed still. Subsequent reviews of the sector have led to further fine tuning of policy settings, including the adoption of a "twin peaks" financial regulation model in 1997.

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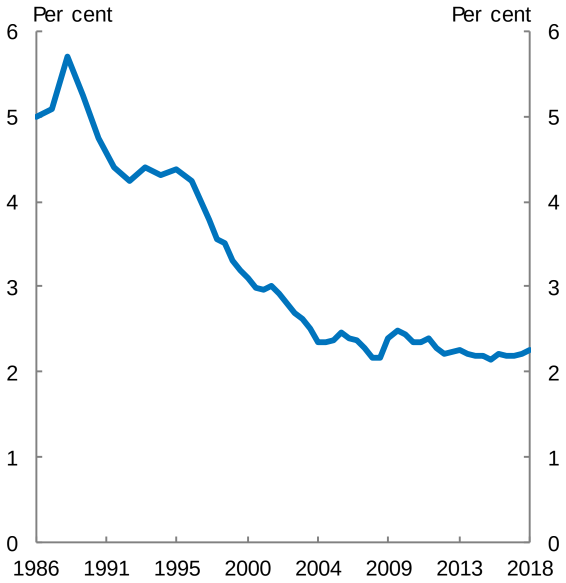
2 The government provides free public hospital treatment and subsidises out-of-hospital medical treatment.

CHART 1: TRADE-WEIGHTED INDEX

Source: RBA.

CHART 2: NET INTEREST MARGINS



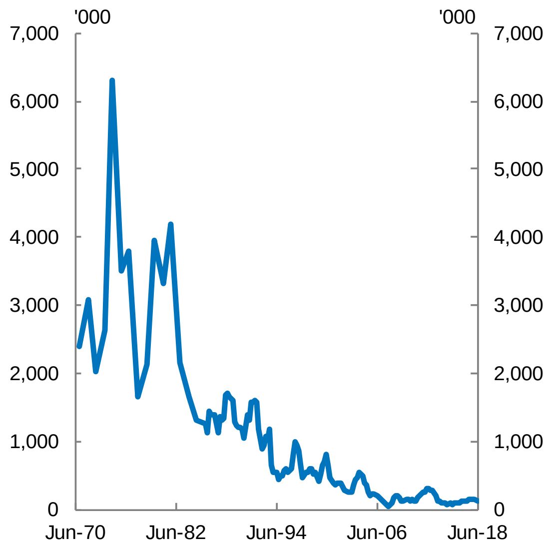
Note: From 2006 data are an IFRS basis; prior years are on AGAAP basis; excludes St George Bank/Bankwest prior to first half of 2009. Source: Banks' Financial Reports; RBA.

The other major macroeconomic stability reform of this period was the 1983 Prices and Incomes Accord, the first in a series of such agreements between unions and the government. In the Accord's initial iteration, unions agreed to contain wage demands to help curb inflation. In return, the government agreed to support workers through a 'social wage' which included increased spending on health and education, tax reform and, later, the introduction of compulsory retirement savings. The broad intention was to raise productivity and ensure the resultant economic gains were shared with workers. The Accord was a response to the economic turmoil of the 1970s, when union wage demands resulted in a surge in real wages despite slow productivity growth – a development reflected in a jump in the labour share of income (Chart 3). As a solution to excessive wage demands, the Accord was unusual, because it increased the role of the unions in the industrial relations system. But it was also effective. Real wages declined over the 12 years successive Accords remained in force, which, combined with other reforms, helped ease inflation. In addition, the Accord was one of a number of developments that contributed to a sharp fall in days lost to industrial action (Chart 4).

CHART 3: LABOUR SHARE OF INCOME

Source: ABS cat. no. 5206.0.

CHART 4: DAYS LOST TO STRIKES



Note: Data shown is days lost in year ended terms.
Source: ABS cat. no. 6321.0.55.001.

Second wave of reforms

The opening up of the external sector in the first wave of reforms emphasised concerns about the poor productivity performance of domestic industry. These concerns were not new. Although Australia was prosperous in the post-war decades, it was recognised that living standards were starting to slip relative to its peers. This realisation sparked a growing discussion among policymakers during the 1960s and 1970s that the existing protectionist economic model was no longer viable. But not until the mid-1980s, as the terms of trade deteriorated and the current account deficit widened, did these concerns spark a concerted policy response. The government saw the solution as a wide-ranging program of reforms aimed at improving the efficiency of the economy. These included tariff cuts, partial decentralisation of wage setting, privatisation of government assets and broader microeconomic reforms.

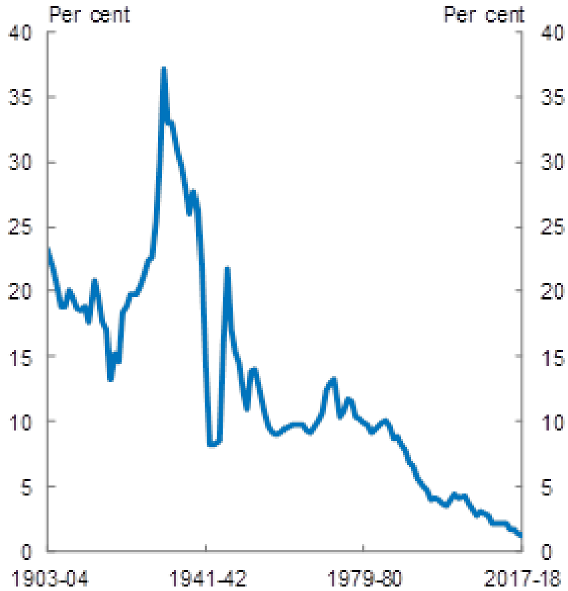
These reforms differed significantly from those undertaken in the first wave in that they were, by and large, planned and premeditated. Tariff reforms, beginning in the late 1980s, were among the first policies introduced during this second wave. Government policy was to regularly and systematically reduce tariffs across the board, with differential rates of reduction depending on pre-existing tariff levels. Effective tariff rates have steadily declined from around 10 per cent in the late 1980s to around 2 per cent today (Chart 5). Even a severe recession in the early 1990s did not slow progress. Some industries received support to help with the costs of transitioning to the new environment, especially when the cuts were first announced. While most assistance packages were small and lasted only a few years, some industries – notably passenger motor vehicles (PMV) and textiles, clothing and footwear (TCF), both of which had very high effective tariff rates – received government support for a lengthy period. Indeed, TCF retains some tariff protection to this day.

The tariff reductions meant the Australian economy was better placed to exploit its comparative advantage, which is in sectors such as mining and agriculture rather than in manufacturing.[3] The reduction in protection contributed to the decline in manufacturing's share of output from around 13 per cent of GDP in the late 1980s to around 6 per cent more recently (Chart 6). But while manufacturing employment declined through this period, real output in the sector steadily increased before peaking in the late 2000s. Yet as the government argued at the time, tariff cuts would eventually deliver net gains to the economy. Job losses in declining industries would be more than offset by gains elsewhere, including in trade-exposed industries benefiting from cheaper input costs and through wider job opportunities that stronger economic growth would provide.[4]

3 For a more detailed description of reform in the agriculture sector, see Box B.

4 In his 1991 industry statement, then Prime Minister Bob Hawke said: "[Tariff cuts] will also make our exporters and our import competing sector more competitive by lowering the cost of their inputs. The overall impact of the reforms will be a net gain in employment, although jobs will be lost in declining industries."

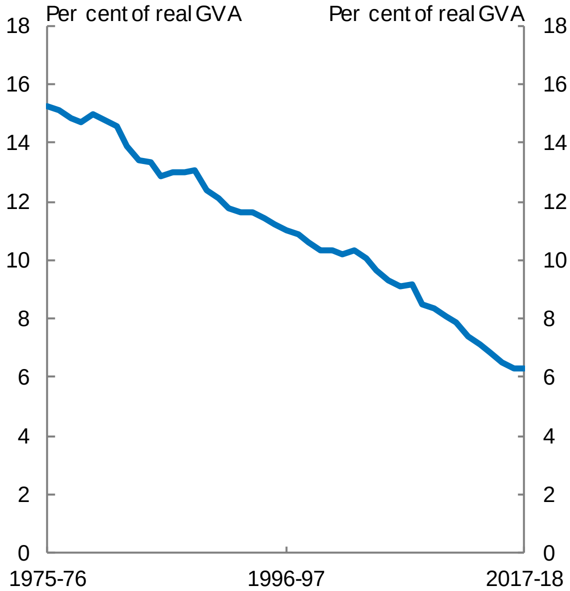
CHART 5: EFFECTIVE TARIFFS



Note: Average tariff protection is calculated as net total duty (inclusive of excise equivalent goods) collected divided by the total value of merchandise imports, excluding the value of Specie and Bullion. Preliminary adjustments have also been made to take into account the transfer of excise collection on tobacco goods from the ATO to DIBP from 2010-11.

Source: Lloyd (2008), ABS cat. no. 5368.0 and 1364.0.15.003 and Treasury.

CHART 6: MANUFACTURING SHARE



Source: ABS cat. no. 5204.0.

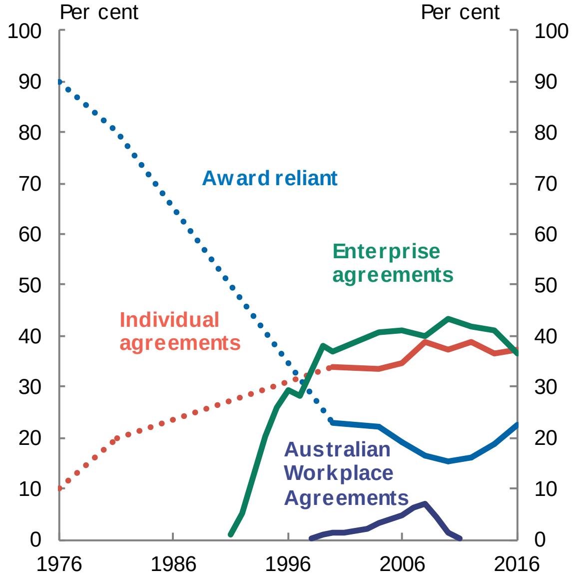
The second wave of reforms also included a shift to a more decentralised wage bargaining system. This occurred through a formalised collective bargaining process at the firm level, including in non-unionised workplaces. Somewhat surprisingly, much of this shift took place with the support of the union movement and through a highly centralised mechanism, the Accord. In part, it was achieved by retaining safety nets for workers in the form of so-called ‘awards’ – centrally determined rulings that set out minimum pay and conditions for particular occupations or industries. But mostly it reflected the union movement’s acknowledgement, following the economic turmoil of the 1970s and early 1980s, that workers’ interests would best be served through productivity gains leading to higher real wages and more jobs. These reforms had the effect of significantly reducing the number of workers on award wages and increasing the number on individual contracts (Chart 7). This has improved the flexibility of the Australian labour market, enabling it to respond relatively smoothly when later economic shocks inevitably arrived.

Lastly, the second wave included a wide range of reforms aimed at promoting competition and raising productivity in a number of goods and services markets. A crucial part of this agenda was the corporatisation and subsequent privatisation of government business enterprises including the national carrier, Qantas, the country’s biggest bank, the Commonwealth Bank of Australia, and the monopoly telecommunications provider, Telstra. Reforms also focused on lowering input costs for business by promoting competition in the delivery of essential infrastructure services including energy, transport and communications.[5] In these and other markets, deregulation had the effect of pulling back direct government control and allowing resources to be allocated by market mechanisms where possible – a shift witnessed in other economies (Chart 8).[6]

5 See Productivity Commission 1996 for a stocktake of progress in microeconomic reform.

6 There are some sectors that have some pricing regulation, for example most state governments regulate electricity or gas retail prices.

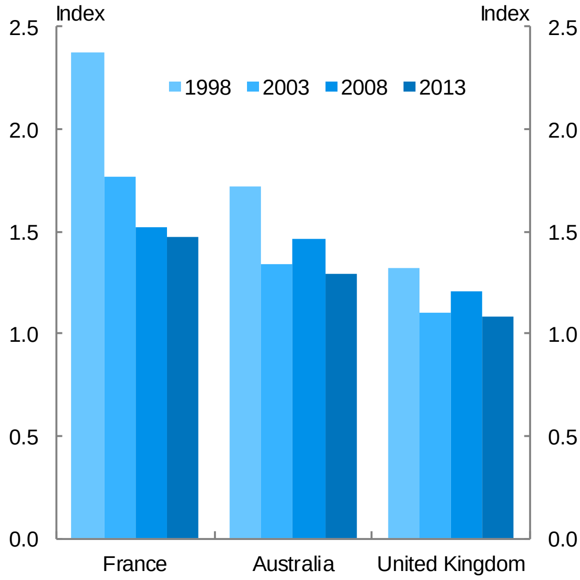
CHART 7: COVERAGE OF ENTERPRISE AGREEMENTS



Note: Data prior to 2004 should be interpreted with caution, as it is approximate and drawn from a range of sources which may not be consistent. Prior to 1991, those not on awards are assumed to be on common law individual agreements, or self employed.

Sources: Borland, J. "Labour market and industrial relations", ABS cat. no. 6105.0, ABS cat. no 6102.0, ABS cat. no 6306.0 and Department of Jobs and Small Business. ABS cat. no. 6306.0.

CHART 8: OECD PRODUCT MARKET REGULATION SCORES



Source: OECD.

Note: A lower score indicates less product market regulation.

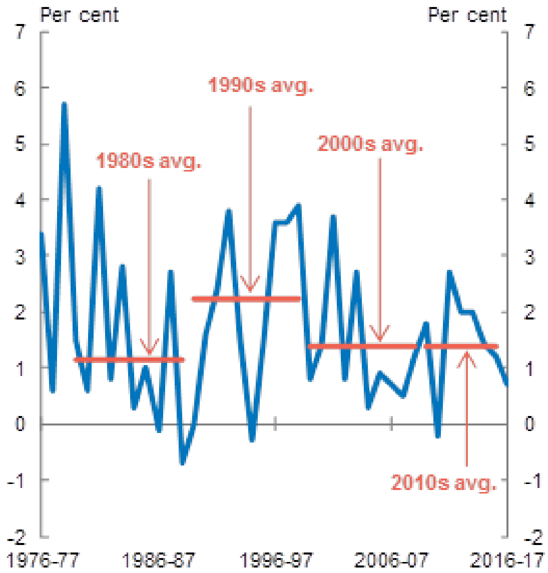
These were arguably the most premeditated and planned economic reforms undertaken in Australia, particularly where they demanded coordination between federal and State governments.[7] This is because their effect was to increase the rate of economic growth and therefore federal government revenues, whereas state government revenues from the operation of assets were expected to fall.[8] This outcome motivated a system of 'competition payments', from the federal to state governments, that were conditional on an independent assessment of the states' progress in implementing reforms. Microeconomic reform by state and federal governments subsequently continued from the mid-2000s under the so-called National Reform Agenda, which targeted improvements in competition policy, regulation and human capital.

Following these reforms, productivity growth rebounded in the 1990s, after having been weak compared with other countries over preceding decades (Chart 9). This is likely to have contributed to the lift in exports as a share of GDP over this period, although the rise of manufacturing value-added chains complicates a comparison with other countries (Chart 10).

7 Implementation of pro-competition reforms took many years and was aided by cooperation among key political leaders, both within federal parliament and between different levels of government.

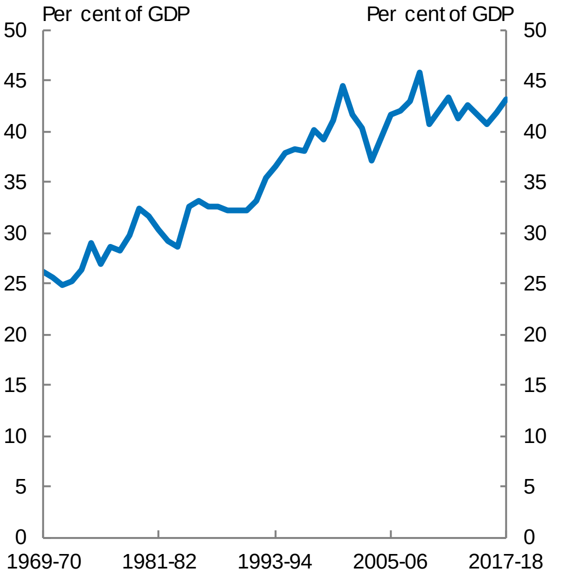
8 See, for instance, Henry 2014 and Productivity Commission 2005.

CHART 9: LABOUR PRODUCTIVITY



Source: ABS cat. no. 5204.0.

CHART 10: AUSTRALIA'S TRADE INTENSITY



Note: Trade intensity is calculated as the sum of nominal imports and exports as a share of nominal GDP.

Source: ABS cat. no. 5206.0.

Third wave of reforms

The third wave of reform targeted fiscal and monetary policy. Successive governments introduced reforms that coaxed fiscal discipline, broadened the tax base, raised national saving, and improved the sustainability of large spending programs such as health, welfare and education. Through a range of measures – on tax, spending and institutional settings – governments took steps to impose greater discipline on fiscal policy without compromising social welfare objectives. Combined with the sale of government enterprises, this helped to reduce net debt (Chart 11) – leaving Australia especially well placed to weather the 2007-08 global financial crisis. Tax reform was also pursued to support economic performance, including company tax cuts that improved Australia's international competitiveness and personal income tax cuts that aided workforce partication. In 1996 a Charter of Budget Honesty was introduced to formalise an approach to fiscal management. In addition, the shift to an independent, inflation-targeting central bank, which has maintained low and stable inflation in Australia over recent decades (Chart 12), was formalised in the 1996 *Statement on the Conduct of Monetary Policy*.

Since the late 1990s, most major reforms in Australia have been to tax policy, even if a number were subsequently repealed. In general, governments have sought to broaden the tax base and reduce reliance on income taxes, including through the introduction of a 10 per cent goods and services tax (GST) in 2000.[9] Notably, there has been relatively little reform in the resources sector, despite its importance to the national economy. This largely reflects the nature of that sector in Australia, which is privately owned and has operated with relatively little government involvement for most of its history. Still, resources taxation has been the subject of much debate. After a 2010 review concluded the sector was undertaxed,[10] a Minerals Resource Rent Tax was legislated but repealed two years later. More recently, a 2017 review called for a rethink of how new oil and gas projects are taxed.[11]

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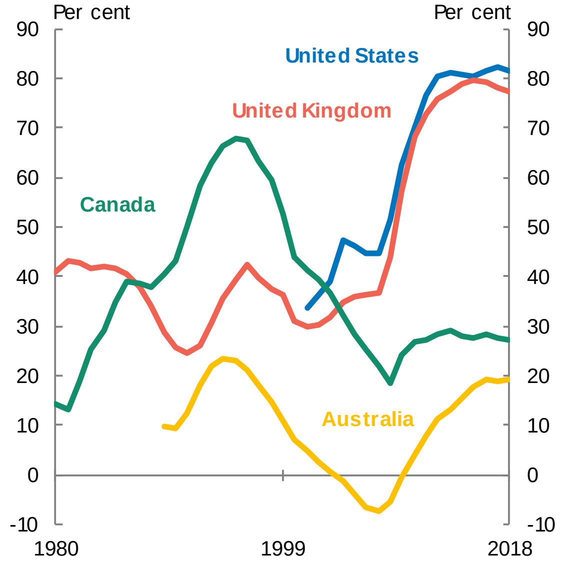
9 It should however be noted that comparing the composition of Australian Government taxes over a number of decades reveals no substantial overall change in composition between the broad categories of indirect taxes (including the GST post-2000), corporate and personal income taxes.

10 Australia's Future Tax System Review Panel 2010.

11 Australian Government 2017 (1).

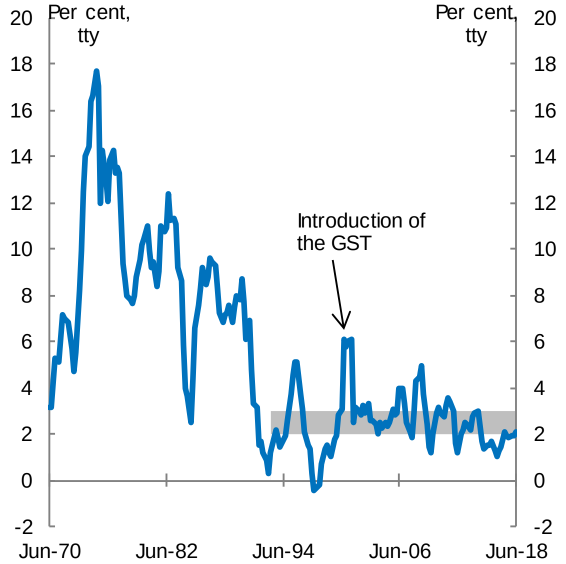
CHART 11: GENERAL GOVERNMENT NET DEBT AS A SHARE OF GDP



Note: General government net debt, which includes all levels of government.

Source: IMF World Economic Outlook Database, April 2018; Thomson Reuters Datastream.

CHART 12: CPI INFLATION



Note: The shaded area indicates the RBA's inflation target band.

Source: ABS cat. no. 6401.0.

2. Reflections on Australia's experience with reform

Australia's economic reforms were not unique. The policies it implemented from the 1970s reflected intellectual ideas that emerged in the decades after the Second World War and which continue to be espoused by economists and policymakers today. These reforms appear to have delivered benefits in terms of economic efficiency and flexibility, especially for a commodity producer like Australia. But success in a reform process is not guaranteed, particularly given the power of vested interests to derail even the most well thought-out policy. Thus this section explores both what the reforms achieved, and how their design and implementation contributed to this success. There has not been one particular factor that stands out; success can be attributed to the overall combination of the reforms and their sequencing, pacing and implementation.

What did the reforms achieve?

It is commonly accepted that Australia's continuing economic and fiscal reforms have benefited its economy overall. Two main benefits stand out. First, in the 27 years since the early 1990s recession the Australian economy has repeatedly demonstrated resistance to shocks – especially for an economy so reliant on volatile global commodities markets. Second, Australians' living standards have outstripped gains in a number of comparable economies.

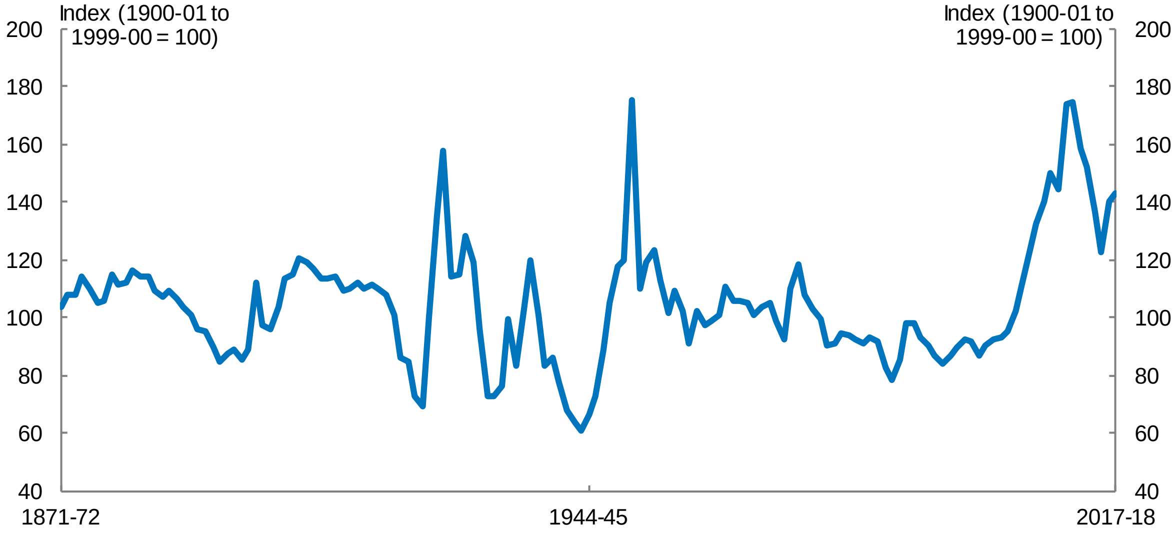
The Australian economy's resilience over the past couple of decades or more is notable. Australia has not experienced a technical recession, meaning a contraction in GDP for two successive quarters, for 27 years – the longest run since the national accounts were first published in 1959. Only a few advanced economies have ever achieved such a record. The next longest such run in Australia was the 10 years leading up to the recession of the early 1970s. In contrast, in the 25 years to 1995, Australia experienced three recessions – in the mid-1970s, the early 1980s and the early 1990s – that together imposed large financial and social pain on the community.[12]

12 In the 1970s, there were three technical recessions but only one of these occurred in trend terms.

This recent economic performance does not reflect a lack of external shocks. Indeed, since the early 1990s recession there has been the 1997-98 Asian financial crisis, the bursting of the US dot com bubble in the early 2000s and the global financial crisis in 2007-08. Further, the period includes one of Australia's largest terms of trade cycles, which generated significant swings in national income (Chart 13). Economic activity also responded to these movements in the terms of trade, not least reflecting an expansion in new private business investment by 5 percentage points of GDP followed by a contraction of a similar magnitude.

Much of the resilience of the economy can be attributed to Australia's flexible exchange rate. Over the course of the past 27 years, the Australian dollar has varied between a value of $US1.11, achieved at the height of the mining boom in mid-2011, and $US0.48, reached in 2001. The dollar depreciated noticeably during each of the crisis episodes outlined above, helped by its status as a proxy for global risk and the Reserve Bank of Australia's preference to intervene only rarely – and then only to avoid disorderly adjustments.[13] The associated improvement in the competitiveness of the traded sector during these crisis episodes helped the country to avoid more serious downturns.

CHART 13: AUSTRALIA'S TERMS OF TRADE



Source: ABS cat. no. 5206.0, Battelino (2010), RBA and Treasury.

The experience of New Zealand in the Asian financial crisis provides a good counterpoint to Australia's experience. While the RBA let the Australian dollar fall, the Reserve Bank of New Zealand (RBNZ) sought to defend the New Zealand dollar, at least initially, only to see its economy fall into recession in 1997-98.

A flexible exchange rate was also critical in helping Australia manage its recent terms of trade boom. Unlike in a number of other resource-rich economies, mining projects in Australia are almost exclusively owned by the private sector. This means the government is less able to moderate the macroeconomic effect of commodity price cycles. From 2003 to 2011, Australia's terms of trade almost doubled as surging Chinese demand for commodities such as iron ore and coal pushed their prices to record highs. The floating dollar acted as a shock absorber. It appreciated as the terms of trade rose, distributing the benefits of the boom during the upswing to households across the country in the form of cheaper imports[14] and allowing resources from trade-exposed industries to shift to the mining sector. The subsequent depreciation of the Australian dollar during the downswing in commodity prices softened the effect on incomes by improving the international competitiveness of large services export industries such as education and tourism.

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13 The last time the RBA intervened was in late 2008 (see Reserve Bank of Australia 2012).

14 This raised the real consumer wage above the real producer wage. See Australian Treasury, 2017, p 18.

In Australia, movements in the exchange rate act as a shock absorber because the foreign currency exposure is small. Indeed, Australia has a net foreign currency asset position (that is, its foreign currency assets are greater than its liabilities) as a large share of foreign liabilities are denominated in domestic currency. In addition, a majority of foreign currency liabilities are hedged back into domestic currency.[15] This means that sizable depreciations are expansionary for the domestic economy. This is not the case for some other commodity-exporting countries, where currency depreciations can significantly raise the debt-servicing burden and can be destabilising. It also emphasises the importance of deep and liquid hedging markets.

The Australian economy's performance during the global financial crisis was also helped by the flexibility in the country's labour market. In the global financial crisis, a significant adjustment in average hours helped to moderate the effects on aggregate employment. In practice this meant that employers retained staff at reduced hours in contrast to previous downturns where retrenchment was the more usual response – a good example of the increased flexibility of Australia's employment arrangements. Keeping more people employed was also likely to have kept consumption a bit higher than it would otherwise have been.[16] Indeed, the increase in the unemployment rate in Australia, of almost 2 percentage points, was one of the lowest in the OECD. Of course, other factors helped Australia weather the global financial crisis, including robust financial regulation, successive reductions in the cash rate, a strong budget position, targeted and rapidly implemented fiscal stimulus and its exposure to China's economy, which itself benefited from substantial fiscal stimulus.

Australia's flexible labour market was also instrumental in helping the economy adjust to the terms of trade boom. Commodity price increases spurred substantial growth in mining investment. Firms increased wages to attract workers from both other parts of Australia and overseas to remote areas of Australia to, among other things, dig holes, drive trucks and construct pipelines.[17] The strong growth in mining investment also increased demand in other industries and, although there was some spillover into generalised wages, there was not a break-out in inflation as had occurred in previous terms of trade booms. As the mining investment cycle turned, workers returned to their home countries and to east-coast capitals, where they were able to moderate capacity constraints sparked by increased infrastructure construction. Wage growth in the mining sector slowed significantly in order to lower relative wages in that industry. As occurred in the global financial crisis, average hours also adjusted noticeably. The increase in the unemployment rate, from 5.0 per cent in January 2012 to a peak of 6.4 per cent, was relatively modest.

The resilience and stability of the Australian economy is particularly apparent when compared with other major commodity-exporting nations. Like Australia, economies such as Chile, Russia, Canada, Brazil and South Africa are susceptible to volatility resulting from large swings in global commodity prices. Among these economies, Australia recorded the lowest volatility in both output growth and inflation during the decade from 2003.[18] This was despite experiencing a terms of trade shock and investment boom as big as any during this period. As in Canada and Chile, a sharp increase in Australia's real exchange rate occurred primarily through the nominal exchange rate rather than through inflation.

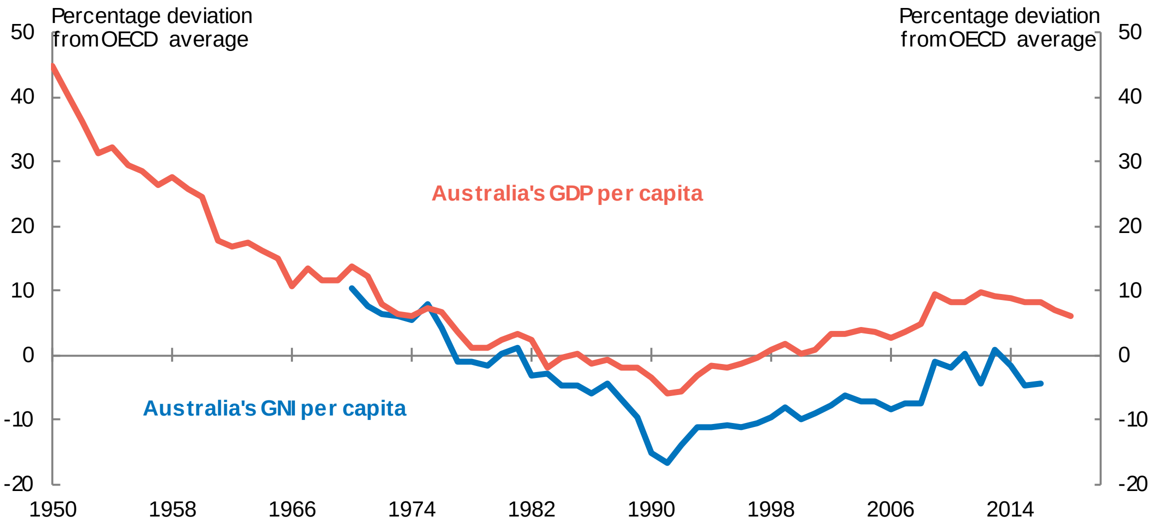
By reducing the incidence and severity of economic downturns, the greater stability in real GDP growth resulting from Australia's economic reforms has helped improve living standards.[19] Macroeconomic reforms, including those to the independence and objectives of monetary policy,

15 Berger-Thomson and Chapman 2017.
16 Bishop and Plumb 2016.
17 Australian Treasury 2017.
18 Connolly et al. 2013.
19 See Haldane 2018 for a discussion of the role of downturns in long-run economic growth.

have also resulted in lower and less variable inflation and unemployment rates. The inflation rate has averaged 2½ per cent since 1996, compared with over 7 per cent in the two previous decades. In addition, the increase in flexibility in labour and product markets means that the economy can grow faster for a given rate of inflation.[20] Australia's unemployment rate has averaged around 6 per cent since 1996, compared with 8 per cent from 1978 to 1995. Reducing volatility in key macroeconomic variables such as inflation boosts economic activity as it provides certainty to businesses and consumers in relation to their consumption and investment decisions which contributes to better allocation of resources in the economy. Living standards have also been improved by the increases in productive and allocative efficiency, which were the main justifications for the suite of microeconomic reforms undertaken in the late 1980s and 1990s. Significantly, Australia has achieved these overall gains with relatively little increase in inequality.[21]

Australia's productivity performance improved noticeably in the years following the major reforms. Labour productivity in the 12-industry market sector grew at 3.1 per cent a year in the decade to 1999-00, compared with just 1.4 per cent during the 1980s. This largely reflected an increase in multifactor productivity growth, which grew at 1.8 per cent a year during the 1990s, up from 0.3 per cent in the preceding decade.[22] Indeed, multifactor productivity growth during this period was rapid and prolonged relative to the history of the series. As well as being high in historical terms, productivity growth was also rapid compared with other countries.[23] Labour productivity in Australia grew faster than the average of other OECD countries between 1992 and 2009, resulting in a relative rise in Australian GDP per capita over this period (Chart 14). This followed the country's relatively poor productivity performance for much of the previous four decades. The decline in gross national income relative to the average of other OECD countries over the period for which we have data had been even sharper, reflecting the decline in the terms of trade.

CHART 14: DIFFERENCE BETWEEN AUSTRALIAN AND OECD AVERAGE GDP PER CAPITA



Note: OECD includes the 24 longest standing member countries, which includes Australia, but Turkey is excluded in the GNI series due to data limitations.

Source: GNI per capita: OECD Annual National Accounts; Thomson Reuters Datastream;
GDP per capita: The Conference Board, Total Economy Database, March 2018.

20 Henry 2001.

21 As the Productivity Commission (2018(2)) found: "While growth is no guarantee against a widening disparity between rich and poor, we show that it has delivered for the average Australian household in every income decile significantly improved living standards. This is in contrast with the United States (which had a similar rate of increase in income inequality as Australia) where the distribution is much more uneven, with income growth in the lower deciles about a quarter of that for Australian households."

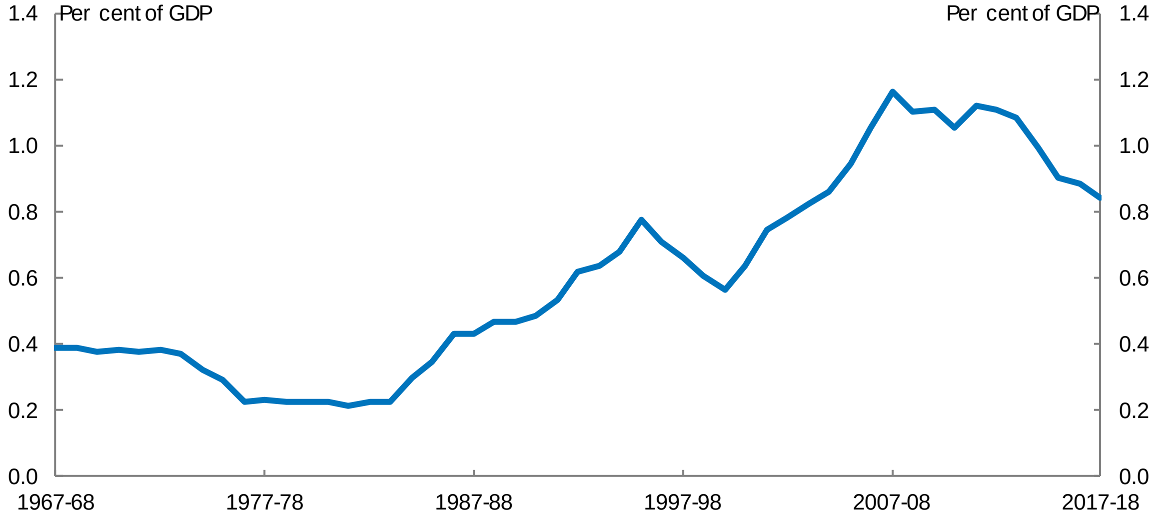
22 See Campbell and Withers 2017 for a discussion of productivity growth.

23 Productivity Commission 1999.

While productivity growth in Australia was relatively fast in the 1990s both compared with growth in other comparable countries and with Australia's productivity growth in previous and subsequent decades, it is difficult to know exactly how much of the productivity growth can be attributed to the reforms. The 1990s was a period of rapid technological change, and Australian firms were relatively quick adopters of new technologies and new business practices compared with their international peers, perhaps because of the broader changes occurring at around the same time. This can be seen in increased spending on Research and Development around this time (Chart 15). Nonetheless, it is difficult to disentangle these factors.[24]

It is important to acknowledge that the efficiency benefits of Australia's economic reforms have not been confined to productivity improvements. Allocative efficiency is also likely to have increased, as more accurate price signals result in an allocation of resources that better matches consumers' preferences. This is likely to have resulted in increases in consumer surplus, though these benefits are much harder to measure.[25]

CHART 15: RESEARCH AND DEVELOPMENT EXPENDITURE BY THE BUSINESS SECTOR



Source: ABS cat. no. 5204.0.

Insights from Australia's experience with reform

The diversity of circumstances and experiences of reform across countries makes it difficult to draw universal conclusions about how best to undertake reforms. Instead, this paper draws broad insights from Australia's economic reform story. There are a number of factors that contributed to the success of Australia's program of reform.[26] First, the sequencing of reforms appears to have been useful in Australia's case. Second, consensus building was critical, particularly because the reforms pursued in Australia typically benefited the many over a vocal minority. Third, Australian policymakers were mostly persistent in their pursuit of reform. They did not give up in the face of adverse outcomes or events and, perhaps most importantly, appeared to learn from past mistakes.

24 For discussions of reforms and productivity growth, see Gruen and Stevens 2000, Forsyth 2000, Henry 2001, Productivity Commission 1999, Bean 2000 and Borland 2014.
25 See, for example, Forsyth 2000 and Productivity Commission 1999.
26 For a similar discussion, see Banks 2005.

Sequencing of Reforms

The order in which Australia undertook economic reforms was unusual. A standard approach might be to improve the efficiency of the economy before exposing it to international competition. To some extent, Australia did the reverse. It began in 1973 with a one-off 25 per cent unilateral tariff cut as a solution to rising inflation. But the cut was controversial and was partly scaled back in a number of industries.[27] The first concerted wave of reform involved deregulating the banking sector, opening it to foreign competition and floating the currency. The second wave was more focused on raising efficiency by reducing trade barriers, decentralising the industrial relations system and implementing microeconomic reform. Canada and the United States followed a broadly similar path.[28]

The timing of reforms in Australia was significantly influenced by developments in the terms of trade and current account. Even through the 1950s and 1960s it was broadly accepted that existing institutional settings were no longer delivering the high living standards that had been promised.[29] Yet reform was delayed relative to other countries by high commodity prices, which kept Australian incomes high and masked the country's relatively poor productivity performance. Not until the 1970s, as the terms of trade deteriorated and the current account deficit widened, did the accepted wisdom lead to action. The first wave of reforms was more responsive, as authorities sought to manage the macroeconomic instability caused by increasing international capital flows, growth of the non-bank financial sector, and a break-out in inflation. Yet the terms of trade and the current account continued to deteriorate in the mid-1980s, prompting a second wave of more premeditated reforms that concentrated on domestic industry and labour markets.

Even within this second wave the ordering was unusual. The staged tariff cuts that started in the late 1980s, which were partly motivated by a desire to expose Australian businesses to international competition and force further reform, began before other pro-competition and industrial relations reforms. By contrast, microeconomic reforms in other countries preceded reductions in trade barriers, in an effort to prepare domestic businesses for greater international competition. Australia's reductions in trade barriers were also relatively unusual in that they were done on a unilateral basis, rather than as part of reciprocal arrangements. Australia had relatively high tariffs at the start of the process, a consequence of the country's decision not to take part in the post-war trade liberalisation that was pursued by most other advanced economies. This decision not to participate was based on the view at the time that Australia's manufacturing industry was relatively undeveloped and that, as an exporter of agricultural products, Australia had little to gain from reciprocity when the multi-lateral rounds excluded agriculture. But the tide began to turn after the National Farmers Federation joined the voices for tariff reduction, arguing the farm sector was hurt by high manufacturing tariffs that increased costs of production – a claim supported by an independent assessment that the cost of protectionism was high. By the mid-1990s, Australia had a low effective rate of assistance compared with many other countries.

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27 For example, in the passenger motor vehicle industry, the tariff on imported passenger vehicles was reduced from 45 to 33.75 per cent as part of the across-the-board tariff cuts. However, during 1974 imports increased rapidly and demand for locally produced passenger motor vehicles weakened leading to manufacturers foreshadowing job losses. In response to increased imports, the tariff was increased back to 45 per cent and from January 1975 import quotas were used to restrict imports to 20 per cent of the market.

28 Canada floated its currency and removed exchange rate controls in the early 1950s, well before it began to open up other markets. The United States floated its dollar and began to open capital markets in the early 1970s, before it began deregulating key sectoral markets in the 1980s.

29 These institutional settings were together commonly known as the 'Australian settlement' (Kelly 1992) and involved high real wages that were set centrally, significant trade protection that supported inefficient domestic industry, substantial government regulation and ownership, and a pegged exchange rate.

There have been both benefits and costs to the ordering of Australia's reforms. On the one hand, some earlier reforms catalysed later reforms. A sharp depreciation in the newly floated dollar fuelled concerns about the current account deficit and an uncompetitive economy. The liberalisation of the capital account and financial sector contributed to an asset price bubble in unproductive sectors in the late 1980s, highlighting the need for microeconomic reform. And trade liberalisation later that decade provided additional impetus for domestic reform, including for a more flexible industrial relations system. On the other hand, some of these lessons were learned at considerable cost. In particular, the late-1980s asset bubble was a significant contributor to the recession in the early 1990s.

There have also been consequences from the speed of change, as well as the sequence. The relatively slow, iterative pace of reform in Australia has arguably facilitated smooth adjustment. For instance, the steady loosening of exchange rate controls through the 1970s enabled the emergence of a fledgling hedging market that helped ready business for the eventual float of the dollar in the early 1980s.

Consensus building

Australia's reforms have largely been implemented with substantive efforts to gain public support.[30] Mostly, they have been implemented with support from the major political parties as well as business groups and the labour union movement, which is unusual when compared with the experience of similar countries. Even those groups in society that were net losers from the reforms were not as vocal in Australia as they were in some other countries. This is notable since the types of economic reforms Australia introduced during this period typically benefited the majority while disadvantaging a small minority, which can often lead to vocal opposition by vested interests. While seeking support may have incurred some costs, most notably by delaying reform, it is also likely to have significantly reduced costs in other areas, for instanced by reducing days lost to strike action. As such, it is likely an important reason why Australian governments were successful in pursuing reform over a relatively long timeframe and were able to push ahead even when faced with conditions that could have set back the reform agenda.

There are many reasons why Australia's reforms were implemented with relatively broad public support: governments were opportunistic and took prudent steps to sell the case for change; the reform agenda had the overall support of business groups and unions, as well as federal and state governments; the slow pace of change allowed time for the community to adjust; benefits and costs were relatively dispersed thanks to both a broad reform agenda, measures to ease transitional pain, and governments' preparedness to offer trade-offs; and successive governments drew judiciously on advice from independent agencies and inquiries. These factors will now be examined in greater detail.

Throughout Australia's reform period, governments have taken advantage of windows of opportunity to make the case for change. These opportunities included declines in the terms of trade, concerns about the size of the current account deficit and recessions. As an example, it took a current account crisis and a significant depreciation of the exchange rate for broad-based reductions in trade protectionism to be actioned, almost two decades after the Tariff Board and others began advocating liberalisation.[31]

30 There are other countries that have taken a different approach. In the early 1980s, New Zealand adopted a big bang approach to reform characterised by the following quote from Roger Douglas, the Minister of Finance at the time: "It is uncertainty not speed that endangers the success of a structural reform programme. Speed is an essential ingredient in keeping uncertainty down to the lowest possible level" (Windybank 2003).

31 See, for instance, Cordon 1995.

As well as being opportunistic, governments still worked hard to build support for reform. For instance in the 1983 economic summit, the government brought together union and business leaders to build consensus on the need for change. In other cases support was sought by using simple messaging to communicate complex economic problems. By controversially warning in 1986 that Australia risked becoming a "banana republic", Australia's Treasurer at the time raised public awareness about threats to the country's standard of living. Another example was the GST. After failing to win support during the 1980s and early 1990s, a GST finally came into force in 2000 after gaining voters' backing through a federal election[32] and following extensive consultation about implementation.

Crucial to Australia's reform experience has been the organisation and support of interest groups, notably those representing business and workers. These included the National Farmers' Federation, which was formed in 1979 and made a deliberate decision, as a major exporter, to argue the case for tariff reform. The Business Council of Australia was established in 1983 to improve business' influence in public policy. And union support for much of the reform agenda helped public acceptance of the process.

Some reforms required consensus around implementation, especially where different levels of government were involved. For example, the National Competition Policy reforms that followed the Hilmer Review – a wide-ranging package of reforms designed to improve productivity in the non-traded economy – spanned both federal and state jurisdictions.

Public support for economic reform in Australia was likely aided by the timeframe over which it took place. Compared with some other countries, Australia's reforms were undertaken over a relatively extended period. This allowed affected groups and the broader public time to adjust.[33] In this respect, lessons were learnt from the negative reaction to the sudden and large 1973 tariff cut.

Opposition to change was also softened by the breadth of reform. Because reform was pursued across a range of fronts – including financial deregulation, industrial relations decentralisation, tariff cuts and tax reform – a group made worse off through one policy change had at least a good chance to eventually benefit through another. In other words, costs or benefits were more likely to be dispersed rather than concentrated.[34] For instance, during the 1980s a largely pro-business reform agenda was accompanied by new taxes that closed loopholes exploited by wealthier Australians. This principle was pursued in a more explicit way through the Accord, under which unions agreed to contain wage demands in return for a so-called 'social wage' – a broader package of non-wage benefits including tax cuts, increased public spending on health and education, and the introduction of superannuation.

Indeed, a recurring theme of Australia's economic reform story is the importance of fairness alongside efficiency and growth. Many reforms included measures to ease transitional pain, particularly where a policy change adversely affected particular groups. Doing so was considered not only appropriate on fairness grounds, but politically savvy – an approach that has also been taken by other countries to a greater or lesser extent.[35] For a discussion of a number of Australian case studies

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32 The government won the 1998 election by securing a majority of electorates but not a majority of two-party preferred votes.

33 As noted in footnote 30, New Zealand chose to fast track a wide ranging reform agenda as a means of avoiding the potentially negative impact of uncertainty. The UK's approach was to push through unpopular reforms. Australia's approach is closer to that of the United States which also undertook a slower pace of reform.

34 Banks 2005.

35 The US, for example, was also careful to introduce social adjustment measures to support workers affected by reform. The 1962 Manpower Development and Training Act was introduced to provide income support and re-employment services for workers displaced by trade agreement concessions and then amended in 1971 to soften the impact on workers of the US moving away from the gold standard.

on transitional adjustment see Box A. But such measures were not confined to businesses or individuals. Under the National Competition Policy, state governments were entitled to receive so-called 'competition payments' from the federal government upon implementing agreed policy changes. The payments recognised that although the reforms were expected to deliver productivity gains that would boost federal government revenue, the cost of implementing the reforms would be borne by state governments. Similarly, support for the introduction of a GST in 2001 was aided by the federal government's commitment that all revenue raised would be distributed to the states.

Finally, as in other countries,[36] governments in Australia have repeatedly drawn on independent advice to build consensus for economic reform. This includes advice from independent agencies, such as the Productivity Commission or the Australian Competition and Consumer Commission, as well as from government-commissioned public inquiries, such as the 1981 Campbell Financial System Inquiry, the 1992 Hilmer Report on competition policy, the 1997 Wallis Report on the financial system, the 2014 Murray Financial System Inquiry and the 2015 Harper Review on competition policy. These fora can lend much-needed credibility to the case for change – credibility that is founded upon both technical expertise and independence. They provide a mechanism for experts, free from political or vested interests, to identify challenges, sift through proposed responses, and recommend the best way forward – whether or not it accords with the government's own views.[37]

Successive Australian governments have used such advice to build a case for politically challenging reforms.[38] For instance, soon after winning the 1983 election the new government initiated the Martin Committee[39] in order to revive the financial deregulation agenda previously recommended by the Campbell Review[40] – a review that had helped to shape the discussion around capital controls and the Australian dollar in the early 1980s, and which prepared the ground for the dollar's float a couple of years later. More recently, a 2011 Productivity Commission review of disability support arrangements supported the introduction of a National Disability Insurance Scheme (NDIS).[41]

The credibility of independent institutions has been bolstered by those occasions they have made recommendations that do not accord with the government's views – at least, not initially. For instance, the Tariff Board, which was established in the 1920s as the agency responsible for determining how much protection should be granted to Australian industry, used its independence to argue *against* protectionism from the 1960s – a stance at odds with the government of the day. The Productivity Commission, a descendant of the Tariff Board, continues in that tradition by providing independent, evidence-based analysis and advice on economic policy. In an example of its preparedness to exert reform pressure on itself, the government recently asked the Productivity

36 Notably in Canada where major commissions have included: (1) the 1933 Royal Commission on Banking and Currency, which led to establishment of Royal Bank of Canada; (2) the 1957 Royal Commission on Canada's Economic Prospects, which reviewed the policy of allowing foreign interests to purchase control of Canada's natural resources and other business enterprises; (3) the 1968 Task Force on Foreign Ownership and the Structure of Canadian Investment, which recommended strict regulation of foreign investment in Canada; (4) the 1964 Royal Commission on Banking and Finance, which made a range of recommendations to reduce regulation in the banking sector; and (5) the 1984 Royal Commission on Economic Union and Development Prospects for Canada, which recommended greater reliance on market mechanisms and a free trade agreement with the United States and reform of the welfare state model.

37 Despite the independence of the institutions and the reviews/inquiries, it is important to note that the government has discretion in appointing the chairs and other senior executives.

38 Other countries have also taken this path. In Canada, the recommendations of the Macdonald Commission were a significant factor in garnering support for the 1988 Canada-US Free Trade Agreement.

39 Note this is different to the Martin Committee commissioned by the government in 1983, with the 1983 committee led by Vic Martin and the 1990 committee led by Stephen Martin.

40 Committee of Inquiry into the Australian Financial System 1981.

41 Productivity Commission 2011.

Commission to publish a review of Australia's productivity performance every five years.[42] On a number of occasions unwelcome advice from an independent arbiter has eventually been adopted. For instance, the Tariff Board's arguments against protectionism eventually became accepted wisdom and contributed, more than 20 years later, to the large, unilateral tariff reductions that began in the late 1980s.

But consensus has been far from universal in Australia's reform experience. Though most economic reforms introduced since the 1980s now enjoy near unanimous support, some issues remain contested. Privatisation of government assets has been a controversial issue, even if the overall trend has been towards continued divestment. Although the shift to less centralised wage setting enjoyed broad-based support – from the major political parties as well as unions and business – this consensus fell apart with the federal government's WorkChoices reforms in 2005. And greenhouse gas emissions policy has been the subject of considerable debate over the past 15 years.

Perseverance with reforms

A feature of Australia's experience is that governments have generally stuck by economic reform, even in the face of some 'failures' and political backlash. Because they typically benefited the majority while imposing transitional costs on certain groups, the reforms Australia implemented through this period were often criticised by vocal vested interests. Yet there have been relatively few instances of major policies being scrapped or scaled back. In part this may reflect political stability; Australia experienced just one change of government in the 24 years from 1983 to 2007. But it may also be attributed to the insights discussed in this section, including the unusual sequencing of Australia's reform, the steps governments took to build political consensus for change, and the frequent use of independent advice. Throughout the reform period, governments have put in place institutional arrangements – such as the Productivity Commission or National Competition Policy – that have had the effect of discouraging them to reverse course.

There were a number of quite high-profile problems resulting from reforms that could have derailed the entire process without strongly held convictions about the need for change and processes in place to prevent backsliding. For example, the depreciation of the Australian dollar in the mid-1980s, shortly after its float, significantly raised the principal value and repayments on some loans that were denominated in foreign currencies (notably Swiss francs), although fortunately these were not a large enough share of total loans to be of systemic importance. There was also a severe recession in the early 1990s, which was partly a result of the deregulation of the banking system combined with a lack of adequate supervision.[43] Yet neither of these adverse events led to the reforms being scaled back or reversed. Indeed, the early-1990s recession was used to push for the microeconomic reforms that were implemented throughout that decade.

The major reforms of the 1980s and 1990s have not all been 'set and forget'. In the financial sector, for example, government-commissioned independent reviews have played a major hand in driving further development. The 1997 Wallis Inquiry led to the adoption of a so-called 'twin peaks' regulatory model, under which one regulator focuses on safety and soundness, and another on conduct and consumer protection. This model was adopted by several other countries. And the 2014 Murray review recommended further refinements in areas such as financial advice, superannuation, the payments system and prudential policy. Further changes are likely to occur as a result of the Royal Commission into misconduct in the banking, superannuation and financial services sector.

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42 The Commission's first report identified health, education and cities as areas where fresh reforms could deliver significant productivity gains (Productivity Commission 2017).

43 See, for instance, Macfarlane 2006, who also acknowledges the central bank's role in that recession.

Australia has also witnessed instances of scaling back or reversing reforms. A salutary example was the 25 per cent across-the-board tariff cut that was introduced in 1973 without warning. The cut was deeply unpopular and, following a backlash by the TCF and automotive industries, there was some scaling back in those industries, including through a range of different forms of industry support. But it at least provided a lesson for policymakers. When a second attempt was made to scale back trade barriers in the late 1980s, it was done gradually and with sufficient warning and included continued industry support, through different mechanisms for those industries that had so vehemently objected to the early-1970s measures.

Policy reversals have been more common in recent decades, reflecting a decline in the informal parliamentary consensus that enabled economic reform to be agreed and implemented during the 1980s and 1990s. Since the turn of the century, a number of major reforms have been introduced only to be scaled back or repealed, or proposed then later abandoned. For instance, an emissions trading scheme with an initial fixed price was legislated in 2011 then repealed two years later. A reduction in the company tax rate was only partially implemented amid continued political debate. A new tax on mining rents was legislated in 2012 but repealed a few years later. And industrial relations reform has been largely off the agenda since the WorkChoices package was introduced in 2005 then repealed soon after.

BOX A: CASE STUDIES ON TRANSITIONAL ADJUSTMENT

Consistent with the approach of consensus building and seeking public support, a number of Australian reforms included measures to ease transitional pain. This was particularly the case where reforms were narrowly targeted, such as those affecting the dairy industry. In other cases, such as for the motor vehicle industry or the steel industry, protection measures that had produced inefficient and uncompetitive industries were wound back in a planned and structured way over a significant period of time to allow for adjustment and transition.

Dairy industry

Under the umbrella of the wide-ranging program of microeconomic reforms proposed in the 1993 Hilmer report (see Box C), attention was turned to deregulation of the dairy industry. At the time the industry was subject to various regulatory and price controls.

In 1999, the federal government announced it would implement the Dairy Structural Adjustment Program (DSAP). This involved the imposition of a levy of 11 cents per litre on consumers of milk products. The levy funded quarterly DSAP payments over eight years to Australian dairy farmers, to help them deal with the social and economic disruption. A number of farmers took advantage of exit payments offered under the DSAP scheme to leave the industry.[44]

Motor vehicle industry

In 1983, the Minister for Industry and Commerce, Senator Button, commissioned a report on the long-term future of the car industry. This followed general concern that 20 years of steadily increasing protection, through measures such as tariffs, local content provisions and import restrictions, had produced an inefficient and uncompetitive industry. Following the review, in 1984 the government announced a plan (‘the Button Plan’) to significantly rationalise and improve efficiency in the industry by removing barriers to trade.

44 Dairy Australia 2018.

Motor vehicle industry (continued)

Under the Button Plan, which was intended to cover the period to 1992, the government committed to:

- maintain the tariff at 57.5 per cent;
- increase the import quota to 22 per cent;
- expand the tariff quota system to include light commercial and four-wheel drive (4WD) vehicles; and
- improve access to export facilitation.

Following a mid-term review of the Button Plan in mid-1988, the reductions in protection were accelerated. The substantial depreciation of the Australian dollar in the mid-1980s had reduced the pressures on the industry to adjust to the 1984 arrangements. Under the mid-1988 arrangements, the government committed to:

- immediately abolish tariff quotas;
- reduce the general tariff to 45 per cent then phase down to 35 per cent in 1992;
- immediately reduce the tariff on light commercial and 4WDs from 35 and 25 per cent respectively down to 20 per cent and phasing down to 15 per cent by 1992.

In December 1990, the Industry Commission (IC), later the Productivity Commission, was able to report that "for the first time in at least twenty years, there have been ongoing reductions in assistance to the industry".[45]

Following another review in 1997-98, the government announced that passenger motor vehicle tariffs would be frozen for five years before legislated reductions resumed from 2005. The plan aimed to provide certainty for the industry. Industry assistance continued in various forms until the car industry closed in 2017.

Steel Industry

Around the same time as the car plan was introduced, Senator Button also introduced a Steel Industry Plan. The Plan was formulated in response to a severe deterioration in the competitive position of the Australian steel industry in the early 1980s. Production, sales, profits and employment in the industry all fell dramatically below the levels recorded during the 1970s.[46] The Plan was informed by an Industries Assistance Commission's report on the Iron and Steel Industry and a report of the Steel Industry Advisory Council. The objective of the plan was the creation of a long-term viable steel industry providing job security for its employees and inputs to a wide range of metal and engineering industries at internationally competitive prices.

The basis of the Plan was that in exchange for Australian government assistance – in the form of payments on certain product categories with an annual ceiling of $71.6 million – the steel industry would keep steel plants open, provide job security undertake investment to improve product quality and reduce production costs. The steel unions agreed that wage increases would be in accordance with the Prices and Incomes Accord.47 The government established a Steel Industry Authority to monitor and report on the progress of the Plan, while State governments were to ensure prices remained contained. It began in 1984 and was due to remain in place for five years.

The Steel Plan marked the beginning of a cultural change within the steel industry which carried over into the Steel Industry Development Program Agreement (SIDA) in 1989 when the Steel Industry Plan ended. Under SIDA, the focus on business improvement and productivity performance continued. Management and unions agreed to performance targets and on processes to identify and implement measures to achieve the targets.[48]

45 Industry Commission 1990 p 12, See also discussion in Richardson 1997.
46 Parliament of the Commonwealth of Australia 1987.
47 Button 1983.
48 Demura 1995.

BOX B: REFORM IN AUSTRALIA'S AGRICULTURE SECTOR

Through the 1950s and 1960s, Australia pursued an interventionist agriculture policy, albeit one less protectionist than in most other developed economies. Though they varied greatly from one commodity to another, common interventions included high tariffs, price controls, production quotas and centralised marketing. The overall effect was to alter prices in a bid to stabilise incomes and expand exports.

But the system came under challenge from the 1960s. Critics noted that the interventions raised costs for consumers and distorted resources allocation. And whereas many policies purported to help smaller farmers, the chief beneficiaries were often big land holders.[49]

These criticisms gained traction during the 1970s. The establishment of the Industries Assistance Commission, which replaced the Tariff Board, provided a forum for these concerns to influence policy. Similar sentiments among farm leaders led to the establishment of the National Farmers Federation in 1979, giving the sector a voice that was not just united, but explicitly promoted free markets.

Consistent with the government's broader microeconomic agenda, farm policy evolved significantly from the mid-1980s. Stabilisation policies began to be unwound, including the removal of price and output controls and the dismantling of centralised marketing schemes – a process accelerated through the Hilmer pro-competition reforms. Tariffs were reduced to among the lowest levels in the OECD. In contrast with the permanent farm support programs in the EU and US, what assistance remained in place tended to be small and transitional, such as drought relief. The overall effect was to ensure that prices in the agriculture sector increasingly reflected actual costs.

For farmers, the transition was softened by a number of factors. What they lost in terms of direct assistance, they typically gained through broader microeconomic and macroeconomic reforms. Workplace reform cut labour costs, financial sector reform freed up access to credit and foreign direct investment, and tariff cuts in the manufacturing sector helped reduce input costs.[50] In some cases transitional assistance was more explicit. For instance, deregulation of the dairy industry was accompanied by a temporary milk levy that funded adjustment programs for farmers leaving the industry. That said, agriculture reform has not always proceeded smoothly – the dismantling of the wool floor price being one example. And improved farm productivity has led to declining populations in many rural areas, raising social and economic challenges.

But the overall result of reform is a farm sector that is more efficient, sustainable, and internationally competitive. Total factor productivity in Australia's broadacre agriculture sector grew 1 per cent a year on average from the late 1970s to the early 2010s, enabling farmers to increase output despite reducing inputs.[51]

49 Botterill 2003.
50 Anderson et al 2007.
51 Gray et al 2014.

3. FIRST WAVE: MACROECONOMIC STABILITY

The first wave of economic reform in Australia, beginning in the 1970s, comprised responsive policy changes largely aimed at stabilising the macroeconomy. Though they built on the reformist thinking that had emerged since the 1960s and 1970s, these were mostly pragmatic, iterative reforms aimed at managing sources of instability – whether inflation, international capital flows or financial innovation.

Financial Sector

Of all the economic reforms Australia undertook over the past four decades, the overhaul of the financial sector was not just the first but the most reactive and consequential. Far from a pre-meditated strategy, the process of floating the dollar, opening up the capital account and deregulating the banks was pursued as a series of iterative and pragmatic steps, each aimed at preserving macroeconomic stability in the face of unstoppable global forces – notably surging global capital flows and financial innovation. Though they were ostensibly responses to distinct challenges, banking and capital account liberalisation were closely intertwined. Together, they triggered a period of far reaching economic reform in Australia.

At its core, the challenge that Australian authorities confronted was the Mundell-Fleming trilemma – the theory that a country cannot simultaneously control its exchange rate, capital flows and monetary policy. Until the 1980s, Australian policy was to try to manage all three. The exchange rate was pegged, although the peg had switched from the British Pound to the US dollar following the collapse of Bretton Woods. This is in contrast to many other advanced economies, such as Canada and most of Western Europe, which had made the decision to move from a fixed to a floating or semi-pegged rate against the US dollar at that time. The capital account was tightly controlled: foreign currency transactions required approval from the authorities and outward investment was heavily restricted, reflecting authorities' desire for domestic savings to be invested at home. And monetary policy was managed – not only through a government-directed central bank, but through strict financial regulations that dictated how much banks could lend, to whom and at what interest rate.

Cracks in this system became evident as early as the late 1960s. Lured by a mining boom and aided by newly arrived merchant banks, international capital flows increasingly targeted Australia. The RBA's usual response was to sterilise inflows by tightening reserve requirements. But its capacity to do so was constrained by another global development: financial market innovation. Tight regulation of domestic banking had spurred rapid growth of non-bank financial institutions such as finance companies and building societies, as well as merchant banks. With a growing share of money held outside the regulated banking sector, the RBA's control of monetary policy was weakened. Though authorities could instead sterilise through open market operations, this meant higher interest rates – which hurt the domestic economy and attracted further inflows. In effect, authorities were grappling with the trilemma; with freer capital flows and a fixed exchange rate, they could not maintain an independent monetary policy. They could resist external pressures, but only at the cost of the domestic economy.

The government's response proceeded down two related tracks: one targeting banking regulation, the other capital controls and the currency. Starting from the early 1970s it steadily wound back regulations on the banks, not only in response to the trilemma but also in recognition that financial innovation demanded a more efficient and competitive banking sector. By 1980 prudential restrictions had been relaxed considerably and controls on interest rates abandoned. Over the same decade the Australian dollar endured a tumultuous journey. Capital controls were tightened then eased. The dollar went through numerous revaluations and devaluations as well as a shift from a fixed to a crawling peg – an evolution which, importantly, led to the development of a fledgling hedging market.[52] The government also improved the marketability of its own bonds by switching from a tap to a tender-based issuance system, meaning it set the volume of securities on offer while the market set the interest rate.[53] The change enabled the government to borrow more from the public and less from the RBA, thereby freeing up the central bank to concentrate on monetary policy.

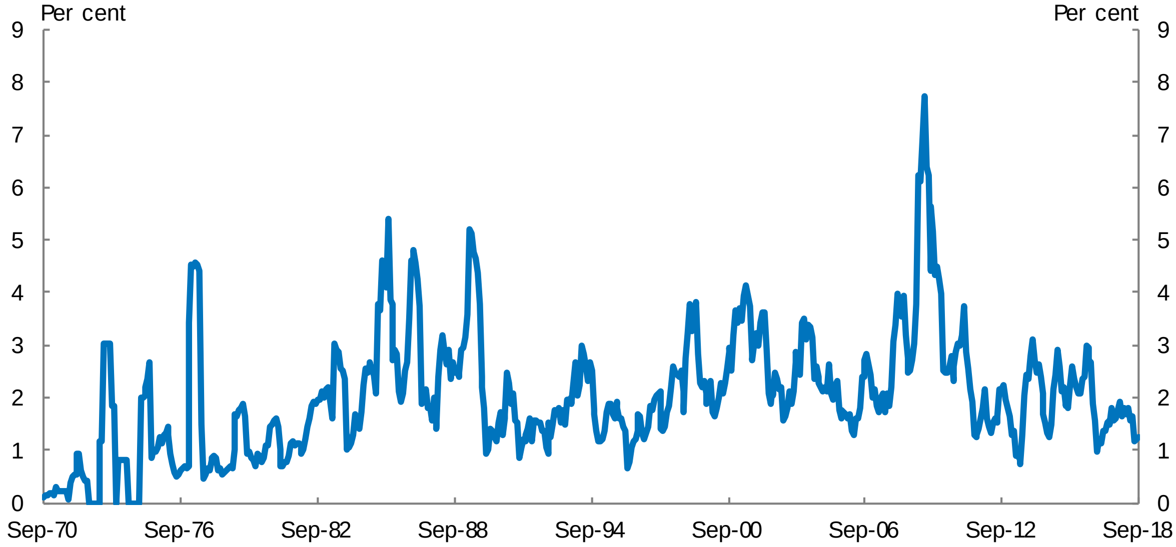
Whereas these reforms took place in a largely ad hoc fashion, with authorities responding to challenges as they arose, an important shift occurred in 1979. Noting the growth of the non-bank sector and international capital markets, the government established Australia's first review of the broader financial system. Two years later, the so-called Campbell Review – named after its chairman, businessman Keith Campbell – advised that Australia's macroeconomic stability could be best achieved by completing the deregulation of the financial sector, exposing banks to foreign competition and floating the dollar. It was a blueprint for pro-market reform. But while some of the Review's recommendations were implemented, its main proposals initially went unheeded, reflecting unease among senior politicians and bureaucrats about such market-oriented remedies. Still, the Review solidified a growing discussion within senior policy circles about the need for change, making an eventual float more likely.

As it happened, the dollar was floated on 9 December 1983 alongside the removal of most foreign exchange controls. The decision was made by a relatively new government, which had already devalued the currency by 10 per cent. Yet frequent attacks on the currency – which had begun in response to a deep recession – continued, prompting RBA interventions that made it increasingly hard for authorities to manage monetary policy. Over the course of 1983 it became clear that the government and the RBA could do little to resist surging capital inflows. Senior policymakers eventually decided that Australia had little option but to let go of the reins. Despite concerns about a sharp devaluation, on its first day as a free floating currency the dollar appreciated.

Compared with other central banks, the RBA has been a relatively hands off participant in foreign exchange markets in the 35 years since the float. But that was not initially the case. In what it describes as the "testing and smoothing" phase of intervention, the RBA made small but frequent interventions in the first few years after the float as it sought both to understand how the currency would operate under the new regime and to smooth day-to-day volatility (Chart 16).[54] Only from the late 1980s, with Australian dollar markets that were deeper and better able to manage volatility, did the RBA shift strategy, by only intervening if it believed speculative trading had pushed the currency to levels inconsistent with fundamentals.

52 Ballantyne et al 2014.
53 See Australian Office of Financial Management 2011 and de Brouwer 1999.
54 Newman et al 2011.

CHART 16 - EXCHANGE RATE VOLATILITY



Note: against end of month US dollar exchange rate: 6 month rolling average of monthly absolute percentage changes.
Source: RBA.

By floating the dollar, Australian authorities effectively accepted a more volatile currency in return for greater macroeconomic stability. Concerns about the currency's increased volatility were high in the years immediately after the float, as reflected in the RBA's intervention strategy. But these concerns diminished as hedging became commonplace. Despite gaining some experience during the turmoil of the 1970s, banks and business were still relatively new to hedging at the time the dollar was floated. As a result, mistakes were made. In the so-called Swiss loans affair, some Australians were steered by their banks into taking out unhedged foreign-denominated loans, only to see their repayment obligations jump in the mid-1980s as the recently floated Australian dollar depreciated sharply. But this episode had unforeseen benefits. By helping raise awareness about the risks of a floating currency, the Swiss loans affair is likely to have contributed to the greater use of derivatives for hedging and the development of those markets.[55] Today Australia's banks use derivatives to hedge almost all of their foreign currency borrowings.[56]

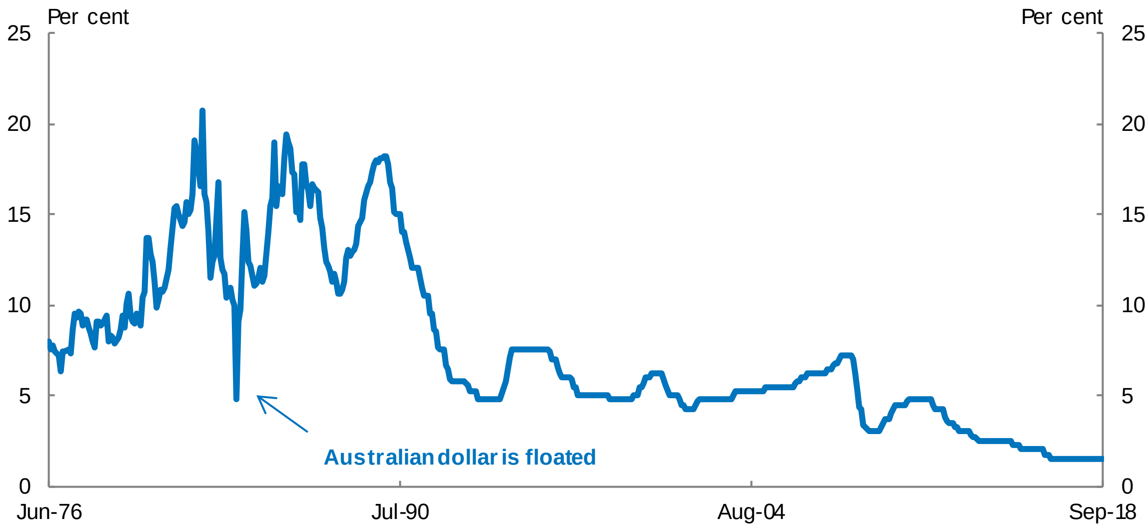
The float of the dollar paved the way for liberalisation of the broader financial sector. By sidelining doubters and making reform seem inevitable, it enabled the government to pursue changes that only a few years earlier had been considered off the agenda. By mid-1985, the government had removed all caps on deposit and lending rates and had invited 16 foreign banks to enter the Australian market.

Financial deregulation delivered considerable benefits to Australia, though only after some time. The removal of controls on banking was sold in part on the promise that competition would lead to improved service and lower prices. Yet it took about a decade for lending margins to start shrinking.[57] Only with the arrival of innovations like securitisation, mortgage broking and automatic teller machines were new entrants able to exert competitive pressure on the incumbents. But some benefits were less obvious. Financial sector liberalisation improved the allocative efficiency of the economy by ensuring capital was directed towards more productive uses. It also aided macroeconomic stability by allowing the RBA to implement monetary policy through interest rates rather than bank regulations (Chart 17).[58]

55 Ballantyne et al 2014.
56 Ryan 2016.
57 Reserve Bank of Australia 2010.
58 Battellino 2007.

But these benefits were only realised after considerable teething problems. In the new liberalised environment, financial institutions struggled to manage their exuberance and regulators struggled to keep them in check. The Swiss loans affair was one example that caused limited economic damage. Of much greater consequence was a destabilising credit boom. As foreign banks entered and incumbent banks rushed to protect market share, borrowing money suddenly became a lot easier – especially in the corporate and commercial property sectors. With rising corporate leverage, surging assets prices and deteriorating lending standards, the economy became increasingly vulnerable to a downturn. And as the RBA repeatedly raised official interest rates in a bid to dampen credit growth, the risk of such a downturn steadily increased. In the early 1990s the economy eventually snapped, leading to Australia's deepest recession since the 1930s Great Depression. One of the country's major banks narrowly avoided insolvency.

CHART 17 - AUSTRALIAN CASH RATE



Source: RBA

Note: The data from 1978 to 1990 is the interbank overnight cash rate.

Even after deregulation, Australia's banking system is not entirely free of protection. Under the so-called "Four Pillars" policy, Australian governments since the 1990s have committed to disallow a merger between any of Australia's four largest retail banks. The policy aims to ensure competition. And though there is no blanket prohibition on a foreign takeover of any of the big four domestic banks, such a proposal would have to be assessed under Australia's foreign investment regime – and none has ever been publicly announced.[59]

Meanwhile, banking regulation has not stayed still. Following the Wallis Review in the late 1990s, Australia adopted a financial regulation regime that allocates responsibility along functional lines: one focused on safety and soundness, the other on conduct and consumer protection. Experience suggests this so-called 'twin peaks'[60] model has performed well. In particular, the banking sector emerged relatively unscathed from the 2007-08 global financial crisis, even if it led some smaller lenders to be acquired by major banks. The financial sector was subjected to further scrutiny in 2014,

59 Four Pillars is contentious. Independent agencies such as the Productivity Commission (2018(1)) and the Australian Competition and Consumer Commission (2017) have warned it potentially stifles competition – an example of the freedom those agencies enjoy to challenge government policy. On the other hand, some observers believe Four Pillars helped Australia's banks avoid the risky investments that derailed many overseas banks during the 2007-08 global financial crisis. For instance, former RBA governor Ian Macfarlane has argued that without the threat of takeover, Australia's large banks did not feel pressure to chase higher returns by pursuing risky overseas investments.

60 Group of Thirty 2008.

when the Murray Review endorsed the twin peaks model but recommended changes in areas such as financial advice, superannuation, the payments system and prudential policy.

Yet financial regulation has not been without missteps – often leading to self-assessment and further reform. For instance, the collapse of a large general insurance company in the early 2000s led the Australian Prudential Regulation Authority to beef up its monitoring and surveillance activities – an initiative which helped ensure the banking sector was in strong shape leading into the 2007-08 crisis.[61] More recently, industry conduct and consumer protection regulation has come under increased scrutiny as a result of a Royal Commission into misconduct in the banking, superannuation and financial services sector.

The Accord

Through most of the 20th century, Australia operated a highly centralised industrial relations regime. Wages were set through a process of compulsory arbitration administered by state governments or the Australian Industrial Relations Commission (and its forerunner), which acted as an umpire between unions and employers. Pay and conditions were set out in awards that encompassed whole industries or occupations, leaving little scope for wages to vary according to the profitability or productivity of particular firms or industries. The system was underpinned by a centrally determined minimum wage based on the cost of living – a reflection of Australia's egalitarian tradition.

But this long standing system came under increased pressure from the 1970s. Unions used their power to push for ever higher over-award wage increases. Industrial strikes proliferated and real wages surged, exacerbating the challenges of stagflation. Another wage breakout occurred in the early 1980s, just as the economy was heading into a recession that caused Australia's unemployment rate to hit double digits for the first time since the Second World War. For the unions, the downturn showed that there was a trade-off between real wage increases and employment.

It was against this background that an agreement, known as the Prices and Incomes Accord, was struck between the government and unions.[62] The country's peak union body agreed to contain their wage demands to help curb inflation. In return, the government would compensate workers through a so-called "social wage" – which over time encompassed tax relief, health spending, education spending and the introduction of a compulsory retirement savings scheme. The outcome also included the employment and income benefits of a stronger economy. First agreed in 1983, the Accord would continue through seven iterations through to the mid-1990s.

Viewed today, the Accord seems something of an anomaly. Other Australian reforms of this period – notably deregulation of the financial sector and the floating of the dollar – largely involved the government pulling back from its role as manager of the private economy. By contrast, the Accord concentrated macroeconomic levers in the hands of not just the government, but the union movement. Whereas economies like the UK moved to decentralise their industrial relations system during this period, Australia in the early 1980s moved in the opposite direction.[63] More than any other policy change of the time, the Accord demonstrates that the economic reforms Australia pursued in this first wave were driven less by an ideological agenda and more by the need for pragmatic problem solving.[64]

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61 Henry 2001.

62 The agreement was struck before the election and it was only once the new government was in power that it came into effect.

63 Wooden and Sloan 1998.

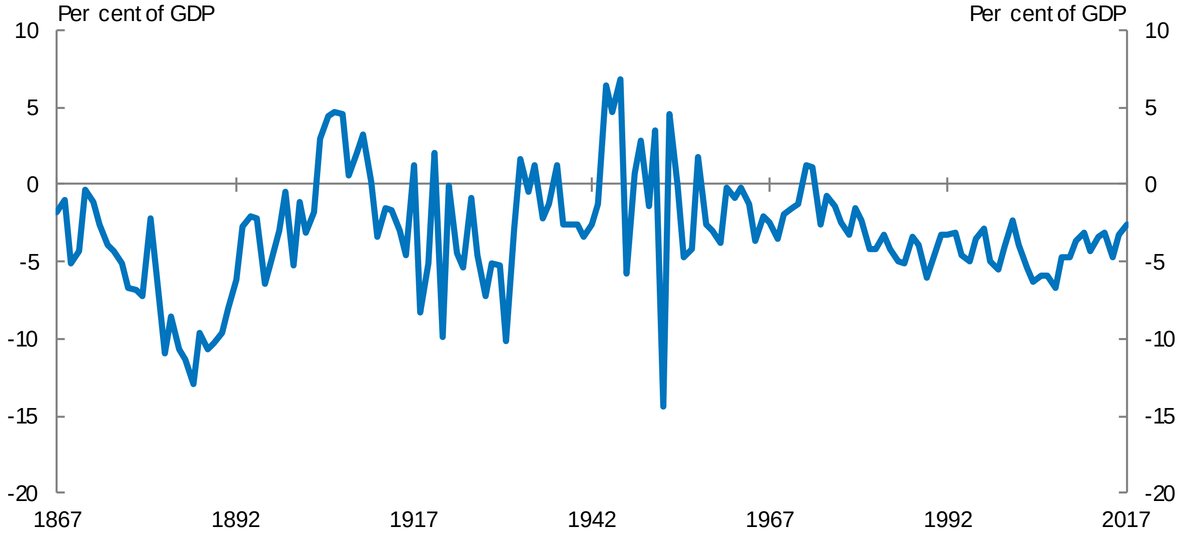
64 See for instance Kelly 1992, de Brouwer 1999, Macfarlane 2006.

The Accord largely delivered on its initial goal to curb wage pressures and support economic growth. Real wages fell over the 12 years successive Accords were in effect, as did the labour share of income. It was one reason the number of days lost to industrial disputes declined dramatically compared with the tumultuous 1970s. But as will be discussed in the next section, the industrial relations system evolved substantially from one Accord to the next, as reform priorities shifted.

4. Second wave: Microeconomic reform and productivity

By floating its dollar in 1983, Australia had effectively invited global financial markets to deliver a real time evaluation of the merits of the Australian economy. And the early judgement was not flattering. The opening up of financial markets, combined with a deteriorating terms of trade, had exposed Australia's poor productivity performance, which over preceding decades had been masked by strong global demand for mining and agricultural commodities. These factors led to a sharp decline in the Australian dollar. After initially appreciating then stabilising in the year after the float, through 1985 the dollar fell almost 30 per cent in trade-weighted terms. Despite this, the economy was doing well, leading to strong growth in imports and an expanding current account deficit. By 1986, the current account deficit had blown out to almost 6 per cent of GDP, well above the 2 per cent it had averaged during the 1960s (Chart 18).

CHART 18 - AUSTRALIA'S CURRENT ACCOUNT BALANCE (PER CENT OF GDP)



Source: ABS cat. no. 5302.0 and 5206.0, Foster (1996) and Vamplew (1987), RBA and Treasury.

The combination of a depreciating dollar and a ballooning current account deficit alarmed Australian policymakers.[65] There were fears the two developments were feeding on each other. Because the country's foreign liabilities were mostly denominated in foreign currencies, a depreciating Australian dollar increased debt-servicing costs – and, therefore, the current account deficit. Meanwhile, the expanding current account deficit was itself a reason for foreign investors to lose faith in the economy, causing the currency to depreciate. The Australian economy appeared stuck in a dangerous spiral.

65 Henry 2001.

The government's proposed solution was widespread reform of labour and product markets to address Australia's poor productivity performance. Although the need for such reform had been recognised for some time, the developments in the currency and the current account increased the urgency to act. This was crystallised in May 1986 when Treasurer Paul Keating declared that unless it got its economic house in order, Australia risked becoming "a third rate economy … a banana republic." Though controversial, Keating's blunt warning helped raise public awareness of the need for Australia to pursue reforms aimed not at stabilising the macroeconomy, but at improving the inner workings of the microeconomy.

In hindsight, concerns about the current account appear overblown. Economists today take a far more benign view of a current account deficit, recognising its level will be moderated by a floating currency. However misplaced, fears about the issue provided the impetus for Australia's political leaders to pursue reforms which had long been discussed but had never been implemented.

As it did in most countries, microeconomic reform in Australia occurred across a wide range of fronts.[66] It meant tariff cuts combined with adjustment plans for industry, a shift away from centralised wage setting, the privatisation of government assets, and the deregulation of closely controlled sectors like agriculture and transport. The overall effect was to remove government from commercial/quasi-commercial operations and biased regulation and increasingly allow resources to be allocated by competitive markets. Compared with the reactive reforms of the 1970s and 1980s, the microeconomic reform agenda was pursued in far more staged, premeditated fashion.

Phased tariff cuts

Comprehensive reductions in tariffs in Australia were implemented in an orderly and phased manner over a lengthy period. For instance, a four-year program of phased tariff reductions commenced in 1988. Apart from the PMV and TCF sectors, tariffs that were above 15 per cent were phased down in annual steps to 15 per cent by 1992 and tariff rates of 15 per cent or less were reduced to 10 per cent over the same period. Further tariffs cuts and reductions in other barriers to trade were made in subsequent years, including in the midst of the early-1990s recession.[67]

The across-the-board approach to reducing tariffs was important to the success of reducing protection and minimising transitional assistance. This was also helped by the introduction of some tax rates that were internationally competitive for a capital-importing country, such as accelerated depreciation and company tax. Still, vocal vested interests meant some industries, such as TCF and PMV, retained high levels of assistance for substantially longer periods of time than others.[68] This was also true of some agriculture commodities, such as citrus, dried vine fruits and tobacco, where tariffs were an important form of assistance. Assistance to the car industry, which persisted until very recently, has been cited as an unsuccessful use of such mechanisms. In a 2014 report, the Productivity Commmission concluded that industry assistance had led to long-running rent-seeking behaviour by Australian car manufacturers and that persistent protection had resulted in inefficient resource allocation and uncertainty for affected workers.[69]

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66 In the 1980s, the US and Canada undertook deregulation of key industries, privatized public sector assets and signed a free trade agreement that led to the creation of NAFTA. Similarly, the UK also deregulated key industries, privatized government assets, reformed the labour market and reformed its financial sector.

67 Henry 2001.

68 Henry 2001.

69 Productivity Commission 2014.

As in many countries, Australia's tariff cuts required a substantial shift in the way the public and politicians thought about the economic effect of such measures. During most of the 20th century up until the late 1980s, Australia's tariffs were high by international standards. This strong protectionist stance was part of the 'Australian settlement', and for much of the early part of the century was seen as critical to strong employment and high wages.[70] But in the 1950s and 1960s there was a growing awareness that, by raising domestic prices, highly protectionist trade policies were one reason Australia's standard of living was rising slower than the OECD average. Strong opposing views emerged on how to address this decline. Through what became known as 'McEwenism', then trade minister John McEwen championed continued support for protectionist policies. At the same time the role of the Tariff Board was evolving, particularly as it sought to quantify the benefits and costs of protectionism by calculating an effective rate of assistance (ERA).

Reduced tariff protection and industry assistance has generally been seen as positive for living standards. This has come through both reductions in import prices and through efficiency gains caused by the increase in competitive pressure on trade-exposed industries. As was the intent, this resulted in the trade intensity of the economy increasing noticeably, for both exports and imports, with particular growth in trade with Asia.

Public support for trade liberalisation has been arguably stronger in Australia than in many advanced economies, suggesting the benefits of tariff reform are perceived to have outweighed the costs. Manufacturing activity moved up the value chain, but still declined from around 15 per cent of GDP in the late 1980s to around 6 per cent today. Although part of the decline reflects a global trend of growth of services sectors, the fall of the manufacturing share of output in Australia has been somewhat larger than in most other advanced economies. At least over the past decade, this may be due to the strength of the Australian dollar, which decreased the relative international competitiveness of Australian manufacturers. While the adjustment has been difficult for certain industries and communities, tariff reform has nonetheless delivered benefits. At a broad level, living standards have risen and unemployment has fallen. At the industry level, low-skilled, labour-intensive manufacturing, which was typified in the textiles, clothing and footwear industry, has largely been replaced by high-value, specialised manufacturing. And for those communities particularly affected by the decline of trade-exposed industries, structural adjustment policies appear to have removed some of the anxiety associated with job losses.

More recent trade liberalisation in Australia has occurred through free trade agreements (FTA), consistent with practices in other countries. In particular, since 2013 FTAs were concluded with Malaysia, Korea, Japan, China and more recently in relation to Trans-Pacific Partnership (TPP-11) and an Indonesia-Australia agreement. These build on earlier agreements struck with New Zealand, Singapore, the US, Thailand, Chile and members of the Association of Southeast Asian Nations (ASEAN). Despite questions about their economic benefits,[71] FTAs have provided a mechanism to pursue trade, investment and regulatory reform with other countries in an environment in which multilateral action through the World Trade Organisation has made little progress since the mid-1990s.[72]

70 Particularly in the absence of a social safety net. See, for example, Garnaut 2002.
71 See, for instance, Productivity Commission 2010.
72 Australian Government 2017 (2).

Microeconomic reform in the markets for goods and services

The economic reforms of the early-to-mid-1980s had raised the efficiency of the trade-exposed and financial sectors by exposing them to foreign competition. But as border controls were removed, inefficiencies behind the border became more apparent. It was recognised that much of the economy was relatively untouched, especially in non-traded sectors. Sometimes by design, and sometimes because of natural monopolies, there remained many markets for goods and services in which competition was restricted and price signals muted.[73] And because it was especially prevalent in essential services – in sectors like transport, electricity, water and telecommunications – this regulation undermined the efficiency of the broader economy.

To address these problems, Australia's federal and State governments commenced a series of pro-competition reforms from the late 1980s. The broad intention was to limit government involvement in the market economy and instead allow resources to be allocated by prices. The reform agenda proceeded down a number of tracks. Government business enterprises (GBEs) were corporatised, exposed to competition or even privatised. Heavy-handed regulations were dismantled in sectors from agriculture to electricity to transport. But the culmination of the reform agenda was the so-called Hilmer report in 1993 and subsequent reforms in the 1990s – a coordinated program of pro-competition reforms undertaken by federal and state governments.

Despite some planning, pro-competition reform in Australia was slow and disjointed, especially in the early years. Progress was hampered by a range of factors, both political and administrative. Whereas its counterparts in the UK and New Zealand[74] pursued deregulation with urgency, in Australia the government sought to build support for change across business, the union movement and the broader community. And because many critical sectors were managed by state governments rather than the federal government, coordination was a persistent problem. The upshot was microeconomic reform in Australia's goods and services market occurred slower than in many other countries – and slower than many observers would have liked.[75]

Corporatisation and then privatisation of GBEs was a central part of the microeconomic reform agenda, though progress was often slow. For instance, though it was endorsed by the opposition from the mid-1980s and by the government from 1987, the privatisation of the national airline, Qantas, did not begin until 1993. In the face of stiff resistance from the union movement and from within the government's own ranks, airline reform instead started with deregulation and corporatisation. Similarly, the privatisation of the Commonwealth Bank did not occur until 1991, half a decade after the sector was opened to foreign competition. And privatisation of the national telecommunications company, today known as Telstra, only commenced in 1997 and was completed in 2006. Whereas privatisation in the UK and New Zealand was typically pursued on more ideological grounds – based on the argument that governments should not own businesses in such sectors – in Australia it was presented in more pragmatic terms, as a means to improve efficiency, attract capital investment and enable everyday Australians to own a share of the some of the country's biggest businesses.

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73 These were not insubstantial parts of the economy. At the time, government businesses accounted for 10 per cent of Australia's GDP and rail, electricity, gas and water accounted for almost another 5 per cent of GDP (Independent Committee of Inquiry into Competition Policy in Australia 1993 p 11).

74 See footnote 30.

75 See for example Kelly 1992.

Coordination between different levels of government proved to be a major challenge, and was eventually resolved through an government-commissioned independent inquiry into national competition policy led by academic and consultant Fred Hilmer. Whereas a major reform like cutting tariffs or floating the dollar could largely be designed and implemented by the federal government, a nation-wide effort to raise competitiveness in the non-traded sector and beyond would require buy-in from nine governments: the Commonwealth, six states and two territories. And to be truly effective, it would require the states and territories to acknowledge that the Australian economy was a single market. The corollary was that if pro-competition reforms were to be introduced on a national scale, states and territories would need to relinquish at least some sovereignty.

Hilmer's report (see Box C), released in 1993, proposed a wide-ranging program of microeconomic reforms that covered everything from regulating agriculture and the professions, to guaranteeing access to critical privately owned infrastructure like rail and ports, to subjecting natural monopolies to competition, to ensuring that remaining GBEs were on a level playing field with private competitors. These reforms would be steadily implemented by the State and federal governments over the following decade and beyond, with profound consequences for the Australian economy.

BOX C: THE HILMER PRO-COMPETITION REFORMS

The Hilmer Review,[76] as it became widely known, proposed a wide range of reforms to promote competition in the Australian economy. Part of this meant revising the main law prohibiting anti-competitive conduct – the Trade Practices Act (1974) – to plug gaps that restricted its application to large swathes of the economy. Another part meant using a 'public interest test' to stop governments restricting competition in particular sectors, such as agricultural marketing schemes, public utilities and professional licensing. Finally, the Review identified four specific areas which required more tailored remedies: breaking up public monopolies to allow competition in sectors like transport, utilities and telecommunications; requiring owners of critical infrastructure like rail tracks or telecommunications networks to provide access to other users; monitoring prices set by natural monopolies; and ensuring that governments did not have an unfair advantage where they compete with the private sector.

The Hilmer Review recognised that for a host of reasons governments deliberately made laws or regulations designed to limit competition. For instance, output quotas and price controls were used in agricultural industries like dairy and sugar to give farmers price stability and market power. In the transport sector, limits on the number of taxi licenses reduced competition and therefore raised fares, but had long been justified on public safety grounds. And a range of occupations, from lawyers to real estate agents, had long used licensing to restrict competitors on the grounds of maintaining professional standards. To manage the over-use of such restrictions, the Hilmer Review said that if anyone wanted a rule that restricted competition, it was up to them to show that it was in the public interest to do so. Importantly, this put the onus on proponents of anti-competitive regulation to demonstrate that the benefits would outweigh the costs. And to prevent anti-competitive rules hanging on in perpetuity, the Review said restrictions on competition should lapse after five years unless re-enacted.

In sectors like electricity, gas and water, the traditional domination of vertically integrated GBE monopolies posed a particular impediment to competition. Consistent with changes already underway, Hilmer's general remedy was to break them up and, where feasible, corporatise or even privatise the fragments. In the electricity sector, for instance, this typically meant separating generation, transmission, distribution and retail. And in markets where they performed the role of regulator, governments had to ensure this function was separated from any GBEs.

But some sectors remained resistant to competition. Natural monopolies may arise where high barriers to entry block potential competitors. Or governments may be unwilling to undertake the structural reforms described above to break up existing monopolies. In these situations, the Hilmer Review called for independent oversight to ensure monopolies did not abuse their market power by setting prices too high. Rather than creating competition, the intention was to limit the cost of a lack of competition.

76 Independent Committee of Inquiry into Competition Policy in Australia 1993.

BOX C: THE HILMER PRO-COMPETITION REFORMS (CONTINUED)

Natural monopolies also pose problems in terms of access. For instance, even if it is not possible to subject a telephone line network to competition – because it would be uneconomic to build another – it is important to ensure the network's *users* still operate in a competitive environment. The risk was especially acute if the owner of the critical infrastructure was itself a user, thereby creating an incentive to deny access to potential competitors. The Hilmer Review therefore proposed a third-party access regime. Where critical infrastructure exists as a natural monopoly, private sector firms should have a legal right to access that infrastructure on "fair and reasonable" terms.

Finally, the Review recognised that in markets where the government operates as businesses, it may enjoy unfair advantages over private sector competitors. The Hilmer Review identified this as a growing problem because governments were increasingly allowing competition in markets it had traditionally monopolised, such as electricity, gas, government printing and government legal advice. In such circumstances, it was common for a government to stop short of privatisation and instead allow its own provider to compete with private sector entrants as a GBE. But GBEs typically had many advantages. They did not have to pay tax, were often exempt from various regulations, and could rely on implicit government guarantees to raise capital far more cheaply than their private sector rivals. To ensure "competitive neutrality", the Hilmer Review proposed that GBEs should adopt principles such as reflective pricing, commercial borrowing rates and compliance with the same regulations as private operators.

Because of the Hilmer report, competition policy reform in Australia occurred in a more planned and premeditated fashion than other reform areas. In the financial sector, deregulation largely occurred as an iterative process that culminated in the floating of the dollar. By contrast for National Competition Policy (NCP) – as the Hilmer program became known – the federal and state governments identified a problem, commissioned a review, broadly accepted the review recommendations, then moved to implementation (Box D). In part, the deliberate nature of this process reflected the administrative complexity and reach of the challenge. Because it required the agreement of all levels of government at every stage, competition reform was ill-suited to iterative reform.

BOX D: IMPLEMENTING NATIONAL COMPETITION POLICY

Implementation of NCP was aided by a number of policy innovations. An independent agency, the National Competition Council (NCC), was established to oversee the process. Governed by five councillors drawn from the business community, one of the NCC's functions was to educate the public about the need for national competition reform. So even if a pro-compeition reform drew resistance from the community, politicians or participating governments, it would have a proponent in the NCC.

However, the NCC's main function was not as an advocate but as a referee – to assess whether state governments were making sufficient progress on their pledges to implement reforms. And for this purpose its judgement had consequences. As part of the protracted inter-governmental negotiations that followed the release of the Hilmer Review, the federal government agreed to make payments to the states conditional on them implementing competition reforms. These payments aimed to recognise that although state governments were largely responsible for implementing the reforms – and that those reforms often resulted in them forgoing monopoly rents – it was the federal government that stood to gain the most in the form of increased taxation revenue. As such, in the first decade of NCP the federal government paid about $5.7 billion in 'competition payments' to the states.[77] But these payments would have been as much as 24 per cent higher in certain years, had the NCC not judged that some states were dragging their feet and should therefore receive lower payments. In a 2005 review, the Productivity Commission judged that the payments system had been an "important motivator of reform".

77 Productivity Commission 2005.

BOX D: IMPLEMENTING NATIONAL COMPETITION POLICY (CONTINUED)

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Though competition reform is considered to have delivered significant economic benefits, its implementation has been far from painless. In its 2005 review, the Productivity Commission estimated that selected NCP reforms had contributed to a permanent 2.5 per cent increase in the level of Australian GDP.[79] But it also acknowledged the transitional costs borne by particular groups. For instance, some dairy farmers had suffered from deregulation, even if dairy farm incomes had risen in aggregate. And although the reforms had raised the efficiency of public utilities, such as water and gas services, this often came at the cost of jobs in rural areas. The transitional pain has at times contributed to the emergence of politicians opposed to economic openness. Concern about an electoral backlash led state governments to sometimes stall on implementation of their NCP commitments, resulting in competition payments being withheld.

Though the microeconomic reforms of the 1980s and 1990s helped raise Australia's productivity growth, these benefits have waned over time.[80] This has led governments to seek new sources of improvement. NCP was followed in the mid-2000s by the National Reform Agenda, which targeted improvements in competition policy, regulation and human capital. And in 2016 the federal government commissioned the Productivity Commission to conduct ta five-yearly review of Australia's productivity performance. The Commission's first report, released the following year, recommended a range of reforms, many of them in non-market sectors like health, education and cities – that is, in areas quite different to those targeted by Hilmer a quarter of a century earlier. As the Commission's report explained: "The greatest prospective gains now lie in services, especially those that all of us consume regularly, thus spreading the gains widely."[81]

Decentralised industrial relations system

The late-1980s shift in the government's reform priorities, from stabilising the macroeconomy to modernising the microeconomy, was most evident in industrial relations policy. Over two decades, the architecture in which wages are set in Australia steadily shifted downwards, away from a central authority and towards the worker. Unusually, this evolution was driven as much by unions as by government or business. It reflected a broad acceptance across the political spectrum that to maintain and raise living standards, Australia needed an economy that was more productive and more flexible. This meant Australia's industrial relations system was generally decentralised in a less

78 Productivity Commission 2005.
79 Productivity Commission 2005.
80 A more detailed discussion of productivity growth benefits may be found in Section 3.
81 Productivity Commission 2017.

acrimonious way than in comparable economies.[82] And it ensured industrial relations reform was pursued with an eye on fairness as well as efficiency.

Somewhat counterintuitively, Australia's shift to more flexible labour system setting occurred through a highly corporatist mechanism: the Accord. As discussed earlier, the Accord's initial iteration constituted a return to more centralised wage setting – putting it at odds both with other major economic reform at the time and with industrial relations developments in other advanced economies. But this changed in 1987 with the Accord Mark III. Its innovation was a two-tier structure: a first tier that set out a minimum safety net for workers' pay and conditions; and a second tier that allowed unions to negotiate at the enterprise level for higher wages that were conditional on improvements in productivity. The implication of this enterprise bargaining framework was that pay could vary from one firm to the next depending on profitability and productivity.

A notable feature of Australia's shift to enterprise bargaining is that it largely occurred with the support of the union movement. This reflected an acceptance by union leaders that increased flexibility would benefit workers by delivering productivity gains that would in turn raise real wages and employment, provided workers were protected by a safety net. The unions' support facilitated reform by enabling the government to build a consensus for change. But it also had some downsides, with some particularly contentious issues being pushed off the reform agenda. For instance, not until 1996 was a federal government willing to break the union monopoly on labour hiring in the ports – a monopoly that had long been recognised as a major impediment to the country's international competiveness.

Though the system has since ebbed and flowed with each change of government, its essential elements have largely remained. After the change of government in 1996, wage setting shifted closer to the worker. Individual workers and their employers were permitted to negotiate pay and conditions without input from unions. They could also trade away award conditions subject to a so-called 'no-disadvantage test', which required that their negotiated agreement should not leave the employee worse off overall compared with the relevant award. A decade later, the government went even further, including by removing the 'no-disadvantage test' and making it easier for small businesses to fire employees. But these reforms, known as WorkChoices, sparked fierce resistance from the unions and contributed to the government losing office in the 2007 election. WorkChoices was subsequently repealed. The episode has had a lasting effect on Australian politics. Industrial relations has since largely stayed off the political agenda, despite continued debate about whether Australia has the right balance between flexibility and protection.

5. THIRD WAVE: MACROECONOMIC MANAGEMENT AND FISCAL REFORMS

The third wave of reforms included measures to clarify the RBA's role as a macroeconomic manager and to put fiscal management on a more sustainable footing. As with other reforms, these changes benefited from government-commissioned independent advice or inquiries, were mostly implemented gradually to allow time for public debate and consensus-building, and often required perseverance during difficult economic times.

82 The UK Government in particular faced strong opposition from unions and workers in its efforts to deregulate the UK labour market and privatize nationalised industries in the 1980s. Estimates suggest the UK lost 27 million working days in 1984 due to strike action.

Monetary Policy

The role and objectives of monetary policy have evolved over time. A number of approaches to achieving price stability, or other desirable macroeconomic outcomes, were tried and failed during the 1970s, 1980s and early 1990s. Prior to the float of the currency, these attempts reflected the challenges presented by the Mundell-Fleming trilemma; as Australian markets became more integrated into world markets, large international capital flows made it increasingly difficult for authorities to control domestic monetary conditions and maintain a fixed or pegged exchange rate.

New monetary policy challenges emerged in the 1980s, as financial deregulation led to rapid credit creation and high rates of inflation. The RBA responded by substantially tightening monetary policy, leading the cash rate to reach 18 per cent in the second half of 1989. The subsequent bust, which led to the failure of a number of financial institutions and the early-1990s recession, sparked debate about whether the RBA was at fault. This raised widespread concern about the effectiveness of monetary policy.

At around the same time, New Zealand moved to what was then a radical new monetary policy regime – inflation targeting. Under this system, the RBNZ would target a stable and low rate of inflation by setting the interest rate at which banks lend to each other in overnight markets – without resorting to an intermediate target of money or some other combination of indicators, as had been previous practice. The substantial reduction in inflation following the early-1990s recession enabled the RBA to adopt a similar regime.[83] This move, which the RBA commenced in 1993, made Australia one of the first countries to do so after New Zealand, Canada and Sweden. The target, which was formalised in the first *Statement on the Conduct of Monetary Policy* in 1996 between the then Governor and Treasurer, required the RBA to achieve an inflation rate "of 2-3 per cent, on average, over the cycle" – a form of words that intentionally provided discretion and a medium-term focus.

The other important element of Australia's monetary policy approach is the independence of the central bank from the government. As with inflation targeting, formal recognition of RBA independence occurred in the 1996 *Statement on the Conduct of Monetary Policy*. New statements are issued when the RBA Governor changes.

When it was introduced, the discretion inherent in the wording of the RBA's inflation target was widely criticised.[84] The OECD and IMF preferred New Zealand's approach, which expressed its target in much more precise language. But this assessment changed over time. Australia's approach has proven to be resilient to quite substantial changes in the macroeconomic environment, including the Asian financial crisis, introduction of the GST and the global financial crisis. Flexibility has come to be seen as a benefit. As such, many countries, including New Zealand, have since switched from a rigid to a flexible inflation-targeting regime.

Since that time, *Statements on the Conduct of Monetary Policy* have changed very little. The most recent Statement, agreed in 2016, has an inflation target of "2-3 per cent, on average, over time" and explicitly acknowledges the RBA's financial stability mandate.

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83 Macfarlane 1997.

84 Debelle 2018.

Fiscal Policy

As with monetary policy, thinking about fiscal policy has evolved to emphasise a medium-term perspective. While incurring deficits during a recession has always been regarded as sensible policy, there has been a shift towards offsetting these deficits with surpluses where possible, in line with ensuring that the government's debt position is stable in the long run. This focus on fiscal sustainability was influenced by concerns during the 1980s and early 1990s about the ballooning current account deficit and external indebtedness.[85]

In response to what was perceived as a national crisis – encapsulated in Treasurer Paul Keating's "banana republic" statement – the government at the time looked for ways to reduce expenditure and increase revenue. It sought to rein in its expenditure by specifying a number of fiscal rules[86] known as the 'trilogy'.[87] Taxation revenue was improved through better targeting and measures to address 'loopholes'. The measures affected nearly everyone in the community, contributing to public acceptance of their adoption. The medium-term role of fiscal policy became to increase national saving and reduce recourse to foreign financing of domestic investment. Even during the early-1990s recession, when the immediate focus of fiscal policy shifted to supporting economic recovery, the government maintained its commitment to this medium-term goal. To help achieve this, it commissioned an independent report on national saving which argued forcefully that 'the greatest scope for raising … national saving lies in the public sector.'[88]

As mentioned earlier, during the late 1980s and early 1990s the idea emerged that the current account deficit was not the national crisis it had been made out to be. This is now known as the 'consenting adults' view of current account deficits. In this case, academic economists were the independent actors that helped to change public views and influence government policy.[89] Nevertheless, large, sustained current account deficits have provided strong motivation for fiscal restraint since the mid-1980s.[90]

By and large, Australia' fiscal restraint has achieved its aims. Since the 1980s there have been periods of both budget surpluses and deficits.[91] Australia's public debt has been low by international standards. Indeed, net government debt fell below zero in the mid-2000s following asset sales and a string of budget surpluses – a product of fiscal discipline and surging commodity export revenues. This meant that the government was well positioned to withstand the 2007-08 global financial crisis and to respond to it with fiscal stimulus to support economic activity. But ongoing deficits have been recorded since that time, reflecting a sharp rise in the deficit during the crisis, weaker tax revenues and difficulties in reducing structural spending. A budget balance is now forecast for 2019-20 and net debt is expected to peak at 18.6 per cent of GDP in 2017-18 – a level well below the OECD average of over 70 per cent.[92]

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85 The arguments that large deficits were a cause for public policy concern and that fiscal policy had a role to play in raising national saving were expressed clearly and repeatedly in the Government's budget documents at that time.

86 Fiscal rules have become an increasingly popular fiscal management tool, increasing from only five countries in 1990 — Germany, Indonesia, Japan, Luxembourg, and the United States—to over 90 countries in 2018 (Schaechter et al 2012 and Eyraud et al 2018).

87 That is, in the three-year life of the parliament it would not raise tax revenue, government expenditures or the budget deficit as a share of GDP.

88 FitzGerald 1993, p 16.

89 See, for example, Corden 1991.

90 Gruen and Sayegh 2005.

91 Budget surpluses were broadly achieved in two periods – the late 1980s and the late 1990s to the mid-2000s. Deficits occurred in the wake of the early-1980s recession, the early-1990s recession and in the decade since the 2007-08 global financial crisis.

92 OECD 2018 (1).

Charter of Budget Honesty

While fiscal policy was increasingly emphasising medium-term fiscal sustainability and increasing transparency, it was not until after a change in government in 1996 that a Charter of Budget Honesty was introduced to formalise an approach to fiscal management. Legislated in 1998 and still in place today, the Charter set out a framework for the conduct of fiscal policy and fiscal reporting, including how estimates should be presented in the budget, mid-year update and pre-election update (see Box E). It also requires the budget be set against a medium-term fiscal strategy – mirroring the medium-term monetary framework applied by the RBA. The Charter's introduction was framed against concerns about the current account deficit; as the 1996-97 Budget explained, "the only sustainable solution to our high structural current account deficit is to boost significantly our level of national saving. Raising public sector saving and thereby, over time, national saving, is the primary objective of the government's medium-term fiscal consolidation strategy".[93] The Charter's operational benefits have largely been in terms of budget transparency and accountability.

BOX E: SUMMARY: CHARTER OF BUDGET HONESTY

The Charter imposes a formal requirement on the Australian Government to set out and report against a medium-term fiscal strategy, which is required to be based on "principles of sound fiscal management". These principles require fiscal policy to have regard to: government debt and the management of financial risks; the state of the economic cycle; the adequacy of national saving; the stability and integrity of the tax base; and equity between generations.

The primary objective of the medium-term fiscal strategy is to maintain budget surpluses, on average, over the course of the economic cycle (2018-19 Budget). This is underpinned by four policy elements:

- investing in infrastructure to boost productivity and participation;
- reducing the Government's share of the economy over time by controlling expenditure;
- policies that support revenue growth, while maintaining a tax-to-GDP ratio at or below 23.9 per cent; and
- strengthening the Australian Government's net worth over time.

The notable feature of the Charter is its principles basis. Compared with the trilogy commitments and with frameworks adopted in other countries, the Charter avoids detailing strict fiscal rules and instead sets out principles on which the government's fiscal strategy must be founded. The fiscal strategy —to "achieve budget surpluses, on average, over the course of the economic cycle" — is described in a way that gives the government 'constrained discretion'. The medium-term focus and flexibility are consistent with the approach taken in the *Statement on the Conduct of Monetary Policy*. In the years since the Charter was adopted, governments have had mixed success in achieving their fiscal strategies. But the discretionary nature of the Charter is balanced by a number of transparency requirements including the requirement to publish a pre-election economic and fiscal outlook report once a federal election has been called, and an Intergenerational Report every five years.

The acceptance of the Charter as a bedrock of Australia's fiscal strategy has occurred alongside a number of other public financial management innovations. In the late 1990s, Australia became one of the first countries to adopt accrual accounting and to shift its budget to a framework based on outcomes as well as outputs, having previously moved to a multi-year budgeting process during the 1980s. Since 2002, in a requirement enshrined in the Charter, the government has released an Intergenerational Report to assess sustainability of current government policies over a

93 Commonwealth of Australia 1996, p 1-9.

40-year horizon. In 2005, drawing on lessons from the first Intergenerational Report, the government established the Future Fund, a sovereign wealth fund with a very specific objective: paying for the unfunded pension liabilities of public servants. And in 2012, a Parliamentary Budget Office was established to provide federal parliamentarians with independent analysis of fiscal and policy issues.

Tax and spending measures

Australia is a relatively small-government economy. Tax revenue from all levels of government was 28.2 per cent of GDP in 2015, well below the OECD average of 34 per cent. It has fluctuated but generally been around this level since the late 1980s, after rising from 21 per cent in the early 1970s. Spending tells a similar story. In 2015, general government spending across all levels of government was 36.2 per cent of GDP,[94] making Australia's government the 8th smallest among 34 OECD nations.[95] This share has bounced around since the 1980s in response to changes in economic performance and policy, including two periods of especially sharp cuts in discretionary spending in the mid-1980s and the late 1990s. And despite strong safety nets, Australia's welfare system is generally more targeted than its peers; public social spending was 19.1 per cent of GDP in 2016, below the OECD average of 21 per cent.[96]

Australia's tax system has undergone substantial reform since the 1970s. The overriding goal has been to improve efficiency and fairness, with sharp reductions in personal and corporate income tax rates accompanied by measures to broaden the base.[97] The top personal income tax rate has been cut from 60 per cent to 45 per cent today, while tax brackets have been steadily shifted upwards.[98] The corporate income tax rate has fallen from 49 per cent in 1986 to 27.5 per cent for smaller businesses and 30 per cent for the remainder, with noticeable step downs in the rate in 1988, 1993, and 2000-2001. These reductions ensured Australia remained competitive with its OECD peers and continued to attract foreign investment.

The 1980s was a period of major tax reform, even if the government's ambitions were constrained by its desire for consensus. The government wanted to introduce a broad-based consumption tax to reduce Australia's heavy reliance on income taxes at that time. However, when it was put forward at the government's national tax summit in 1985, the consumption tax proposal was quashed by unions, business and welfare groups. Nonetheless, much of the rest of the reform program was endorsed. Alongside big cuts in personal and corporate income tax, the government introduced dividend imputation to stop corporate profits being taxed twice: first through company tax on corporate profits, and second through personal income tax on dividends paid to shareholders. And its adoption of a fringe benefits tax and capital gains tax broadened the tax base.

A consumption tax would have to wait another 15 years. In 1998, a new government announced A New Tax System (ANTS), a comprehensive tax reform plan with a 10 per cent goods and services tax (GST) as its centrepiece. Exemptions on food and education were included to ensure support for the GST in the parliament. Over time, consumption of tax-exempt items has increased such that in 2014 Australia's GST base covered close to 50 per cent of household expenditure compared with 96 per cent in New Zealand.[99] The GST replaced a narrow wholesale sales tax and various state-based taxes, and enabled further reductions in personal income taxes. The government also lowered the company tax rate further and broadened its base.

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94 The statistics incorporate the revenue and spending of all three levels of government in Australia. In order to calculate an aggregate deficit across all levels of government, tax and non-tax sources of revenue need to be taken into account.

95 OECD 2018 (2).

96 OECD 2018 (3).

97 A more detailed discussion on tax reform can be found in Reinhardt and Steel 2006.

98 Income tax thresholds in Australia are not automatically indexed to inflation.

99 OECD 2016.

Up until the most recent personal income tax reforms legislated after the 2018-19 Budget, reforms since have been relatively incremental or temporary. Personal income tax brackets have been periodically adjusted up, offsetting the effect of fiscal drag. A carbon tax was introduced in 2011 but repealed three years later. And a rent tax on coal and iron ore mining was introduced for a little over two years from mid-2012.

Australia has achieved its relatively strong fiscal position despite maintaining effective safety nets and introducing major government service initiatives, including in health and education. A universal public healthcare scheme, called Medicare, was reintroduced in 1983. The Higher Education Contribution Scheme (HECS), introduced in 1989, requires students to start paying for their tertiary education through the tax system once their income exceeds a threshold. And after a Productivity Commission review highlighted inadequate support for disabled people and their carers, the government introduced the National Disability Insurance Scheme. Meanwhile, sharp targeting means Australia runs a welfare system that provides strong safety nets at a lower cost relative to its OECD peers. Still, a recent review found the country's progressive tax system and targeted transfer system work together to significantly reduce income inequality.[100]

To take pressure off its public pensions system, Australia since 1992 has had a compulsory retirement savings scheme known as superannuation.[101] Funded by a mandatory 9.5 per cent levy on wages, the retirement saving system today has nearly 15 million members[102] who together own about $2.6 trillion in assets.[103] This has been transformational for the wealth of individuals, with retirement saving accounts for many Australians growing to be the second largest asset after the family home. This system has also generated a large and sophisticated funds management industry that has arguably led to growth in financial services innovation. But superannuation policy settings have been refined over time, often in response to government-commissioned independent reviews of the broader financial sector. For instance, the 1997 Wallis inquiry eventually led to changes that gave consumers greater choice about their superannuation fund, including the option of self-management. Superannuation policy is under renewed scrutiny following the 2014 Murray Financial System Inquiry.

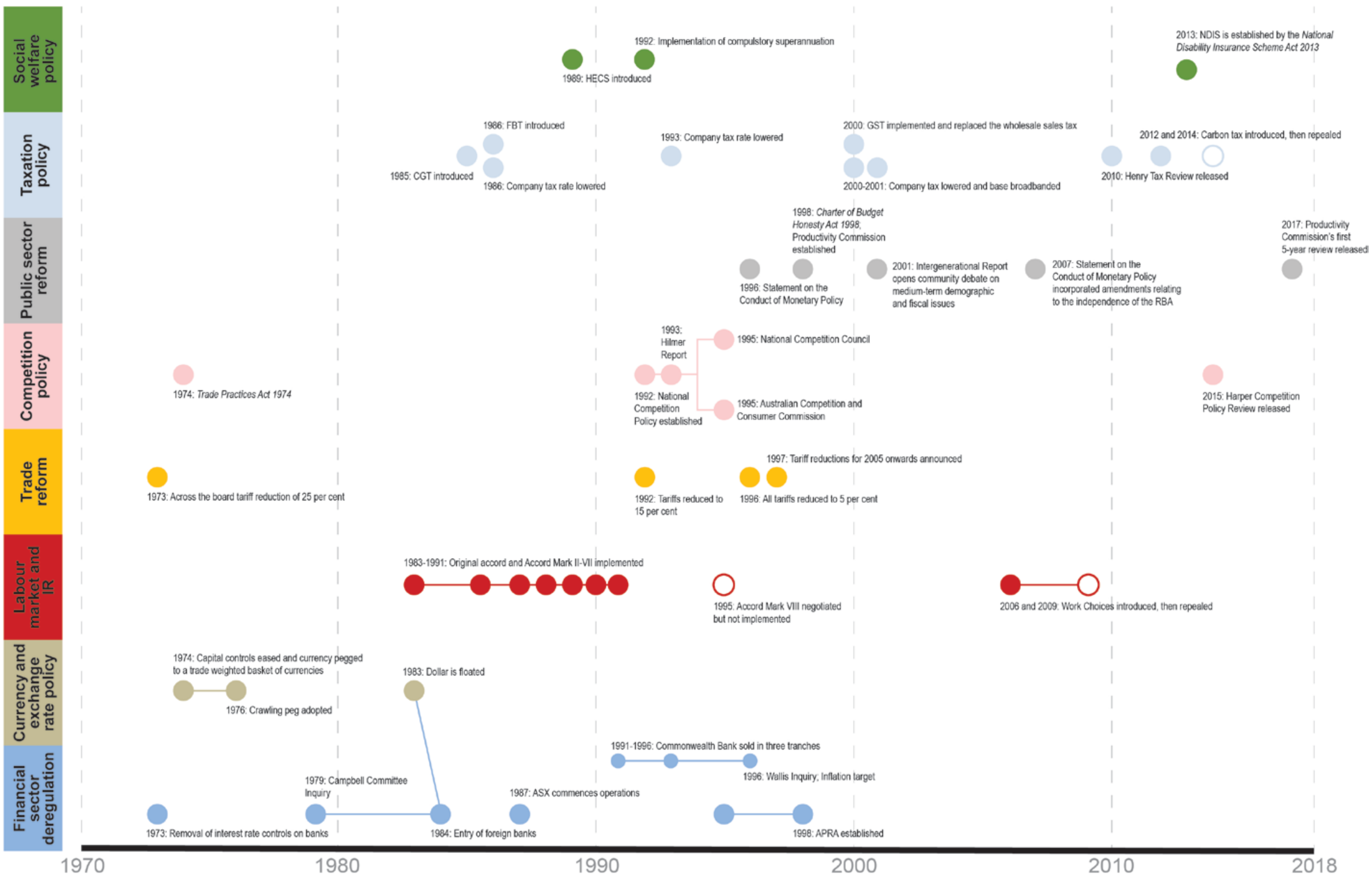
100 Productivity Commission 2018.

101 The Commonwealth regulatory framework for retirement saving system dates back to the 1970s. But it received a boost in 1985 when, under the second Accord, unions agreed to help limit inflation by directing a 3 per cent pay rise into superannuation rather than wages.

102 Australian Taxation Office 2018.

103 Australian Prudential Regulation Authority 2018.

REFORM ROADMAP



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