



# Economic and Political Overview 2014

## About this publication

Economic and Political Overview 2014

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ISSN: 0813-121X

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Page 30: Medicare office in Penrith Plaza, Sydney, Newspix/David Hill; COAG meeting at Parliament House, Canberra, AAP Image/Alan Porritt; COAG meeting at Parliament House, Canberra, AAP Image/Alan Porritt.

Page 32: Ross Garnaut, CEDA event, Low-emissions technology and the innovation challenge, Sydney, March 2011; COAG meeting at Parliament House, Canberra, AAP Image/Alan Porritt.

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## About CEDA

CEDA – the Committee for Economic Development of Australia – is a national, independent, member-based organisation providing thought leadership and policy perspectives on the economic and social issues affecting Australia.

We achieve this through a rigorous and evidence-based research agenda, and forums and events that deliver lively debate and critical perspectives.

CEDA's expanding membership includes 700 of Australia's leading businesses and organisations, and leaders from a wide cross-section of industries and academia. It allows us to reach major decision makers across the private and public sectors.

CEDA is an independent not-for-profit organisation, founded in 1960 by leading Australian economist Sir Douglas Copland. Our funding comes from membership fees, events and sponsorship.

## CEDA – the Committee for Economic Development of Australia

Level 13, 440 Collins Street  
Melbourne 3000 Australia  
Telephone: +61 3 9662 3544  
Fax: +61 3 9640 0849  
Email: [info@ceda.com.au](mailto:info@ceda.com.au)  
Web: [ceda.com.au](http://ceda.com.au)



committee for economic development of australia

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Katie Hill, Economist, ANZ

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Vice Chancellor's Fellow, Victoria University

Rodney Maddock delivers an analysis of the economic effect of red tape and government regulation. He examines the current areas of concern and ways to address excessive red tape.

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The content in the 2014 Economic and Political Overview was up-to-date at the time of printing. Due to rapid changes in the current economic and political environment, it may not address the most recent developments.

CEDA's Economic and Political Overview series, taking place around Australia at the time of the publication's release, will provide the latest analysis from the report authors and business and political leaders.

# foreword



This year has the potential to be a significant year of change for Australia, with a new Federal Government attempting to lock in its policy agenda for the next three years against a backdrop of continuing changing domestic and world economic conditions.

The 2014 Economic and Political Overview – the 32nd edition – once again upholds the CEDA tradition of delivering a comprehensive overview of the key issues in the year ahead. It also provides analysis of the economic and political environment the business community will be operating in over the next 12 months.

ANZ Chief Economist Warren Hogan, along with economist Katie Hill and the ANZ research team, have once again put together an excellent assessment of the likely movements on key economic issues, from the global recovery and the Chinese economic outlook, to movements domestically for the commodity markets, residential construction and interest rates.

The political chapter completed by respected Canberra journalist and ABC 7.30 Political Correspondent Sabra Lane, provides an overview of the key issues likely to dominate the political agenda now that the turmoil of 2013 has passed. Key issues identified include if the new government will meet the high expectations of industry and business, the Commission of Audit and likely spending cuts, changes in the makeup of the Senate and foreign affairs.

As identified in the political chapter one of the biggest tests for the new government will be how it handles the unexpected.

Signs suggest that the 2014 broader world economic outlook will provide a more sustainable economic environment with which Australian policymakers can engage with a degree more certainty. However, it is still early days for the new government

and, as indicated by authors in the EPO, some policy direction uncertainty exists and the jury is still out as to whether the policy changes required will be delivered.

Polling has already shown that, in contrast to almost every other new government in the last 40 years in Australia, the wedding ceremony lasted longer than the honeymoon, with swings against the government already.

CEDA members' expectations are high for improving economic performance following the return of policy normalcy with a government with a clear majority. The Abbott Government's ability to bed down its agenda and provide clear policy direction to the voting public will be significant in determining if the polling post-election is just a short term anomaly.

Articulating a clear agenda for key areas requiring policy reform such as in taxation and improving productivity, competitiveness and innovation, as identified by CEDA members in our Big Issues survey in December, should be high on the new government's agenda if it wants to curtail the fall in polls.

In addition to the economic and political chapters, this year's publication also includes chapters around red tape, government productivity and the changes globally that will impact Australia in the coming year.

Griffith University Centre for Government and Public Policy Associate Professor Anne Tiernan's chapter – *Government productivity* – explores the difficulty in measuring public sector productivity, options for reforming public sector performance, barriers and impediments and possible unintended consequences.

Export Finance and Insurance Corporation (EFIC) Chief Economist Roger Donnelly's chapter – *How the 'Great Convergence' is changing Australia* – explores the external forces shaping Australia and the potential impact, in particular examining China and providing analysis of what may be in store.

Finally, Monash University Adjunct Professor and Victoria University Vice Chancellor's Fellow Dr Rodney Maddock's chapter – *Red tape in finance and its discontents* – explores the economic effect, current key areas of concern and ways to address excessive government red tape.

These three topics were chosen because each will without a doubt be significant themes on the national agenda during 2014.

I would like to thank each of the authors for their important contributions to this publication and I look forward to seeing many of CEDA's members at the EPO events being held in every Australian state and territory capital city to coincide with the launch of this publication.



Professor the Hon. Stephen Martin  
Chief Executive, CEDA



# economic OVERVIEW



**Warren Hogan** is ANZ's Chief Economist and is responsible for the bank's Economics and Global Markets Research. Warren has extensive financial markets and banking experience having worked as an economist and strategist with

Australian and international banks for nearly two decades. Warren has been at ANZ for the past seven years, having run the Global Markets Research team and the Australian Economics team before being appointed Chief Economist in 2010.

Warren's research focus is global macroeconomics, monetary economics and the financial markets. Prior to joining ANZ, Warren was Chief Economist and Head of Interest Rate Product Research at Credit Suisse First Boston and he held senior economic positions with Westpac Banking Corporation and NSW Treasury Corporation.

**Katie Hill** is an Economist at ANZ working with the Chief Economist in the Global Economics and Strategy team. She conducts research and analysis in relation to the global economy and financial markets. She previously worked at Morgan Stanley in the research division. Katie holds a Bachelor of Laws degree and Bachelor of Business (Economics) degree from the Queensland University of Technology.

**ANZ Research Team:** The Global Markets Research team consists of product-specific strategy teams that are organised on a global basis. The strategists utilise the core views of the economics team and apply these to the relevant markets. In doing this they assess market valuations of financial instruments and commodities as well as providing market risk assessments. ANZ Research provides a cohesive view of the economic and financial forces affecting the global economy with particular reference to the Asia-Pacific region.

## Introduction

We expect a cyclical pick-up in global economic activity in 2014 and into 2015, which should mark 2013 as the low point in global growth since 2009. The main driver is an improved contribution from advanced economies: the US, Europe and Japan. In these economies growth will be supported by: ongoing accommodative monetary policies, improving balance sheets across most of the private sector, and an easing in fiscal consolidation. Importantly, asset prices are rising and financial markets are broadly stable.

For Australia, this global backdrop will be supportive of the critical transition the economy is undertaking in the wake of the mining/energy investment boom which now appears to be in contraction. Stronger growth in the advanced economies and rising asset prices should support business and consumer confidence helping with the revival of consumer investment in property and business investment across services, manufacturing and agriculture. At the same time, still strong growth in China and emerging Asia is expected to support commodity prices, reducing the drag on national income from a substantial decline in the terms of trade.

Many uncertainties hang over the Australian economic outlook, not least the prospects for a vigorous

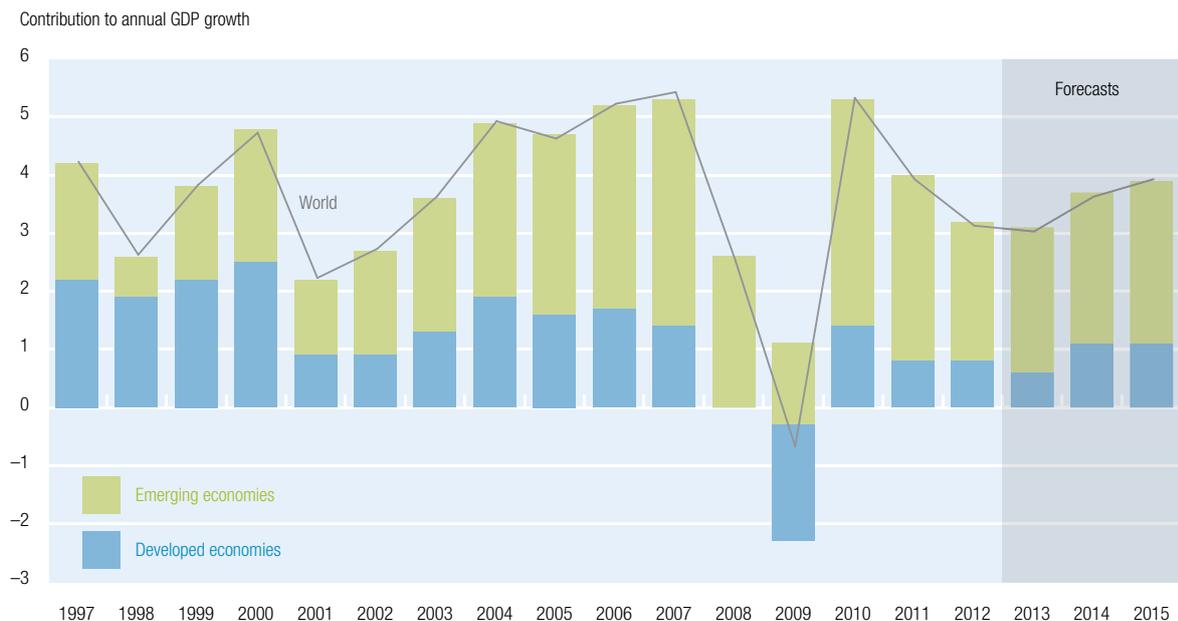
revival of non-mining business investment. A historically high currency, expensive labour costs and the prospect of sustained fiscal tightening in this year's Commonwealth Budget all pose downside risks to the growth outlook. Internationally, Australia is as dependent on the Asian economy as it has ever been. Most of the capacity put in place around the mining and energy complex is there to provide for a growing Asian economy. Any setbacks in Asia could be deeply felt in Australia.

## Global recovery on track

The US recovery hinges on housing, which we expect to strengthen over the first half of 2014. We forecast US GDP growth to accelerate to three per cent in 2014 from 1.8 per cent in 2013 largely due to diminished fiscal drag. Private demand should be underpinned by solid consumption, a resilient housing recovery and a moderate pick up in business capex. Although solid growth should contribute to a further tightening in the labour market, inflation pressures should remain modest as there is still considerable slack across the economy.

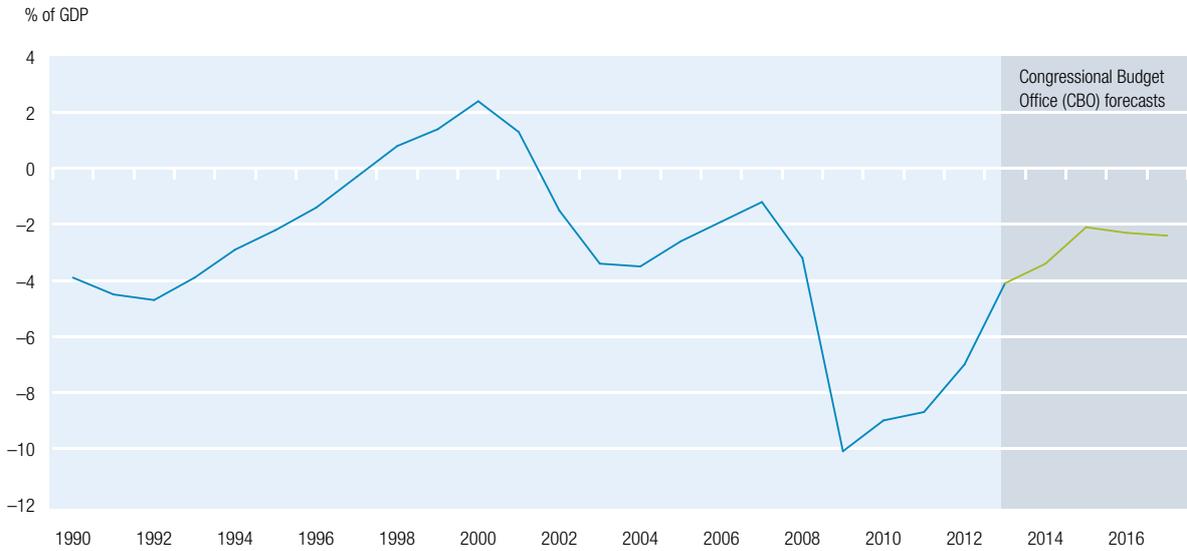
Fiscal policy tightening was a significant drag on growth in 2013. The US Federal Government budget deficit declined 2.7 percentage points (from 6.7 per cent to 4.0 per cent of Gross Domestic Product) in

**Figure 1**  
Global growth forecasts



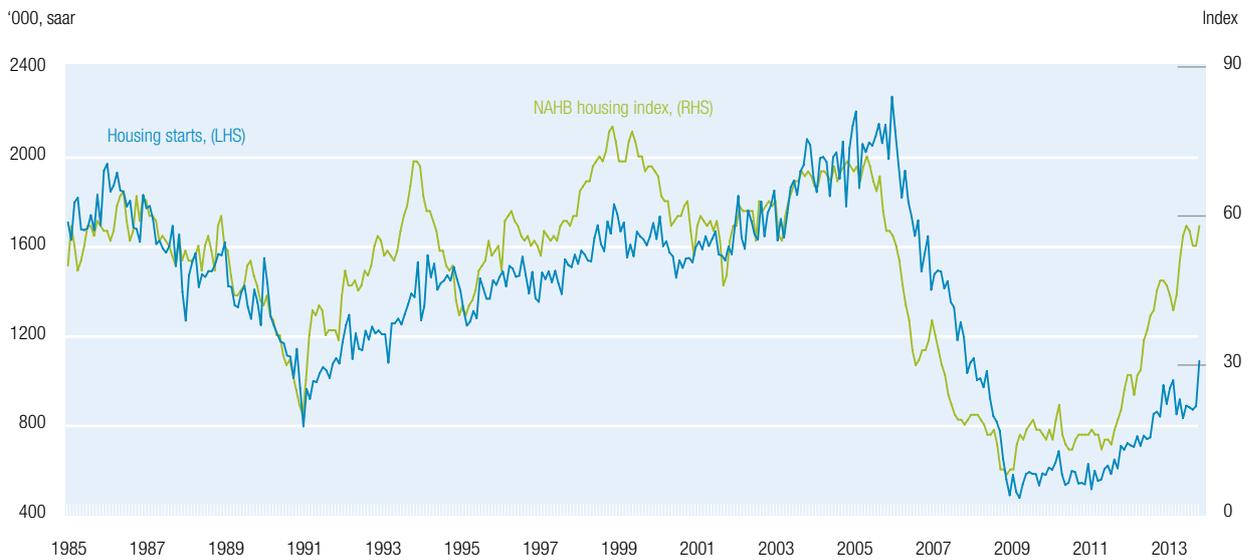
Source: IMF, ANZ Research

**Figure 2**  
US budget balance



Source: BEA, CBO, ANZ Research

**Figure 3**  
US housing starts and lead indicator



Source: US Census Bureau, NAHB, ANZ Research

the fiscal year ending September 2013. That the US economy still managed to grow by two per cent over the year to September 2013 suggests that the economy has renewed resilience. Indeed, our own composite activity index based on a number of business surveys suggests that momentum has been building across much of the economy over the past year.

We are confident that the US housing recovery will continue and drive growth. After five years of extraordinarily weak activity in this sector, the oversupply of houses has been worked off. A tightening in residential vacancy rates suggests the balance is now shifting to insufficient supply. The household formation rate should step up amid a strengthening labour market and low interest rates. We expect starts to

gravitate towards the 1.5m level (our estimate of underlying demand) by 2015. Without an upswing in house construction, the US economy may fail to gain the cyclical momentum to take the expansion to the next stage.

We expect interest rates will remain low, supporting the housing recovery. The main challenge in 2014 for a Yellen-led Federal Reserve is how the central bank articulates and/or enhances its forward guidance to markets, that the Fed Funds rate will remain low for an extended period. Providing the Fed is successful, this will keep bond yields anchored. We expect bond yields will rise very gradually and are unlikely to impede the housing recovery.

The European economy has grown recently, but any recovery is likely to be patchy. The challenge for the Euro Area in the next couple of years will be to lift aggregate demand in a meaningful way to prevent further disinflation and/or deflation. Although activity is set to become more domestic-demand driven and therefore more sustainable over the next couple of years, any pick up is likely to be modest and below potential. Thus further disinflationary pressures seem inevitable. The European Central Bank (ECB) cut rates in November to counter this threat and stands ready to act again.

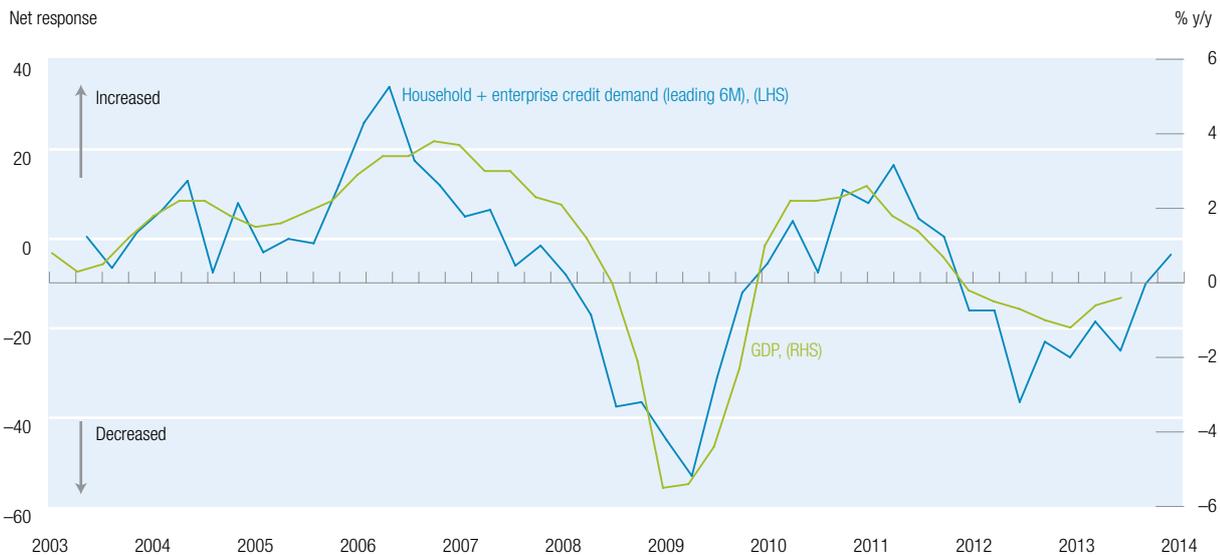
Japan should achieve good economic growth this year and the next. Abenomics – an ambitious three-pronged reflation strategy involving aggressive monetary policy, flexible fiscal policy and a growth strategy – has had an encouraging start with financial

“We are confident that the US housing recovery will continue and drive growth. After five years of extraordinarily weak activity in this sector, the oversupply of houses has been worked off.”



conditions and sentiment improving and real spending lifting in response. However, much work still needs to be done to sustainably lift growth and inflation. Structural economic reforms will be key.

**Figure 4**  
Credit demand provides a reasonable lead on Euro area future activity



Sources: Bloomberg, ECB, ANZ Research

## Reform to dominate the Chinese outlook

We expect China's growth will moderate to around 7.2 per cent in 2014, down from an expected 7.6 per cent in 2013. This reflects our expectation that the Government's 2014 growth target could be lowered to seven per cent in order to allow room for structural reforms and to address the problem of overcapacity and out-dated capacity, especially in heavy industry. China will continue to rebalance its growth from investment led to consumption but we expect this process to be glacial, taking at least another five, if not 10 years. However, this will create more sustainable growth and reflect a more sophisticated economy with a dominant middle class. In this context, we expect services consumption to lead the way over the medium-term.

Commodity prices will also be supported as urbanisation will remain the major strategy to provide employment opportunities and sustain the economy with continued infrastructure investment especially in the central and western regions. Further, in the event of a slowdown in activity, we expect the Government to step in to boost infrastructure spending in order to stabilise growth.

As GDP growth slows, we expect China's inflationary pressures will remain manageable in 2014. We consider that Chinese authorities will maintain the inflation target at 3.5 per cent and we expect

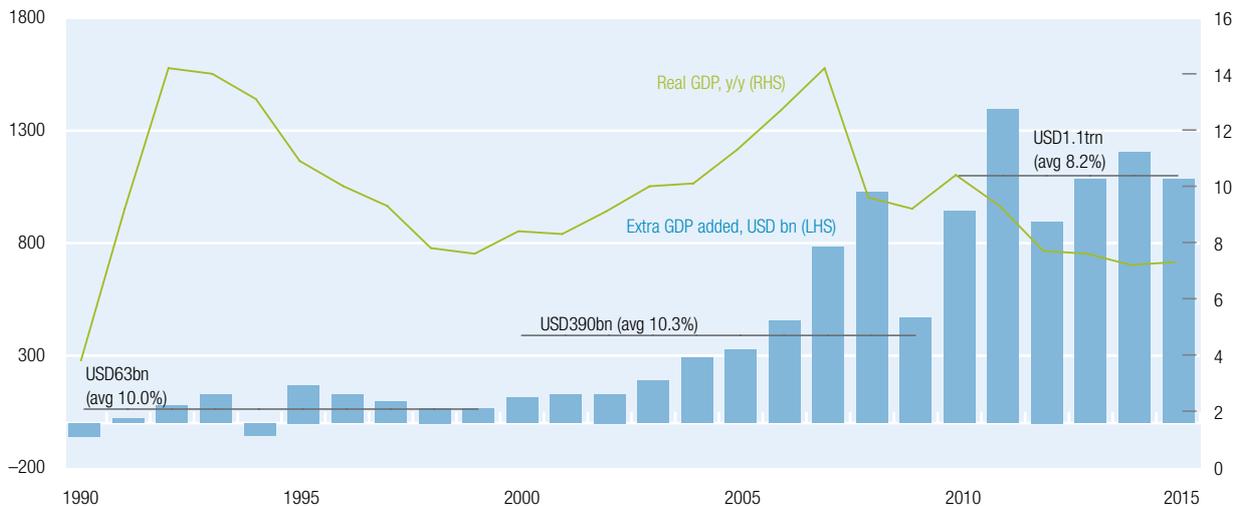
consumer price index (CPI) inflation growth around 3.2-3.4 per cent. There is more uncertainty over asset prices, especially residential property, although continued financial reforms will alleviate some of the pressures in this sector as a greater range of investment options are opened up to Chinese savers.

The central bank is likely to maintain relatively tight financial conditions, using frequent money market operations to manage liquidity. We expect the current market liquidity tightness will persist over the year ahead, reflecting reasonable growth in credit across the economy but also the risks of financial excess in a period of financial liberalisation. Yi Gang, Deputy Governor of the People's Bank of China (PBoC), said that China will nurture a short-term benchmark market interest rate as a new anchor rate, to push forward the interest rate liberalisation process. He stated that the Shanghai inter-bank offered rates (SHIBOR) and Bond Repurchase Agreement will be the candidates for the new policy rate.

Against this monetary policy setting, the RMB will continue to appreciate as capital inflows remain large, driven by substantial interest rate differentials between onshore and offshore markets. However, we do not expect an overly strong RMB and forecast that the RMB will likely reach 5.98 against the US dollar by the end of 2014.

Property prices will remain elevated under the current monetary policy framework in spite of the existing policies to curb leverage in this sector. We believe that property prices in the top-tier cities are

**Figure 5**  
China – annual GDP growth



Source: CEIC, IMF, ANZ Research

likely to continue to rise as the supply is still quite constrained, although the upside would be quite limited by this policy and tight monetary conditions. In the meantime, property prices in the third and fourth-tier cities have had little price pressures, as the stock of unsold housing is expected to build up in the next year.

While we believe the downside risks have been mitigated after the Communist Party of China's Third Plenum, policy execution is also key to ensuring the success of reforms. In the near term, the authorities will have to address the rising cost of funds, financial risks embedded in the shadow banking system, as well as those associated with local government financing platforms. More broadly, the authorities will also need to get their policy sequencing right in order to mitigate downside risks to the economy.

China's top leadership concluded the Third Plenary Session of the 18th CPC Central Committee on 12 November 2013, and later released the main document *The Decisions for Major Issues Concerning Comprehensively Deepening Reforms*. We believe the reform measures outlined in the decisions are unprecedented. China's top leadership pledged to remove the privileges granted to state-owned enterprises, remove barriers to competition, use the markets to determine factor prices, accelerate deregulation of interest rates and capital flows, lower curbs on foreign investment, reform the fiscal system, and grant local government the rights to issue bonds.

## Emerging Asia on a firm footing in 2014

The Emerging Asia region ended 2013 with activity on a slightly firmer footing, having weathered significant volatility in capital flows. We expect output to shift to a more expansionary trajectory in 2014. This is a function of an ongoing pick up in US and European growth and a stabilisation of Chinese and Japanese growth. China and the G3 remain key drivers of Asian production and with China stabilising on the back of the Third Plenum reforms, the risks to Asia now appear to be skewing more to the upside over the next few years.

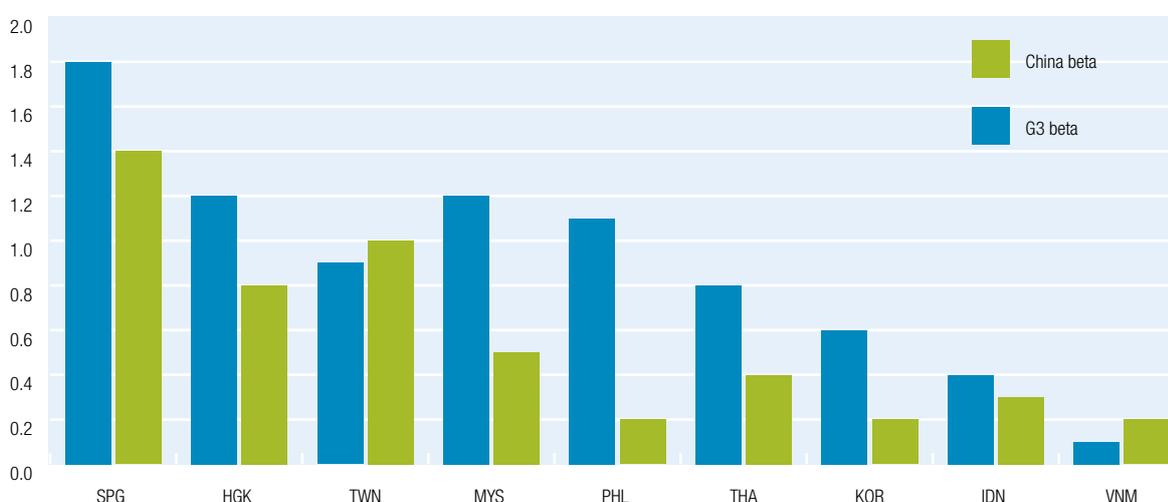
Currency depreciation over the course of 2013, coupled with firmer external demand, may see inflation return as a policy issue in 2014. We would expect a number of the Association of Southeast Asian Nations (ASEAN) economies to start tightening cycles in the second half of 2014.

The main risk to our forecast is a significant pick-up in financial market volatility, that is capital outflows, generated by Fed tapering. However, portfolio flows, in our view, should not be sufficient to derail the beneficial impact of a stronger world economy in 2014.

Downside risks are concentrated in India and Indonesia. Their problematic inflation and current account dynamics has seen respective policymakers move policy to a restrictive setting. This means that these two economies will decouple from the rest of

**Figure 6**

**Asia's sensitivity to China and G3 growth**  
(Asia's responsiveness to a one per cent change in external demand)



Sources: CEIC, Bloomberg, ANZ Research

Asia, slowing – perhaps significantly – as the rest of Asia is expected to benefit from improving external demand.

## Commodity markets to stabilise

We expect most commodity markets to improve in 2014 after an average eight per cent decline in 2013. Commodity performances are likely to be skewed, with improved global growth over the next 12 months, offset in some cases by rising supply and high stockpile positions. We expect the important commodity-consuming Chinese market will stabilise, which should reset the overly-cautious view that has been held concerning China.

### Bulks (coal and iron ore)

We expect the bulk markets to diverge in 2014. Thermal coal is expected to be a stronger market, coming off a low base and a tighter supply backdrop. In fact, thermal coal prices are forecast to be our best overall bulk performer in 2014. The iron ore and coking coal markets should be more closely tied to Chinese steel prices, which in the absence of stronger supply discipline, will likely struggle to generate much better price gains. The increased supply response in iron ore and inelastic output decisions in coking coal should also weigh on both of these markets.

We expect thermal coal should have the support of visible supply discipline kicking into key producing markets of China, the US, and to a lesser degree Indonesia. There is likely to be some price divergence with the higher-ranked coal markets outperforming the lower-ranked coal markets. This should come partly from attractive price differentials, but more structurally from the increasing likelihood that the

key consuming country of China will swing its consumption from dirtier low-ranked coal to cleaner higher-ranked coal.

Iron ore is our least preferred bulk commodity exposure in 2014, falling off a high level from 2013. This key strategic commodity for China surprised on the upside in 2013 as Chinese steel mills showed an insatiable appetite for imported iron ore. While we expect a similar trend to occur in 2014, as domestic iron ore production wanes, large new expansion in Australian iron ore output should more than meet the supply gap. Coking coal should firm marginally, and may benefit from lower iron ore prices, with steel mills having more wriggle room to accept higher prices.

### Precious metals

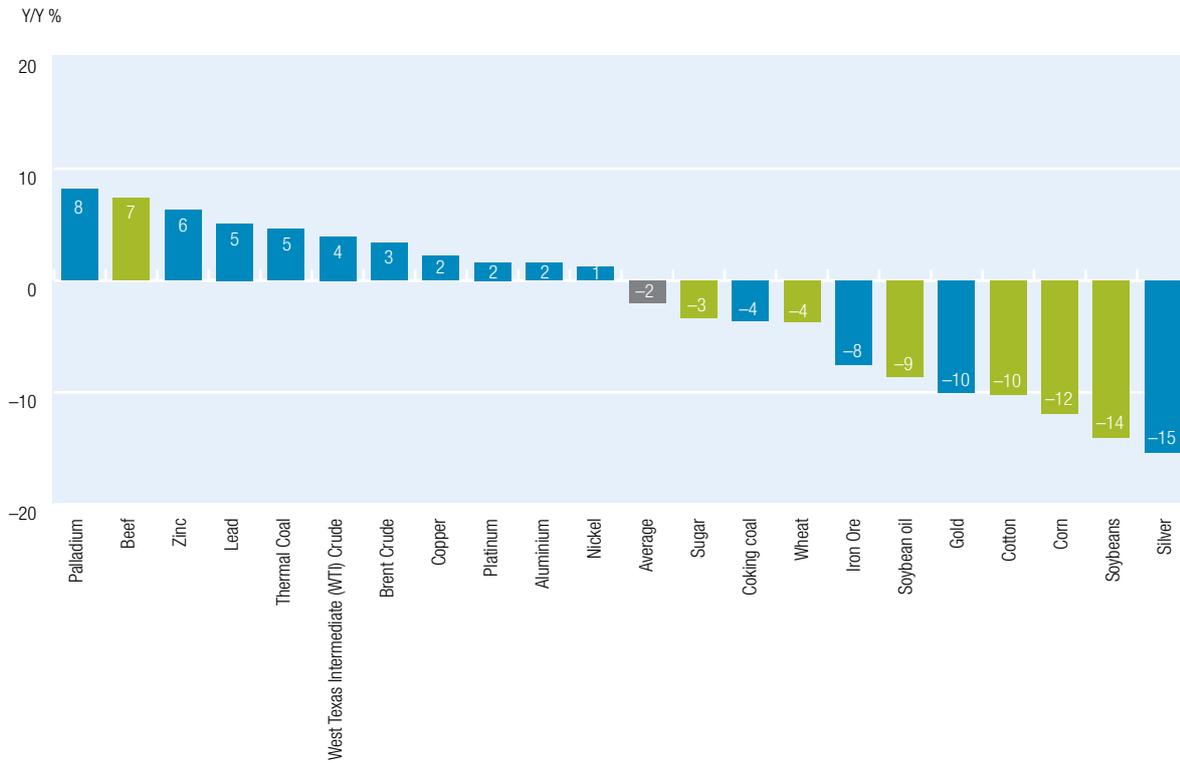
We expect precious metal markets will underperform again in the coming year, but potentially bottom out at some stage in 2014. The short-term focus is likely to be the headwind of the winding back of the US Federal Reserve's asset purchase program and the impact of higher bond yields. However, this is expected to fade into the second half of the year, when the market focus should shift toward gold's improving demand fundamentals.

Chinese demand for gold will continue to be the key supportive factor for the physical trade. While 2014 is likely to be a slower year than 2013 due to the front-loading of demand, we expect China's imports to remain robust at 900mt, the second highest year on record. In India, importers are unable to take advantage of current high domestic premiums to the maximum extent given continued Reserve Bank of India (RBI) import restrictions. This looks set to continue given India's on-going balance of payments problems, leaving India's gold import activity subdued in 2014. This should leave China to retain the mantle of the world's largest gold consumer for the second year running.



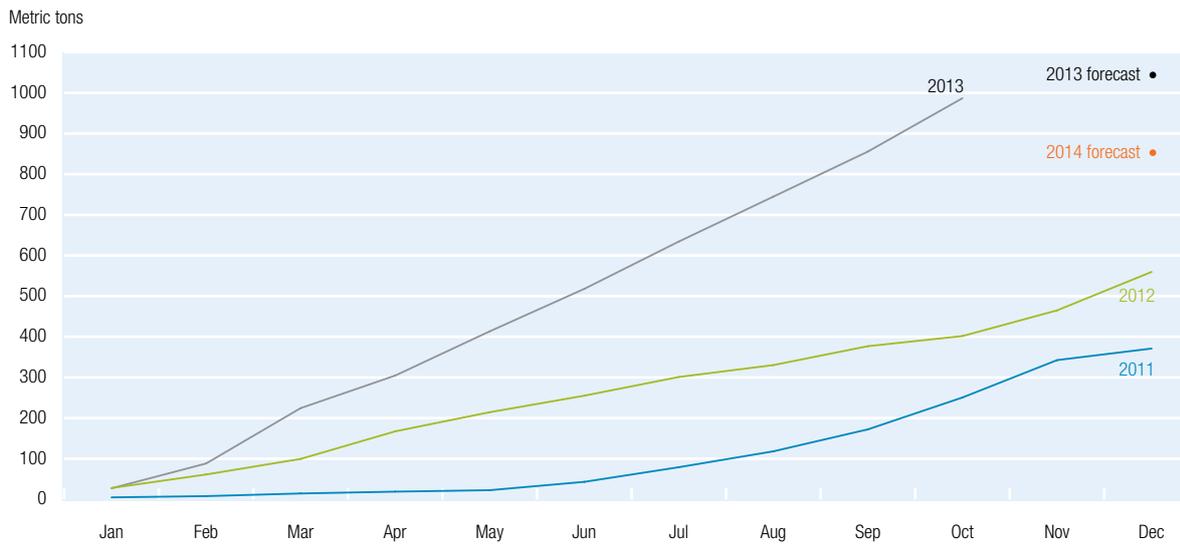
“We expect the bulk markets to diverge in 2014. Thermal coal is expected to be a stronger market, coming off a low base and a tighter supply backdrop. In fact, thermal coal prices are forecast to be our best overall bulk performer in 2014.”

**Figure 7**  
Forecast 2014 commodity price performance



Source: Bloomberg, ANZ Research

**Figure 8**  
China cumulative gold imports



Source: Bloomberg, ANZ Research

## Will Australia make the transition?

The key theme for the Australian economy remains the transition of growth from mining investment to other sectors of the economy. Mining investment has risen from around two per cent of GDP (as a long-term historical average) to almost eight per cent of GDP currently. We anticipate that investment in the resources sector will decline particularly sharply from mid 2014 and likely reach around three – four per cent of GDP a few years from now. Up to half of this decline is expected to be offset by lower imports. Nonetheless, a significant drag to domestic demand will emerge over the next few years.

As the boost from mining investment to growth wanes, other sources of growth need to strengthen. Strong resources export volumes are expected to make a large contribution to growth. However, the export phase of the resources boom is much less labour intensive than the construction phase so it will be imperative that other sectors strengthen sufficiently to support demand and employment.

We are tentatively optimistic about the outlook but we continue to believe that the next 12 months will be a difficult transition period as mining investment comes off sharply. We expect GDP growth will remain reasonable at 3.2 per cent in 2014, underpinned by a 1¼ percentage point contribution from resources exports.

## From below trend growth...

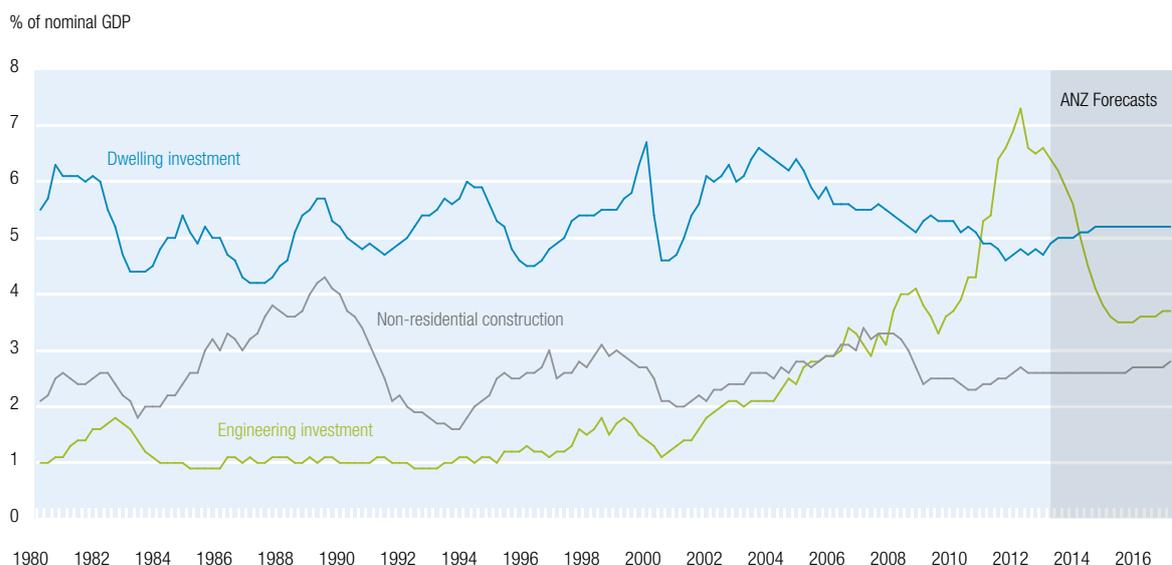
Growth currently remains below trend. Mining investment has largely plateaued and the effects of lower commodity prices and cost cutting by mining companies are already filtering through the economy. Pressure remains on the Federal budget, inhibiting the Government's ability to provide stimulus to the economy. Employment growth has been soft and household labour income growth has also slowed sharply, leading to a slowdown in household spending.

## ...to a residential construction boom?

To smoothly transition the economy to the non-mining sector, housing will be the key for Australia. We expect the housing market is at the early stages of a solid cyclical upswing, buoyed by low interest rates, tightening underlying market supply/demand fundamentals and improved affordability.

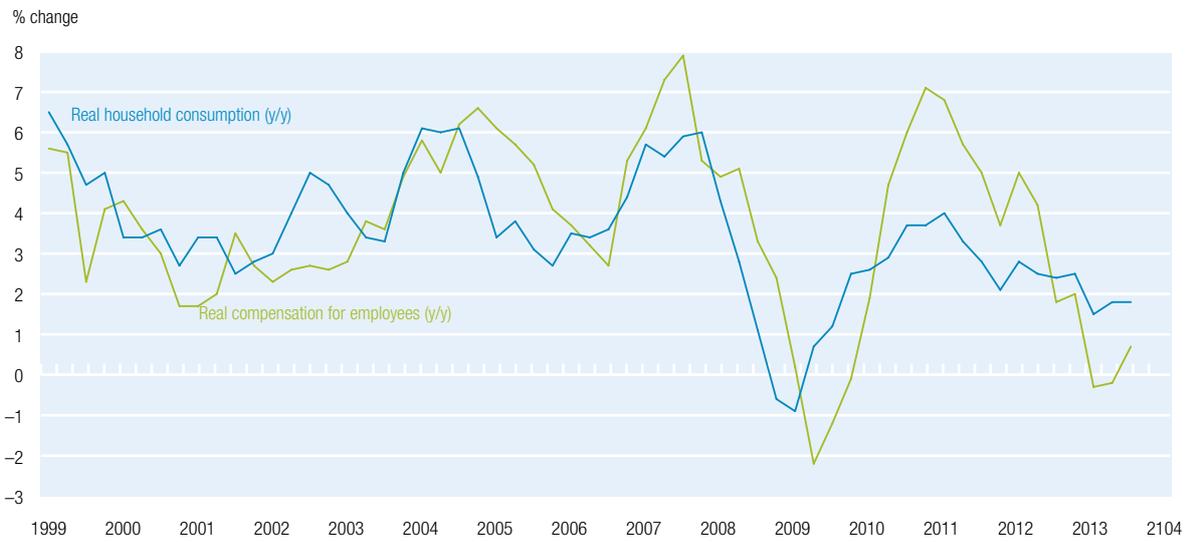
Building approvals for both houses and apartments have been rising strongly, pointing to solid growth in housing construction into 2014. Elevated home sales, solid price gains and lower interest rates have underpinned a solid rebound in new dwelling approvals since early 2012. More recently, solid investor (domestic and offshore) and owner occupier demand for medium to high density apartments have supported many new development proposals,

**Figure 9**  
Mining investment set to fall sharply



Source: ABS, ANZ Research

**Figure 10**  
Household spending has slowed



Source: ABS, ANZ Research

**Figure 11**  
Residential building approvals



Source: ABS, ANZ Research

particularly in Sydney, Melbourne and Brisbane.

Strong momentum in the home sales market is being compounded by solid population gains. This is exacerbating an already unprecedented (and increasing) shortage of physical housing stock. Population growth strengthened in 2012 and remained strong in 2013.

The recovery in residential building approvals is being led by NSW. Approvals in NSW have risen sharply and are now sitting at their highest level since late 2002 (in trend terms). This is consistent with our view that after a decade of underbuilding, the NSW housing market is expected to record a strong cyclical upswing in construction.



“The strongest signal that this is not a housing bubble is the lack of credit growth. Housing bubbles are typically credit driven whereas Australian annual housing credit growth is just above five per cent, near the lows of the last 40 years.”



### House price outlook

We expect a 15–20 per cent lift in home prices between 2013 and 2015. House prices are rising across most capital cities, with the strongest gains posted in Sydney, Perth and Melbourne. Following an extended period of weak housing sales in 2012, sales market activity has surged, with elevated auction sales and clearance rates, lower days on market and increasing housing finance reflecting renewed home buyer and vendor confidence.

Investor – both domestic and offshore – and upgrader/downsizer demand have been the main drivers of the housing market upturn. Of some concern, is that first home buyers have been the weakest segment of the market.

Despite our expectation of further house price gains, our view is difficult home deposit affordability, higher unemployment and ongoing household and lender caution are likely to moderate price gains relative to earlier recoveries.

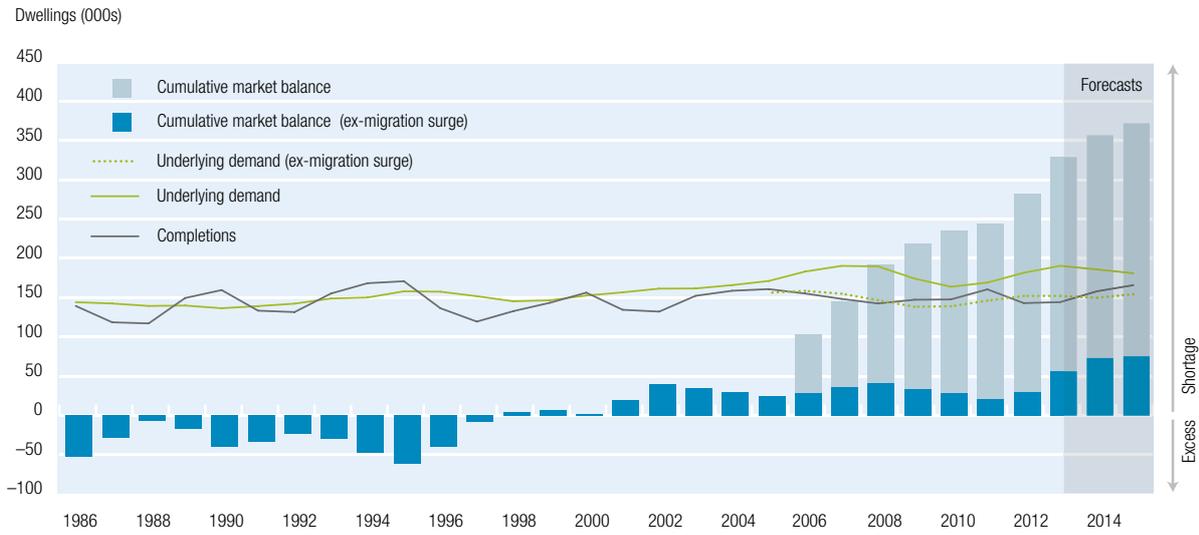
### Are we in a bubble?

Despite speculation that strong price gains represent the early stages of a house price bubble, our view is prices on the whole remain largely explained by low interest rates, sharply improved affordability, the release of pent-up sales demand created over recent years and an unprecedented (and increasing) shortage of physical housing stock.

The strongest signal that this is not a housing bubble is the lack of credit growth. Housing bubbles are typically credit driven whereas Australian annual housing credit growth is just above five per cent, near the lows of the last 40 years. Changing demand drivers also support the absence of a bubble. Offshore property investors are an increasingly important source of demand and tend to be funded by capital inflows from overseas, rather than domestic credit.

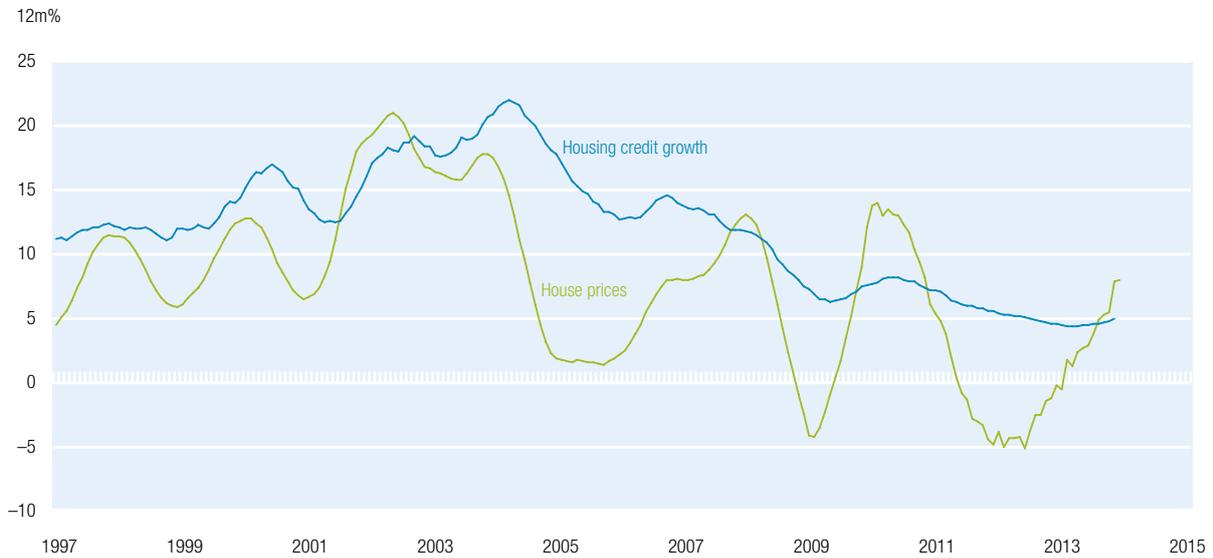
Further, house price growth has been relatively subdued in every capital city except Sydney.

**Figure 12**  
A pent-up demand for housing?



Source: ABS, ANZ

**Figure 13**  
House prices and credit growth



Source: RP Data Rismark, RBA, ANZ Research

However, gains in Sydney reflect catch up after a decade of underperformance and underbuilding rather than bubble like dynamics.

However, we do not discount the possibility of a bubble in the future. If Sydney experienced 10 per

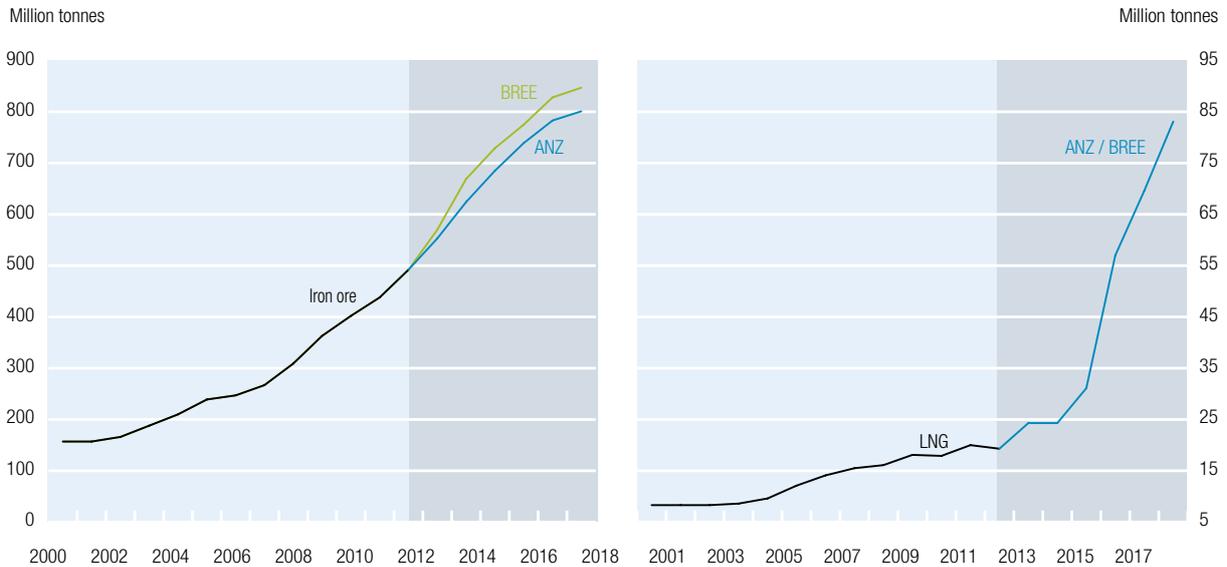
cent+ gains over multiple years and strong price gains broadened to other capital cities driven by accelerating credit growth, then we would be concerned and the RBA would likely be prompted to raise rates.

**Figure 14**  
Less risk averse consumers should mean a drop in household saving



Source: ABS, Melbourne Institute/Westpac, ANZ Research

**Figure 15**  
Iron ore and LNG export volumes will rise sharply



Source: ABS, BREE, ANZ Research

### Housing should lift consumer spending

We expect household spending to strengthen in 2014 buoyed by improving consumer confidence, 'wealth effects' from rising house and equity prices, and somewhat better employment prospects.

Rising house and equity prices are resulting in declining household risk aversion. As Figure 14

shows, easing consumer caution should lead to a lower household saving rate which would boost spending into 2014. This is already becoming apparent with retail sales showing solid improvement in the second half of 2013.

Our forecast of an Australian dollar in the high USD0.80s will also support a gradual reallocation of spending from overseas (through travel and online

shopping at overseas websites) to domestic (through domestic tourism and Australian retail).

### Non-mining investment to gradually strengthen

The outlook for business investment is a key uncertainty surrounding the outlook as business investment will be a key driver of job creation, unemployment and consumer confidence over the medium-term.

We expect that non-mining business investment is likely to remain relatively subdued over the next year. Positively, business confidence is now improving. However, rising confidence is not flowing swiftly through into stronger activity. Business conditions are only gradually improving, recent anecdotes are mixed on business spending intentions and capacity utilisation is still at relatively low levels.

Our view is profitability will be a key determinant of business investment. Absent a broad-based recovery in demand in Australia, a lower AUD will be important to support stronger profitability in non-mining industries, particularly in goods and related sectors like manufacturing.

### Exports to play a major role in driving GDP

The outlook for exports is very positive. Resource exports look set to add over one percentage point to GDP in 2014 as new capacity comes on stream in bulk commodities, particularly in iron ore. Exports should continue to make a very strong contribution to growth in 2015 and 2016, as liquefied natural gas (LNG) exports ramp up.

More broadly, the global backdrop will be positive for Australia. Better growth prospects in developed economies and less volatile financial markets will boost external demand. NSW, in particular, with its large finance sector and closer linkages with the global economy will benefit. Despite an overall slowing in growth in China, we expect growth will remain investment intensive, supporting demand for commodities.

### The labour market will remain subdued

For the labour market, we expect the unemployment rate in the 5¼-6 per cent range for some time. Some positive signs have emerged recently: measures of job ads have stabilised in recent months and average hours worked have risen a little recently. These indicators suggest labour demand is improving in at



“Some positive signs have emerged recently: measures of job ads have stabilised in recent months and average hours worked have risen a little recently. These indicators suggest labour demand is improving in at least some industries.”



least some industries. However, we expect that as labour demand picks up, some discouraged job-seekers are likely to re-enter the labour force, slowing any improvement in the unemployment rate.

### Risks to the outlook

The key growth risks on the downside would be a further significant decline in the terms of trade, which would weaken income growth and nominal GDP. On the upside, a stronger global economy and/or a moderate reduction in the saving rate as confidence returns would support growth.

“A potential policy dilemma for the RBA that could play out in 2014 is the combination of strong housing but softer than expected employment growth. In this scenario, the RBA may want to stimulate the economy further but would be reluctant to lower rates due to the risk of overheating the housing market.”



### Interest rates and the RBA: A year of inaction?

We expect an extended period with a low and stable cash rate of 2.5 per cent. The strength in the housing sector suggests that monetary policy is now clearly stimulatory for the domestic economy. We expect the RBA is reluctant to stimulate the economy further through lower rates and would prefer a lower AUD to support the transition in growth to stronger non-mining activity.

The RBA has been frustrated with the strength in the dollar. The Bank's jawboning does seem to have had some success very recently with the currency moving down to around USD0.90 from a high of USD0.97 in October.

A potential policy dilemma for the RBA that could play out in 2014 is the combination of strong housing but softer than expected employment growth. In this scenario, the RBA may want to stimulate the economy further but would be reluctant to lower rates due to the risk of overheating the housing market. The key question would be whether regulators would be willing to introduce macro prudential rules to cool the housing market, enabling the RBA to provide further monetary accommodation. This will be determined by the extent of divergence in the performance of the housing market versus the tradeable sectors of the economy.

We do not expect the RBA to hike rates until 2015. Rates are likely to be structurally lower (through

the cycle) over the next decade due to higher levels of leverage and lower global rates. Hence, the next tightening cycle is expected to see a lower peak than previously.

### Foreign exchange markets

We expect the currency to average in the high USD0.80s over 2014. The decline in the AUD to around USD0.90 over 2013 largely corrected its valuation overshoot against traditional metrics such as commodity prices, the terms of trade and the USD. Commodity prices should continue to be a key driver but we expect less traditional, financial factors will also be important in 2014. These include the reallocation of credit in China, the strength of the US economy and capital flows into Australia.

Over the medium term, we expect the AUD in the USD0.80 to USD1.10 range. Our view is commodity prices will remain elevated and rates will stay low in developed markets for an extended period. Comparatively higher interest rates in Australia will mean the interest rate differential will remain supportive of the Australian dollar.

*The views in this article are those of the authors and should not be attributed otherwise.*

## Forecast tables

### GDP

	2008–2012 average	2012a	2013f*	2014f*	2015f*
United States	1.1	2.8	1.8	3.0	2.7
Euro area	-0.4	-0.6	-0.4	0.8	1.5
United Kingdom	-0.6	0.2	1.4	2.3	2.3
Japan	0.1	2.0	1.7	1.8	1.5
China	9.2	7.7	7.6	7.2	7.3
India	7.1	3.2	4.7	4.0	5.0
New Zealand	1.1	2.7	2.9	3.2	2.4
<b>World</b>	<b>2.9</b>	<b>3.1</b>	<b>3.0</b>	<b>3.6</b>	<b>3.9</b>

### Australia – annual % growth

Key indicators	2012	2013f*	2014f*	2015f*	2016f*
<b>Economic activity</b>					
Private final demand	4.5	1.6	0.7	1.3	2.9
Household consumption	2.5	1.8	2.4	3.4	3.2
Dwelling investment	-3.3	1.9	6.4	4.9	3.1
Business investment	14.3	0.5	-6.4	-7.2	1.8
Public demand	3.0	-2.2	1.9	0.7	2.2
Domestic final demand	4.2	0.8	1.0	1.1	2.8
Inventories (cont. to GDP)	0.0	-0.6	0.2	0.0	0.0
Gross national expenditure (GNE)	4.0	0.2	1.2	1.2	2.8
Exports	5.8	6.5	6.0	6.5	8.8
Imports	6.2	-3.1	-2.4	-1.6	2.9
Net exports (cont. to GDP)	-0.1	2.1	1.8	1.8	1.5
<b>Gross domestic product (GDP)</b>	<b>3.6</b>	<b>2.4</b>	<b>3.2</b>	<b>3.2</b>	<b>4.0</b>
<b>Prices and wages</b>					
Inflation: Headline CPI	1.8	2.5	3.2	2.6	2.8
Underlying (RBA core)	2.3	2.3	2.4	2.3	2.4
Wages	3.6	2.9	2.5	2.9	3.2
<b>Labour force</b>					
Employment	1.1	1.1	1.0	1.5	1.6
Unemployment rate (annual average %)	5.2	5.7	6.0	5.9	5.8
<b>External sector</b>					
Terms of trade (annual % change)	-10.2	-4.8	-3.2	-0.6	-0.3
Current account balance (A\$ bn)	-61.8	-47.9	-39.7	-26.1	-10.1
Current account balance (% of GDP)	-4.2	-3.1	-2.4	-1.5	-0.6

\* Forecast



# political OVERVIEW



**Sabra Lane** is the chief political correspondent of ABC TV current affairs program 7.30. She has been covering federal politics in Canberra since 2008. Prior to her current position Sabra was the ABC Radio Current Affairs Chief Political Correspondent. Regarded as one of the best political interviewers and astute journalists in the country, Sabra led the Radio Current Affairs coverage of federal politics, for the agenda setting programs AM, The World Today and PM.

Prior to going to Canberra, Sabra was a reporter for ABC Radio Current Affairs in Sydney, as well as regular fill-in executive producer on AM, The World Today and PM.

Before joining the ABC, Sabra was the executive producer for Sunday Sunrise on the Seven Network. For more than four years, she was responsible for the network's weekly national news and public affairs program. As well as managing the editorial content, Sabra put the program to air, was responsible for the 'look and design' of the show and negotiated interviews with political guests.

While at the Seven Network, Sabra helped produce Seven News' Olympic team for the Sydney Olympics.

Sabra began her journalism career in 1989 in Adelaide as a reporter/producer for Channel 10.

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## Introduction

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In his New Year's address the Prime Minister, Tony Abbott, urged Australians to "have a go" this year in helping build a stronger and more prosperous nation.

While Mr Abbott is eager to present himself as 'cheer leader in chief' in encouraging Australians to do their bit for the economy, the opposition will try to portray him as 'cutter in chief' as 2014 unfolds.

The year will be crucial for the government and the nation as major challenges confront both. Like all new governments, the Abbott Government has had a somewhat rough start to its tenure, and it will be anxious to settle in during 2014 to chart a smooth course for itself and Australia.

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## Business expectations and challenges

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Business has high hopes for the government yet has been taken by surprise on some early announcements by the coalition. While the Prime Minister declared on the night he was elected that Australia was once again 'open for business', the corporate world was taken aback by the decision to reject a foreign investment bid for grain handling giant, GrainCorp. Corporate Australia will keep an eagle eye on future Cabinet deliberations, to weigh up whether government decisions do match Mr Abbott's election-night pledge.

There was also concern among the captains of industry over how the government handled General Motors Holden's decision to end the local production of cars. Leaders were bewildered over the leaking of details regarding the company's deliberations and concerned about splits within senior government ranks.

Behind the scenes Mr Abbott and his Cabinet are carefully crafting a plan that the government hopes will fire up the economy and become the foundation stone for the coalition as it settles in for its first term and meet its long-term ambition to balance the nation's books.

The blueprint centres on the coalition's promises of a smaller government and a nation that can live within its means.

Last year ended soberly for Australia, with the General Motors Holden decision to cease production in 2016. The last National Accounts figures delivered in 2013 showed lacklustre growth for the nation with no prospect of a sharp recovery, sentiments that were backed by the Mid Year Economic and Fiscal Update.

With the peak of the mining investment boom over and falling commodity prices, Australia faces a very challenging future.

Another major car manufacturing company, Toyota has given advance warning that it too will make a decision on whether to remain in Australia or leave, by mid 2014.

With experts predicting the Australian dollar will remain high for some time yet, all manufacturing sectors will continue to struggle, fueling an ongoing political debate about whether Australia can be a nation 'that makes things'.

Companies have already pressured the government for help, notably food processor SPC Ardmona. The Federal Government recently decided it would not grant \$25m in government support to the company. The Prime Minister has defended the decision, telling ABC's 7.30 program "we are moving from the age of unsustainable entitlement to the era of sensible responsibility".

The flying kangaroo is also asking for a helping hand seeking either parliamentary approval to change the Qantas Sales Act or allow the airline access to a government guarantee on its debt. Both examples will be closely watched, as the Prime Minister has previously warned that the era for corporate welfare is over.

The business community is likely to maintain pressure on the coalition for further changes regarding industrial relations laws. Yet the Prime Minister has made it clear any major reforms would need to go to a future election, seeking majority voter endorsement through a new mandate. Mr Abbott and his senior colleagues are keen to avoid any perception that Work Choices, or anything resembling it, will be implemented without first seeking voter approval.

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## Commission of Audit and the Budget

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The Commission of Audit will take up much of the political spotlight for the year. Its brief is to review all aspects of federal government spending, service delivery, duplication and waste. The Business Council of Australia's Chairman Tony Shepherd chairs the commission. While it will hand up its report to the government in March, Mr Hockey has indicated that the report will be released before the budget – a change in the government's previous position to reveal what they will adopt from the audit's recommendations on Budget night. Releasing the report ahead of May, and before major policy changes, will give the government an opportunity to explain options to the public, and put the case for change.

The recommendations – or at least those adopted by the Prime Minister – will become the hallmark of the government. Already, debate has touched on issues such as Medicare and whether a \$6 per doctor visit co-payment charge should be introduced to help meet burgeoning medical costs.

The government’s first budget won’t be all about cuts. The Treasurer has emphasised new infrastructure projects and spending on these programs will help steer the nation through the future, as the economy struggles to meet trend growth.

But the Federal Government hasn’t any capital in the political bank to expend on further policy missteps or poor execution.

The Abbott Government has not enjoyed a political honeymoon period with voters since the September election, as survey results from both

major opinion polls Nielsen and Newspoll attest.

“We’ve never seen that before in 40 years of polling,” Nielsen’s Director of Research John Stirton said.

“What normally happens after an election, is the Government gets a reasonable honeymoon, and it’s averaged over the last 40 years up to a year ... or three years in the case of Bob Hawke.

“So this time not only has there not been a honeymoon where the swing post-election has gone to the Government, but the fact is the swing is going the other way, and that’s a big worry for the Government.”

While pollsters believe the results should be a concern to government, the coalition insiders are not worried by it and believe the public will change its mind as the government’s agenda begins to unfold.



“The government’s first budget won’t be all about cuts. The Treasurer has emphasised new infrastructure projects and spending on these programs will help steer the nation through the future, as the economy struggles to meet trend growth.

“But the Federal Government hasn’t any capital in the political bank to expend on further policy missteps or poor execution.”





“A fresh vote across the Nullarbor will be a major test for Tony Abbott who will most likely campaign hard on the issue of a frustrated mandate with the current Senate blocking his plans to scrap the carbon and mining taxes.



## The power of the Senate in 2014

In the Senate, the government remains frustrated in its ambition to have the Carbon and Mining Taxes repealed. Neither major party enjoys a majority in the Upper House, with the Greens and independent crossbench senators wielding significant power.

The Federal Government has argued it has a mandate to have both legislative agendas passed by Parliament. Yet Labor and the Greens also contend they have a mandate, with their supporters keen to see the parties uphold their policy positions on both the carbon and mining taxes.

The Senate elected in 2013 will sit for the first time in July 2014.

The government is hoping the new Senate will rubber-stamp the abolition of both taxes, and has scheduled a rare July sitting of parliament to accommodate that. There'll be a great deal of attention on how the Palmer United Party senators vote, along with other so-called 'micro parties' – the Motoring Enthusiasts Group and the Liberal Democratic Party.

At the time of writing this article, the Senate result for Western Australia was under legal review by the Court of Disputed Returns. More than 1300 votes went missing during a re-count in that state, with neither the Australian Electoral Commission nor an independent inquiry able to explain what happened to the votes.

None-the-less, a result was declared and if it is allowed to stand, the government will need the votes of six of eight senators on the crossbench, to pass its legislation from July.

Long-time coalition adviser and lobbyist Grahame Morris believes if the current numbers stand, the Senate will be favourable to the coalition government, but will still require enormous diplomatic skill to manage.

“I think the new Senate will shift from herding elephants to herding cats,” said Mr Morris.

“It will take some negotiating skills, but there are some of these new people coming in, they're not Labor rat-bags, they're not 'fairies at the bottom of the garden', they are conservative people who have some strong centre-right views.”

## 2014 electoral contests

Many constitutional experts believe the Court of Disputed Returns will order a fresh vote for WA, as the Australian Electoral Commission has asked the court to declare the 2013 WA result void.

Given the Federal Government's poor polling to date; the coalition cannot automatically expect to retain three Senate positions in a new electoral contest, even though the West is regarded as a coalition stronghold.

A fresh vote across the Nullarbor will be a major test for Tony Abbott who will most likely campaign hard on the issue of a frustrated mandate with the current Senate blocking his plans to scrap the carbon and mining taxes.

The vote will also present a huge challenge for Labor's recently installed leader, Bill Shorten, providing him an opportunity to clearly articulate his alternate plan for Australia.

The ALP's leadership rule changes during 2013 mean Mr Shorten should have the entire parliamentary term to put his case to the public, without fear of removal due to poor polling results. For most of the Australian electorate Mr Shorten remains something of a political enigma; they know him only as the MP who had a hand in removing two serving Prime Ministers.

The likely fresh WA Senate election will be the second major federal electoral test for the year.

In February a by-election will be held for the Queensland seat of Griffith, vacated by the former Prime Minister Kevin Rudd. In the 2013 election the LNP's candidate and former Australian Medical Association President, Dr Bill Glasson, managed to record a huge swing, turning the once-safe Labor seat, into a marginal electorate. Dr Glasson will stand again in this by-election, though the ABC's election analyst Antony Green believes it is unlikely that Dr Glasson will repeat 2013's performance and secure an extra three per cent swing required to win the seat.

## State elections

Tasmania, South Australia and Victoria will all go to the polls for state elections this year. Holden's decision to leave Australia will be a factor in the SA and Victorian polls.

Labor's held power in SA for the last 12 years, and during the last parliamentary term in Tasmania the party has shared government with the Greens. In January, Labor ended its power-sharing agreement with the Greens in Tasmania. The announcement was made as Premier Lara Giddings announced Tasmanians would go to the polls on March 15. (SA will also go to ballot box on that day.) Premier Giddings has also ruled out future coalition arrangements with the Greens party. Many within Labor have argued the ALP has alienated its traditional blue-collar support base - and damaged its brand - through power-sharing arrangements with the Greens in Tasmania, and in Canberra. Premier Giddings admitted as much as she revealed the poll date and sacked two Greens Ministers from Cabinet.

"It's clear that having the Greens in Cabinet has disappointed many Labor voters and made it harder for us to highlight our achievements," she said.

The ALP is not expected to retain power in either state.

In Victoria, the coalition's struggled in government since the resignation of Liberal MP Geoff Shaw in early 2013 - even though he guaranteed the government his support.

## Spending cuts

The Commission of Audit will deliver findings regarding the long-term sustainability of government spending beyond the four-year budget cycle, courtesy of big spending programs like the National Disability Insurance Scheme and the new school funding scheme. The independent Parliamentary Budget Office has already indicated both programs will be a burden on the nation's bottomline for the next decade, if no other actions are taken to help pay for them. Australia's ageing population too means the health budget is exponentially increasing every year. In fact over the past decade, health costs have grown at a much faster rate than the Consumer Price Index. The Grattan Institute has found that health costs now take up 19 per cent of all Australian governments spending. The cost increases can not be blamed on just the ageing population, patients are gaining access to more expensive medical procedures and medicines. Expect the commission to make recommendations regarding health costs. If Australians want access to the latest and best treatments, are they prepared to pay for it through a tax increase? Already, many believe test balloons to gauge the public's appetite in accepting reductions in government assistance have been sent up; for example, the suggestion of a Medicare co-payment.

## Foreign affairs

The government has had a bumpy ride on the international stage; with foreign relations with Indonesia strained, following revelations of spying on President Susilo Bambang Yudhoyono and the coalition government's controversial boat turn-around policy. Relations between Canberra and Jakarta have not yet returned to normal; indeed it's not certain the 'leaks' via the former US National Security Agency contractor Edward Snowden have been exhausted.



“Relations between Canberra and Jakarta have not yet returned to normal; indeed it’s not certain the ‘leaks’ via the former US National Security Agency contractor Edward Snowden have been exhausted.”

## 2014 constitutional focus – a new Governor General and Indigenous Australians

The Prime Minister is a well known advocate for retaining the Monarchy in Australia and as expected he has recently announced that retired Defence Force Chief Peter Cosgrove will replace Quentin Bryce as Australia’s Governor General when Ms Bryce’s term expires in March. On other constitutional matters, Mr Abbott has promised to use the year to prosecute the case for recognition for Indigenous Australians in the nation’s most important document. In March, Mr Abbott will clock up 20 years as a federal member of Parliament. He’s promised to continue his long-tradition of living one week each year, in a remote indigenous community, to highlight his ‘hands on’ approach in dealing with Indigenous disadvantage.

## G20 – an opportunity to end 2014 on a high

The government will hope to end the year on a high, after hosting the annual G20 Leaders meeting in Brisbane during November. This will be a major opportunity for the Prime Minister, Treasurer and the Foreign Minister, Julie Bishop. Leaders from the world’s most important economies (including the US, UK, Russia and China) will meet in Brisbane to discuss ways to promote stronger economies, create

more jobs and make the world more resilient to cope with future economic shocks.

## Ex-politicians to deliver in 2014

For political die-hards for whom ‘too much politics is never enough’, 2014 will continue to deliver, by the book-load. Three former Prime Ministers are working on weighty tomes; Julia Gillard is penning a memoir, John Howard is writing about the Menzies era and Malcolm Fraser is putting together a book on the Australia-US alliance.

A handful of former ministers – Wayne Swan, Greg Combet and Bob Carr – are also writing about their time in politics. On the conservative side, there’ll be a biography about the Treasurer, Joe Hockey.

## The biggest test of 2014: Handling the unexpected

The big test for any government is how it handles the unexpected. It’s easy to plan for the known events, it’s how they cope with the surprises that gives the public confidence to trust or distrust the government. As the past year has shown: the global economy, natural disasters, armed conflicts and leaks can and do throw up challenges without any warning. While there have been early missteps by the government, they will be only regarded as major mistakes if the government does not learn from them.



# Government productivity



**Anne Tiernan** is an Associate Professor in the Centre for Governance and Public Policy at Griffith University. She is Director of postgraduate and executive programs in policy analysis and public administration in Griffith's School of Government and International Relations.

Anne's research interests include: policy advice, executive advisory systems, policy capacity, federalism and intergovernmental coordination. She is author of several books including the forthcoming *Lessons in Governing: A Profile of Prime Ministers' Chiefs of Staff* (with R.A.W. Rhodes, Melbourne University Press, 2014), *Learning to be a Minister: Heroic Expectations, Practical Realities* (with Patrick Weller, Melbourne University Press, 2010) and *Power Without Responsibility: Ministerial Staffers in Australian Governments from Whitlam to Howard* (UNSW Press, 2007).

Anne is a Member of the Public Records Review Committee of the Queensland State Archives and serves on the Board of Directors of St Rita's College. Between 2008 and 2012 she was a member of the Board of Commissioners of the Queensland Public Service Commission. Anne also consults regularly to Australian governments at all levels.

## Introduction

Issues of productivity and international competitiveness are at the forefront of contemporary policy debate as Australia adjusts in the wake of the resources boom. Declining productivity growth is characterised as being at best problematic,<sup>1</sup> and at worst a national crisis that analysts attribute to a lack of political leadership and a failure to embrace the kinds of policy reforms that positioned the nation for two decades of growth and prosperity.<sup>2</sup> Softening economic growth and revenue write-downs detailed in December's Mid-Year Economic and Financial Outlook (MYEFO) have made more urgent the need for governments to enhance productivity through more carefully targeted public spending and more effective regulation.

Here, as in other countries, the productivity of government has become the focus for reforms, recognising the public sector comprises a significant share of GDP and that governance and policy settings affect productivity in the broader economy. The productivity of government embraces both the policy and regulatory frameworks set by governments, and governments' role in and approach to the provision of public services.<sup>3</sup>

This chapter reviews recent efforts to address these two dimensions of productivity in Australian government. It examines directions and priorities for reform emerging from the National Commission of Audit and comparable processes at the sub-national level; the Council of Australian Governments (COAG) and other reviews and inquiries initiated by the newly-elected Abbott Government. The chapter's primary focus is on reforms to public service delivery being pursued across Australian jurisdictions.

The chapter highlights four dilemmas that will have to be confronted as we debate strategies to enhance the productivity of government:

1. Inherent differences between the public and private sectors raise important questions about the applicability of conventional measures of productivity to the provision of public services. Quality and effectiveness are more meaningful indicators of performance in the complex networks that comprise public sector delivery.
2. Australian governments are experimenting with diverse approaches aimed at boosting the efficiency and performance of their public sectors. Examples from health and education suggest that micro-level reforms being pursued at the enterprise level may have greater potential to yield improvements in service quality and effectiveness than efforts to affect large-scale, system reforms,

which are complex and fraught with risks of unintended consequences.

3. The experience of more than 40 years of almost continuous reform to Australia's public sector has wrought accumulated costs as well as benefits. Frequent, disruptive organisational change and policy instability undermine capacity for efficiency and innovation in public sector delivery networks, as does the loss of expertise and institutional memory from the career bureaucracy.
4. Coalition governments at Commonwealth and state and territory levels claim to support devolving decision-making authority and fostering competition, diversity and choice in the delivery of public services. Successful implementation of such reforms will require a change in the attitudes and habits of Australia's 'policy class', particularly at the federal level. It will also require them to take risks and to hold their political nerve. In challenging the cultures of 'complacency' and 'entitlement' that many believe have developed during the nation's boom years, these directions are likely to prove contentious with a public accustomed to consistency and equity of access to public services.

## Productivity and the delivery of government services

Public sector productivity is notoriously difficult to measure.<sup>4</sup> Appropriate and robust methodologies or measures are lacking because as Economist Ross Garnaut explains:

"Productivity relates to the amount of economic value generated from a given amount of labour and capital. Productivity as conventionally measured only makes sense for the production of goods and services exchanged in markets."

Unlike private firms, public sector organisations operate for purposes other than profit. They serve multiple and often conflicting policy objectives. They provide universal services, irrespective of citizens' ability to pay. There is a strong political expectation these will be delivered equitably and accessibly, including and perhaps notably, in areas of market failure, or where – say in rural or remote areas, there is no functioning market.

The absence of price as a measure of the value of outputs complicates efforts to assess productivity. In government, outputs can be weighted with reference to costs, but apportioning administrative costs and overheads can be problematic, especially for things

that apply uniquely to the public sector – the costs of policy development, consultation and accountability requirements, for example. Hence Ross Garnaut notes that:

“The idea of productivity can be applied to non-market services within the public sector. However, there is a danger that any particular measure of value for these services provided by government will be arbitrary, contentious and liable over time to give a false sense of precision. I prefer to talk about the *effectiveness* (emphasis original) of the public sector, so that we are not pretending that we are dealing with anything precise.”<sup>5</sup>

However, Garnaut’s careful qualifications seldom feature in debates about government productivity. There is a tendency to ignore the significantly different expectations and imperatives governing the two sectors. The impact of their very different operating contexts on public and private sector organisations

is frequently downplayed. The general consensus is that public sector productivity is flat or lower; and moreover, that a substantial ‘productivity gap’ has developed between the two sectors in recent decades. For example, a recent report by global consulting firm Deloitte cites data from the United States and the United Kingdom to claim that while there has been productivity growth of 50 per cent in the private sector, there has been a net reduction in public sector productivity – as measured by the value of production per hours worked.<sup>6</sup> The report’s authors argue this ‘productivity gap’ is attributable mainly to “government’s inability to dynamically absorb and capitalise on new technologies like we’ve seen in the private sector”.<sup>7</sup>

In Australia, consulting firm EY bases its estimate that the ‘productivity gap’ between the public and private sector is costing Australian taxpayers



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“The absence of price as a measure of the value of outputs complicates efforts to assess productivity. In government, outputs can be weighted with reference to costs, but apportioning administrative costs and overheads can be problematic, especially for things that apply uniquely to the public sector – the costs of policy development, consultation and accountability requirements, for example.”

\$2.4b, on a survey of public servants' attitudes to productiveness and engagement.<sup>8</sup> Similarly, a report by consulting firm Accenture suggests "that boosting total public sector efficiency gains across all expenditure by less than one per cent a year (actually 0.91 per cent) could save up to \$58b in annual Government expenditure by 2025".<sup>9</sup> While acknowledging the potential for innovations in information and communications technologies and investing in human capital to deliver efficiency and performance improvements, Secretary of the Department of the Prime Minister and Cabinet (PM&C) Dr Ian Watt has expressed scepticism about estimates of savings that can be achieved through public sector efficiency gains measured only as a function of size.<sup>10</sup> Nonetheless, as a significant component of the overall economy, even incremental improvements in public sector efficiency can have significant economic benefits. For example, in 2006 the Productivity Commission estimated a five per cent productivity gain in the health sector would release \$4b for other uses.<sup>11</sup> Gary Sturges estimates cost savings of 20–25 per cent are "not unusual" when government services are exposed to competition.<sup>12</sup>

However, given the critical differences noted above, it is worth asking whether productivity, as "a measure of the relationship between outputs and inputs, expressed in volume terms",<sup>13</sup> is relevant and applicable to the delivery of public services. A school that achieves sustained improvements in the educational attainment of disadvantaged students delivers a massive productivity dividend – both to individuals and the broader economy over those children's lifetimes. If that same school shares its knowledge about the learning and teaching practices that helped to achieve those results across educational systems, and those are successfully adapted in other contexts, the benefits for human capital and life chances are magnified many times over.

This is not to suggest that public sector organisations should ignore opportunities to make more effective use of resources, or to drive efficiencies and improved performance. Nor that it might not be possible, over time, to establish methods and data sets to trace productivity growth, even accounting for policy shifts, frequent restructuring and other changes. It does suggest, however, that alternative measures – the quality and effectiveness of outcomes achieved from the investment of public funds, for example, might be more appropriate to assessing performance in areas where government maintains a role in service provision. Innovation, adaptation and the diffusion of practice improvements may be more salient measures of quality and effectiveness, particularly in the delivery of human services.

## Reforming public sector service delivery

The belief that the techniques of business can be used to improve the efficiency and effectiveness of government has been an enduring theme of public sector reform initiatives that began in the 1970s. Australia was among the group of countries that 'started earliest and went furthest' in embracing a suite of reforms that are known by the scholarly shorthand of 'the new public management' (NPM).<sup>14</sup>

NPM was a response to neo-liberal critiques that argued bureaucratic hierarchies were inefficient and unresponsive to the needs of citizens and clients. Exposing public sector organisations to contestability and competition was intended to make public services more dynamic, innovative, responsive and efficient. However, the introduction of multiple actors and interests in the delivery of public services brought a range of unintended consequences. It created problems of fragmentation and new challenges of coordination, consistency and sustainability. A plethora of providers who in practice shared responsibility for different facets of service provision also created difficulties in holding providers accountable for the quality of services.<sup>15</sup>

The involvement of so many actors and interests in delivering public services raises questions about what counts in analyses of government productivity and where efficiencies and improvements might be sought. For historical and practical reasons including size and scale, systems of provision in most areas of service delivery are mixed. The largest: health, education and transport, comprise complex and interdependent networks of public, private and not-for-profit organisations all coordinating to deliver services that citizens consume with little regard for who provides them.

Few service users appreciate the complex, dynamic and evolving interconnections between providers, processes, locations, stakeholders and other players that comprise the delivery chain. Nor do they much care. Ministers have long since learned they cannot avoid dealing with, or wearing the political costs of delivery problems, even in services that are contracted out. At any time they know their career might be threatened by a 'rude surprise' from somewhere in the system. This explains their urge for central control and their demands for early warning systems – tying bureaucratic resources up in endless briefings and accreting new layers of monitoring and reporting for fear of, and in the wake of, a service failure. This can lead to paralysis in both effective policy development and efficient service delivery. It

also negatively impacts staff motivation, and their willingness to take the risks necessary for innovation and performance improvement.

This complexity and interdependence, the ubiquity of links and feedback loops, means there is always potential for consequences – both intended and unintended – to flow from interventions in one area to other parts of the network. It follows that a systems perspective is a more meaningful and accurate way to conceptualise public sector delivery.<sup>16</sup> It is to systems then, and the organisations that comprise them that we need to look for improvements that will drive efficiency and service quality.

### Incentivising performance improvement

System change is hard and rarely has it been immediately successful in a public sector whose direction is set by the constantly shifting priorities and concerns of politics. The time horizons are far longer than the tenure and electoral fortunes of even the most successful minister. Notions of success are strongly contested – for philosophical and ideological as well as substantive reasons. Results may be more visible at the individual service level than in the aggregate, given the many variables at play.

A potentially more fruitful approach to improving the quality and performance of public services is to trust the capacity and expertise of those at the front-line and to allow them to get on with their jobs, free from excessive oversight, interference and constantly shifting goalposts. In the 1980s this approach to public sector reform was described as ‘letting the managers manage’. Central agencies devolved responsibility for program management, staffing and budgeting to departments and established more flexible management frameworks, including incentives for improved efficiency and service outcomes. New accountability arrangements provided a basis for ‘making the managers manage’. Market-based reforms that introduced competition and choice into the provision of public services was another plank of this agenda under the Hawke, Keating and early Howard governments.

But as has been well documented, more recent Australian governments lost their reform zeal. Both sides of politics have been criticised for fostering a ‘culture of entitlement’ – for seeking to ‘buy’ political support with electoral bribes and feeling obliged to compensate any individual or group that stands to lose or be affected by policy change. Analysts like

Ross Garnaut argue the nation’s leaders failed to use the proceeds of the economic boom to prepare for the adjustments necessary when its end came, as inevitably it did in 2013. Garnaut has outlined a reform blueprint for Australia after the boom, but he argues our political culture – the inability or unwillingness of entrenched interests to make concessions to the ‘public interest’ – now represents the greatest impediment to reform.<sup>17</sup>

The economic imperatives facing Australia – to remain internationally competitive, to grow new industries and jobs to offset tapering demand for resource exports, and to address domestic challenges such as the rapid ageing of the population, have led many to question the role of government in society, the services it should provide and how these should be delivered. Improving the efficiency and effectiveness of the public sector has again become a priority for governments internationally, including at all levels in Australia. Such efforts are not new. Indeed the public sectors of Commonwealth and state governments have undergone 40 years of almost continuous ‘reform’ and change since the 1970s.

Such efforts have tended to focus on high-level reform blueprints, initiated from the centre and focused on policy and system-wide changes. Often the capacity to implement them is ignored. Some have disrupted rather than enhanced operations, subverting attention away from the efficacy and efficiency of service provision. A corresponding thickening of monitoring and oversight processes has mired front-line personnel in red-tape and compliance. A similar dynamic has evolved within Australian federalism as the Commonwealth government has expanded into areas traditionally the province of the states and territories.

Would-be reformers often fail to appreciate that the public sector organisations they seek to improve are not greenfield sites. Rather, they are the sum of their experiences – sedimented with the accreted layers of earlier reform efforts. Academic colleagues in Britain have coined the term ‘civil service reform syndrome’ to describe the effects of frequent, discontinuous change on public sector organisations and importantly on their staff.<sup>18</sup> Regular restructuring and machinery-of-government changes are a net cost to performance, though this is rarely acknowledged, or perhaps is not understood by political masters, whose interest in and attention to such changes is seldom sustained beyond the flurry and symbolism of the initial announcement.



“Would-be reformers often fail to appreciate that the public sector organisations they seek to improve are not greenfield sites. Rather, they are the sum of their experiences – sedimented with the accreted layers of earlier reform efforts.”



## Jurisdictional approaches to government productivity

Against this background, it is worth reviewing the measures Australian governments are taking to drive efficiency and improvement in their public sectors and particularly within the large delivery systems that consume so much of their budgets.

### Commissions of audit and fiscal repair

It has been relatively common for new governments to commission reviews or audits of government finances and operations upon taking office. These provide for (at least nominally) independent panels to create a strategic framework and focus for government policy and arms-length political cover for electorally unpopular reform proposals. West Australian Liberal-National Premier Colin Barnett established an Economic Audit Committee shortly after his government was elected in 2008 to ‘conduct a wide-ranging review of the operational and financial performance of the Western Australian public sector’.<sup>19</sup> Coalition governments in NSW, Victoria and Queensland each undertook a Commission of Audit type process on taking office.

The themes emerging from these recent state-based Commissions of Audit have been broadly consistent. Overall, their focus has been on:

- Reducing the size of the public service.
- Refocussing on core services and responsibilities of government, with government as facilitator and enabler of services, but not necessarily responsible for delivery.
- Devolving authority and accountability for decision-making to the local level.
- Making areas of service delivery contestable and using competition and partnerships with private and not-for-profit sector providers to achieve quality services at lower cost.
- Creating a more dynamic and innovative public sector culture with a greater customer focus.
- Promoting workforce flexibility and ‘more modern’ work practices.
- Better leadership and improved performance management systems.

Some incoming governments have opted to make budget savings by rapidly reducing the headcount. The size of the WA public service fell by 6000 between 2010 and 2012.<sup>20</sup> In Queensland, more than 14,000 permanent and temporary public sector workers left employment in 2012 and 2013. These cuts have been immediate – usually justified by a ‘budget emergency’ – and implemented before a sober assessment of what services government wants to deliver and the approach to delivery it wants to pursue. Obviously it is preferable that a government comes to office with a broad and long-term view of its philosophy of administration and the principles it believes underpin the efficient and

effective provision of public services. Experience suggests leaders are better to eschew blunt, short-term savings measures – efficiency dividends and cuts to staffing achieved through hiring freezes and poorly targeted and costly redundancy programs. These have costs and consequences for productivity and performance, since important skills and institutional memory are lost and uncertainty saps the morale of ‘survivors’.

Sensibly, the Abbott Government used the MYEFO to confirm its intention to “streamline the public service”, but indicated it would “review the timing and approach” to implementing its election commitment to reduce the size of the Australian Public Service (APS) by 12,000 positions through natural attrition.<sup>21</sup> Its Labor predecessor had budgeted for significant staffing cuts and other savings measures to take effect from 2013/14. The findings of the Commission of Audit will inform decisions about the public service head-count.

#### The National Commission of Audit

After its election win the Abbott Government commenced its own National Commission of Audit chaired by Business Council of Australia (BCA) President, Tony Shepherd AO. Four other Commissioners have been appointed including:

Dr Peter Boxall AO; Tony Cole AO; Robert Fisher AM and former Howard Government minister and Ambassador to Italy, the Hon. Amanda Vanstone. The Commission Secretariat is led by Peter Crone, BCA Director of Policy and former Economic Adviser to Prime Minister John Howard.

The Government argues the National Commission of Audit has been given “a broad remit to examine the scope for efficiency and productivity improvements across all areas of Commonwealth expenditure, and make recommendations to achieve savings sufficient to deliver a surplus of one per cent of GDP prior to 2023–24”. Its first report is due by the end of January, and its second by the end of March 2014. Some commentators have questioned whether this relatively short timeframe means the Government already has fixed views about key aspects of the Commission’s deliberations.

The Audit is one of a plethora of reviews and inquiries initiated by the Abbott Government in its first 100 days, including a promised White Paper into Federal-state relations.<sup>22</sup> Its deliberations are ongoing, but we can discern likely directions from the Coalition’s election platform and from the publicly expressed views of some of the Commissioners, including extensive policy advocacy from the BCA.



“Experience suggests leaders are better to eschew blunt, short-term savings measures – efficiency dividends and cuts to staffing achieved through hiring freezes and poorly targeted and costly redundancy programs. These have costs and consequences for productivity and performance, since important skills and institutional memory are lost and uncertainty saps the morale of ‘survivors’.”

The BCA released its *Action Plan for Enduring Prosperity* in July 2013.<sup>23</sup> The report identifies nine areas where governments need “to get things right” if Australia is to remain competitive and achieve sustainable economic growth. It argues the Australian economy has been subdued for the past two years, in part due to a shift away from consumption to saving and the fallout from the GFC, but also due to “policy uncertainty and regulatory overreach”. Further, “regulatory interventions and new tax imposts...introduced without necessary consultation” have led to inefficiencies and “perceptions of regulatory risk”.

### Reforming the Federation

Although primarily concerned with regulatory reform, including by harmonising and streamlining regulation between the different levels of government, the BCA identifies the need to reform the Federation. It urges the incoming government to undertake a root and branch audit of the role and responsibilities of the Commonwealth and the states and territories. It cites areas of overlap between the Commonwealth and the states in health, education, aged care, Indigenous welfare and environmental approvals as all requiring investigation, with the aim of developing a clearer delineation of policy and service delivery responsibilities.

Premiers and others endorse the need to urgently reform Australia’s federation,<sup>24</sup> and particularly to address the vertical fiscal imbalance that has left revenue-constrained states with unpredictable and often unstable sources of funding to meet the increasing financial burden of high-demand services (health, education, and transport infrastructure), of which they are the primary providers.<sup>25</sup> Reforming federal financial relations is complex and politically contentious. However, the Commission of Audit process and the Federal Government’s White Paper on *Reform of the Federation* present opportunities to move beyond well known and generally accepted descriptions of the problems of Australian federalism, towards a clear plan for reform that would yield significant efficiencies and improve performance across key areas of public service delivery.

The December 2013 COAG meeting provided some positive signals about the Abbott Government’s approach to intergovernmental relations, including a more respectful relationship than has characterised the interface between the Commonwealth and sub-national governments over the past decade. The Communiqué notes:

“The Commonwealth respects the States and Territories as sovereign in their own sphere. They should be able to get

on with delivering on their responsibilities, with appropriate accountability and without unnecessary interference from the Commonwealth.”<sup>26</sup>

This more ‘hands-off’ approach to areas of service delivery is evident too in the policy statements of federal ministers, notably the Education Minister. Christopher Pyne, a prominent advocate of school autonomy, has consistently opposed Commonwealth ‘command and control’ over states’ management of their school systems. He has called on sub-national governments to give schools greater autonomy and freedom from control by central education bureaucracies. Sub-national leaders argue significant savings and efficiencies could be achieved if the Commonwealth reduced those parts of its bureaucracy responsible for overseeing areas of state provision, mainly schools and hospitals.

These themes of decentralisation, autonomy and local control, of restoring a culture of personal responsibility and reducing the role of government in the lives of citizens, of addressing duplication and overlap between Commonwealth and state governments, recur in the rhetoric of Abbott Government ministers. They are likely to be reflected in the recommendations of the Commission of Audit. A key challenge for the Government will be to integrate its recommendations and the findings of the various reviews and inquiries it has established – including multiple references to the Productivity Commission – into a coherent program of reform to lift the productivity and efficiency of government. Already some stakeholders are questioning the Government’s reform credentials and whether the Prime Minister has the political will to take hard and potentially unpopular decisions. The Coalition’s philosophy of smaller government and the scope of the fiscal repair task outlined in MYEFO makes inevitable that the government will reduce or withdraw from areas of service provision.

### Marketisation and contestability

Marketisation and contestability are key elements of reforms to make the provision of public services more efficient, innovative and responsive. Thirty years of experience and experimentation means a far broader range of instruments are available to governments seeking to catalyse public sector reforms using market-based mechanisms. Alternative models reflect varying degrees of government control and can take a truly mixed variety of forms – drawing on providers in the public, private and third sectors, or a range of hybrids comprising all three.

Competition changes the operating environment for public service provision – it harnesses the

knowledge, skills and motivations of those engaged in service delivery and incentivises them to innovate by allowing them greater decision-making authority and leaving them to make professional judgments about how specified outcomes can be achieved – free from episodic interference and control from the centre.

However, competition and contestability are predicated on diversity and choice. Gary Sturgess argues “diversity matters because it increases the effective choice available to the beneficiaries of public services, at both the individual and collective level”. Diversity brings with it a range of other benefits including flexibility and adaptiveness; and innovation. This is because diversity enables experimentation, problem-solving and learning to occur in parallel rather than in serial.<sup>27</sup> But diversity challenges a key tenet of public sector provision: consistency and sameness. It is likely to provoke a political backlash among constituencies who distrust governments’ motives and fear that savings are political code for poorer services.

The shift to network delivery implies a fundamental shift from direct control by governments to arrangements that depend on mutuality, negotiation and importantly, on trust. Hierarchical chains of accountability are inappropriate to service models that may embrace a diverse mix of public, private and not-for-profit providers, operating with varying degrees of autonomy. In the network delivery context, the role of government becomes that of strategic commissioner and network manager. There is greater reliance on and recognition of professional decision-making at the individual service unit level.<sup>28</sup>

A particular challenge of network delivery concerns the design of governance arrangements – striking a balance between what should be centralised and what is more appropriately decentralised or devolved, and to what level of the delivery system. The current trend towards devolution and ‘localism’ reflects an ambition to devolve power and resources away from central control and towards front-line managers, local democratic structures and local consumers and communities, within an agreed framework of national minimum standards and policy priorities.

These principles underpin changes in the area of schools education currently underway in several state jurisdictions. Autonomy, variously described as ‘local management’, ‘school-based management’, or ‘school self-management’ has emerged as a key reform direction, informed by international experience. It involves reducing the role of central education bureaucracies in the management of schools, which become self-managing by taking

responsibility for some or all aspects of funding, decision-making regarding the curriculum, hiring staff, professional development, and educational service delivery. Victoria has a long tradition of school autonomy and is examining options for extending a greater degree of local control to school communities. Western Australia is four years into implementing Independent Public Schools. The potential of this model to deliver efficiencies and improved learning outcomes – performance and quality – is being carefully monitored by other states.

In a devolved delivery context, the role of the ‘centre’ becomes that of ‘system steward’ – responsible for setting and specifying outcomes, assessing performance and disseminating good practice. This latter role has been described by American performance management expert Shelley Metzenbaum as the centre becoming a ‘learning leader’ – using its access to comparative performance data to “identify what works, motivate uptake of effective interventions and encourage the ongoing search for ever more productive ways to prevent, mitigate and treat problems”. In this way, ‘the centre’ – be it national government, central agencies, or central units within government agencies, seek to shift their focus from monitoring and compliance towards efforts to enhance performance accountability by helping delivery units learn and improve by showcasing promising practices.<sup>29</sup>

Empowering experience is a theme in the broader public management literature, including in Australia. However, it represents a challenge to politicians, political advisers and policymakers – a group Gary Sturgess has provocatively described as the ‘policy class’.<sup>30</sup> He argues the complexity of modern governance renders impossible (and inefficient) top-down control and that:

“...our response should lie in less regulation of front-line public services, not more; in systems that are coupled less tightly rather than more; in empowering and developing the leaders of relatively small-scale organisations within the public service sector, in preference to building leadership at the top.

“I would suggest that the key to successful reform lies in recognising the diversity of the public interest, in building a public service economy that is directly responsive to the concerns of customers rather than being dominated by producer interests.

“The future of public services in this country – certainly in state and local government – lies in focusing more on ‘firms’ that are charged with front-line delivery than the departments who are responsible for the design and implementation of policy.”



“Politicians have driven successive waves of public sector reform – particularly the ‘political management reforms’ that sought to make the public service more responsive to the government of the day, and give ministers and Cabinet far greater control over policy direction. Yet ministers have been strangely absent from reviews and inquiries into the performance of the public sector. They are apparently a ‘no go zone’ in debates about government productivity.”

## Barriers and impediments to realising government productivity

To date the focus of reforms aimed at improving the productivity of government has been solely on public sector organisations, to the exclusion of those who govern it and determine its direction. Politicians have driven successive waves of public sector reform – particularly the ‘political management reforms’ that sought to make the public service more responsive to the government of the day, and give ministers and Cabinet far greater control over policy direction. Yet ministers have been strangely absent from reviews and inquiries into the performance of the public sector. They are apparently a ‘no go zone’ in debates about government productivity.

Legendary mandarin Sir Arthur Tange noted this critical omission in his 1981 Garran Oration. He urged reformers to focus on “the total fabric and process of government”, arguing:

“It is remarkable that the analyses, and the remedies for public service deficiencies, have seldom looked at ministers – what they are, their workloads and habits, their priorities...

“... the focus of investigations and recommendations concerning (public sector) reform has been too narrow. Changes recommended have been directed to some parts of a complex living constitutional organism without enough regard to the effect elsewhere in it.”<sup>31</sup>

More recently, and reflecting the findings of their analysis of public reform in 12 countries, Pollitt and Bouckaert have argued that political executives should be included in considerations of reforms to improve government performance. This echoes views expressed in the Australian context. In the past year, two key industry groups – the BCA and the Committee for Economic Development Australia (CEDA) have released reports calling for reforms to “address a deterioration of good policy processes and sound governance arrangements...”<sup>32</sup> CEDA’s report stresses the importance and long-term benefits to be gained from good policy and deliberative processes, of disciplined routines, of valuing the Cabinet, the Parliament and intergovernmental fora. Gary Banks argues similarly the significance of good policy processes in designing, implementing, sequencing and importantly, selling to the public productivity-enhancing reforms.<sup>33</sup> Those are squarely in the court of ministers and their advisers.



“Because delivery systems are mixed, the reform task is infinitely more complex than what can be realised through arbitrary cuts to the public service. It requires collective commitment and an informed public debate about the role of government and the services the public is willing to pay for.”

## Conclusion

There are formidable barriers to the successful implementation of reforms that would yield genuine improvements in the efficiency and performance of Australia’s public sector. These are primarily political, consistent with the critique of the capacity of the nation’s political processes and institutions to embrace and sustain policy reform. They also reflect tensions inherent to our system of governance: between hierarchy and networks; autonomy and central control; expectations of universality and consistency on one hand, and diversity and choice on the other. Because delivery systems are mixed, the reform task is infinitely more complex than what can be realised through arbitrary cuts to the public service. It requires collective commitment and an informed public debate about the role of government and the services the public is willing to pay for.

Adversarial politics and a culture of entitlement may yet prove the greatest impediment to lifting the quality and effectiveness of government. It is often

remarked that Australia manages adversity far better than it handles prosperity. There may be opportunity in the fact that the governments who will determine the next phase of reform are those with the greatest stores of political capital; with significant electoral majorities and who face depleted oppositions.

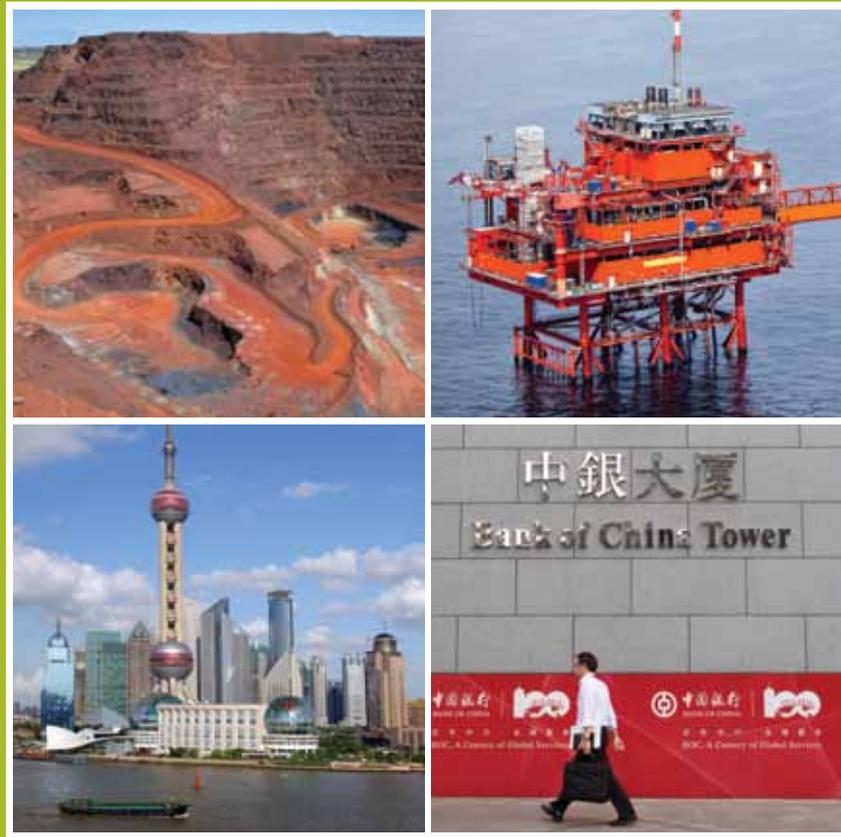
In a 2012 speech Reserve Bank Governor Glenn Stevens described increasing productivity as “a test of adaptability”, “every day doing a thousand things a bit better than yesterday”. In the public sector improved efficiency and effectiveness will flow from increased adaptability in the provision of services. The challenge for governments then is to imagine service systems that unleash the potential for innovation – harnessing the energy, knowledge and networks of local providers to improve services, while also ensuring high standards of accountability, and appropriate risk management.

*The views in this article are those of the author and should not be attributed otherwise.*

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# How the 'Great Convergence' is changing Australia



**Roger Donnelly** is Chief Economist at the Export Finance and Insurance Corporation (EFIC), where he is responsible for country risk assessment and rating. He also provides in-depth market briefings to clients, industry and government on economic and geopolitical

issues and the outlook for Australian exports and investment.

Before joining EFIC, Roger worked for the Commonwealth Treasury, the Office of National Assessments and as a consultant to both Australian and foreign companies and the Organisation for Economic Co-operation and Development (OECD). His experience spans public policy analysis, economic forecasting, investment feasibility studies, country risk assessment and lecturing.

## Introduction

What have been the external forces shaping Australia's international economic relations over the past decade? And how will they change over the coming decade?

Without a doubt, the rise of China, or more broadly the 'Great Convergence',<sup>1</sup> has been the predominant one. But will it continue to be, as China embarks on a transition to a different growth model?

The answer is almost certainly yes, regardless of the future development path China and other converging economies take. That doesn't mean however, that the path Australia will take in response is easy to foresee. It will be heavily influenced by three things – how fast and with what commodity intensity converging economies grow, how rapidly and cheaply worldwide commodity suppliers meet the demands of the converging economies, and how ably Australians can meet non-resource demands of converging economies.

## Past decade

### Three worldwide shocks

As the Organisation for Economic Co-operation and Development (OECD) has noted, the decision of China, India and the former Soviet Union to open up their economies – the better to raise their living

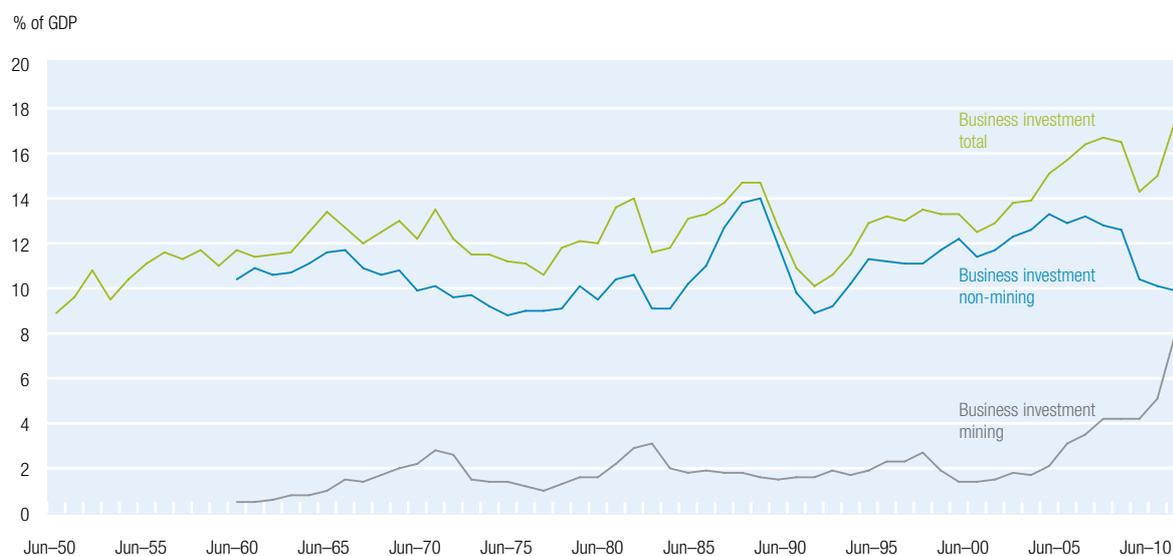
standards to those of rich countries – delivered three huge shocks to the world economy.<sup>2</sup> The first one was to the world labour market – 1.5 billion workers joined the integrated part of the world economy in the 1990s, increasing the supply, and decreasing the relative price, of many traded goods and services. The second shock was to world commodity markets – the converging economies added more to world resource demand than to supply, igniting the commodity supercycle. The third shock was to world capital markets – the converging economies lifted their saving faster than their investment. This created a savings glut, which pressed down international real interest rates, and created one of the preconditions for the financial crash of 2008.

### Resource boom

The first and second of these shocks in turn delivered a terms of trade boom to Australia. How big a boom? As Reserve Bank of Australia (RBA) Governor Glenn Stevens noted in 2010: "Five years ago, a ship load of iron ore was worth about the same as about 2200 flat-screen television sets. Today it is worth about 22,000 flat-screen TV sets – partly due to TV prices falling but more due to the price of iron ore rising by a factor of six."<sup>3</sup> This boom alone directly increased national income by around 13 per cent over the decade to 2011. It also set off the biggest resource boom since the 19th century gold rush.<sup>4</sup>

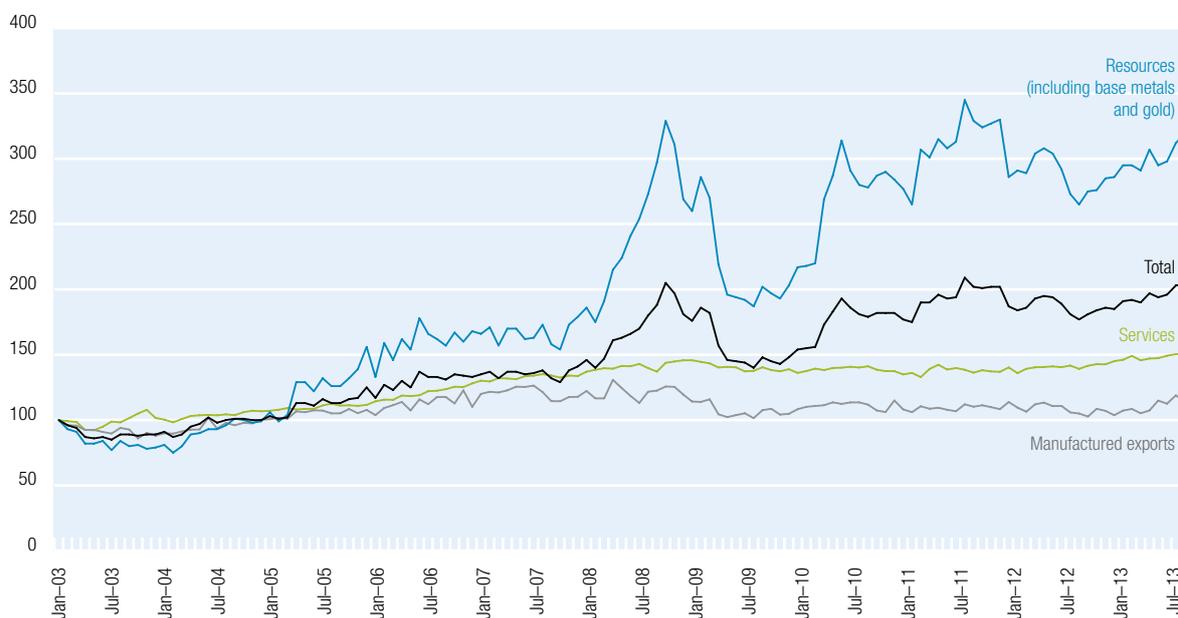
The investment phase of the boom saw resource investment as a share of gross domestic product

**Figure 1**  
Business investment



Source: ABS, Butlin, RBA.

**Figure 2**  
**Australian exports by type**  
 Index, Jan 2003 = 100



Source: ABS, EFIC, RBA.

(GDP) shoot from an average of around two per cent over the five decades to 2003 to more than eight per cent in 2012 (Figure 1).

It is now spawning an export boom, in which capacity added during the investment phase is supporting strong growth in resource exports, particularly iron ore.

Actually, resource exports have been growing strongly ever since the commodity supercycle got underway a decade ago – and far outpacing non-resource exports (Figure 2). There is, however, a difference now. Whereas past growth of resource exports was price-driven and volume-constrained, this year it is price-constrained and volume-driven.

Moreover, the weak growth of non-resource production and exports is the counterpart of the booming resource sector. Its demand for labour and capital has put upward pressure on the real exchange rate, which has crimped the growth of the non-resource sector. Manufactured exports have been flat since the boom began in 2003, and service exports have grown at less than four per cent per annum (Figure 2). When one sector booms in a basically fully employed economy, the other sectors have to contract or at least slow.

This much of the story is well-documented and well-known.

### Diversification of Australian outward Foreign Direct Investment (FDI)

But there are also wider repercussions of the boom that are less well-documented and known.

The commodity price boom has persuaded many Australian resource and mining equipment, technology and services (METS) companies to go on a worldwide hunt for new resource supplies and contracts, which has served to internationalise Australian outward FDI flows and stocks beyond their traditional bias towards the Anglosphere (US, UK, New Zealand, Canada) and the EU.

It is not widely appreciated, for instance, that there are now more than 200 Australian mining companies with more than 700 projects operating in Africa.<sup>5</sup> Virtually all of this presence was established during the boom that started in 2003.<sup>6</sup>

### Customer equity

Moreover, many Australian exports to China and India are coming to be associated with investment by the Chinese or Indian buyer in the Australian supplier, rather than being just a simple sale by the Australian supplier to a Chinese or Indian buyer at arm's length.

“Not all of the hopes raised by China’s rise have been fulfilled. Chinese FDI, for instance, has not really helped Australian companies integrate into regional supply chains. Cases of integration seem to be few and far between.”



One example of such ‘customer equity’ is the Australia Pacific LNG (APLNG) project at Curtis Island near Gladstone. The Chinese state oil company Sinopec has a 25 per cent equity interest in this venture, and has agreed to take almost 90 per cent of the planned gas production in long term take-or-pay contracts. Another example is the Karara iron ore mine in WA. This is a joint venture between Australia’s Gindalbie Metals and Chinese steel producer Ansteel. The mine has a long term offtake agreement with Ansteel.

There are also cases of customer equity investment in agribusiness, such as the Cubbie Station in Queensland, in which the textile firm Shandong Ruyi has an 80 per cent interest, and an investment by the Sichuan Taifeng Group in the McLaren Vale winery, Gemtree.<sup>7</sup>

### State development banks

The equity finance provided by Chinese customers has often been accompanied by debt finance from state development banks. This is again a little-noticed

aspect of the resource investment boom. For the APLNG project, China Eximbank is contributing US\$2.8 billion to a project finance package. For the Karara mine, debt finance has come from the Bank of China and China Development Bank. There are also other deals such as loans to the Gorgon LNG venture to buy tankers.

All up, financing from overseas export credit agencies, export-import banks and state development banks brought virtually nothing into Australia in 2009, yet by 2012 had soared to at least US\$20b (in project finance deals signed).<sup>8</sup>

### Unfulfilled hopes

Not all of the hopes raised by China’s rise have been fulfilled. Chinese FDI, for instance, has not really helped Australian companies integrate into regional supply chains. Cases of integration seem to be few and far between. In 2009, Chinese carmaker Geely bought the Australian car component maker, DHI Holdings, which resulted in DHI supplying Geely with transmissions. In 2000, Huagong Technologies

acquired Farley LaserLab, a Melbourne producer of hi-tech cutting and drilling machines.<sup>9</sup> That is about it.

Integration is also not showing up in the trade data. If Australian firms were integrating into regional production chains, one would expect a rising volume of exports and imports of intermediate goods, and correspondingly, declining value-added content in Australian trade. Yet recent research by the RBA suggests that: “The value-added content of Australian trade has been relatively stable, while the value-added share of trade in most countries has fallen over the past two decades as they increasingly source intermediate inputs from overseas.”<sup>10</sup>

It is important to be clear here. Chinese investment is certainly helpful. In fact it has a twin benefit – helping Australians to finance more worthwhile investment than they could manage otherwise, while at the same time ensuring that the investment clinches overseas customers and can therefore pay for itself. But there is little evidence that it is helping Australia to integrate into regional supply chains – unless one wants to make the weak, semantic point that it is helping Australians to entrench themselves at the raw material starting point of those chains – a position we have always occupied.

### Keeping China in perspective

As important as the rise of China and other converging economies has been, it shouldn't be overstated. Other important changes in Australia's trade and investment patterns have taken place, which do not seem to be traceable to China or 'Chindia' or Asia.

One important one is growing income earned by foreign affiliates of Australian resident companies. Unfortunately, the ABS has collected data on this for only 2002–03,<sup>11</sup> before taking an updated look in 2009–10 at just the finance and insurance industry.<sup>12</sup> Anyway, the data reveal that 4012 foreign affiliates generated more than \$142b in sales revenue from goods and services in 2002–03. This compares with \$152b worth of traditional goods and services exports in the same year.

In the 2009–10 study, the ABS found that foreign affiliates of Australian resident finance and insurance firms had sold almost \$39 billion of services to third countries and more than \$35 billion in the host country. This compared to reported service exports for the finance and insurance industry of just \$1.4b. In other words, sales by foreign affiliates made up more than 96 per cent of Australian financial and insurance services supplied to the rest of the world in 2009–10.<sup>13</sup>

So foreign affiliate sales almost equalled traditional

exports a decade ago, and they dwarf exports for the finance and insurance industry. But there is more – outward Australian direct investment has been increasing rapidly, suggesting that the ratio of foreign affiliate sales to exports has increased over the past decade.

This growing reliance on offshore investments to earn the income Australians need to pay their way in the world is a big shift. Yet because it is measured imperfectly it doesn't get the attention it deserves.

As I remarked earlier, it isn't a phenomenon related to the rise of converging economies – for at least two reasons. First, it predates the Great Convergence and the commodity price boom. Second, it isn't particularly focused on Asia or other large and dynamic emerging economies. Foreign affiliates in New Zealand, the UK and US predominate on all aspects measured by the ABS – sales, purchases, employment and payrolls.

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## Coming decade

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### China anxiety

The peaking of the commodity supercycle in 2011 and of the resource investment boom in 2013 have understandably caused anxiety among many Australians about where future economic growth will come from. All manner of reports have sprung up asking questions like ‘Where is the next wave?’<sup>14</sup> and warning that ‘dog days’ are upon us following previous ‘salad days’.<sup>15</sup>

In trying to get a handle on where the economy goes next, many commentators have focused upon China's forthcoming economic transition. The old economic model that relied on cheap labour, exports and investment to drive growth has become “unbalanced, uncoordinated and unsustainable”, to use President Xi Jinping's words. To make it more sustainable, so that China can ‘grow rich before it grows old’, almost everyone – including the Chinese Communist Party – agrees that more emphasis needs to be placed on domestic demand, consumption, services, productivity, efficiency, conservation and innovation.

But what will this mean for Chinese demand for Australian resources? What will the emerging Chinese middle class buy from Australia other than minerals and energy? What adjustments will the Australian economy need to make to capitalise on the changing opportunities?



“...almost everyone – including the Chinese Communist Party – agrees that more emphasis needs to be placed on domestic demand, consumption, services, productivity, efficiency, conservation and innovation. But what will that mean for Chinese demand for Australian resources?”



### Will commodity prices mean-revert or settle higher?

There are various conceivable scenarios.

At one extreme, China curtails its demand for resources and international resource supply expands rapidly without rising marginal cost. Then Australian resource export prices and even volumes disappoint. The real exchange rate has to undergo a big depreciation to maintain the external and internal balance of the economy.<sup>16</sup> In response to this depreciation, non-resource exports expand rapidly.

At the other extreme, Chinese demand for resources remains buoyant and the international supply response to high prices is weak. Prices settle at a high level and the real exchange rate remains strong. Far from resource investment peaking and rapidly declining, as it seems set to do currently, “there is the potential for a rebound in investment”, says the Bureau of Resource and Energy

Economics.<sup>17</sup> In these circumstances, the economy has no need to spur its non-resource exports in order to make ends meet in the balance of payments or to keep labour and capital fully employed.

Let’s call Scenario 1 ‘Terms of trade mean-revert’ and Scenario 2 ‘Commodity supercycle continues’. Which is more likely? Frankly, the question is wide-open.

In the Scenario 1 camp are Professor Ross Garnaut and the OECD. Garnaut sees growth in China moderating to six to eight per cent per annum from the previous nine to 10 per cent or more, as the economy adapts to growing labour scarcity and the need to moderate investment: “Seven – eight (will be) the norm but (there will be) acceptance of six when the cycle takes the economy there.” Besides, energy and metals demand will lag behind GDP growth as efforts are made to conserve resources and decarbonise the economy, and the less commodity-intensive service sector grows as a share of GDP.



“If growth in converging economies stays rapid and commodity-intensive, and commodity markets encounter a rising marginal cost of supply, the Australian economy will keep the resources skew it has gained this past decade.”

The result, he believes, will be “an immense adjustment to much lower resources investment and terms of trade”.<sup>18</sup> A fall in the real exchange rate of 20–40 per cent from its peak in the first quarter of 2013 will be necessary.<sup>19</sup>

The OECD seems to think similarly, because it assumes the terms of trade will stabilise at their 25-year average.<sup>20</sup>

In the Scenario 2 camp is Deloitte-Access Economics. It apparently assumes that continuing urbanisation and industrialisation in China and other emerging economies plus growing worldwide commodity scarcity will keep the terms of trade above historical standards for a long time. Or more precisely, the long-run terms of trade settle at their post-boom average from 2003–04, some 40 per cent higher than the OECD assumption.

Finally...

“At around the midpoint of these two alternatives is the long-run terms of trade assumption used by Treasury in the projections that underpin the Commonwealth Government Budget. Following the 10 per cent fall in the terms of trade forecast from

2012–13 to 2014–15, the terms of trade is projected to fall 20 per cent over the 15 years from 2015–16 to 2029–30. This projection balances two factors: the prospect that demand for Australia’s non-rural commodity exports has undergone a structural shift due to the growing need for steel and energy to support development in emerging Asia; and the outlook for a significant increase in global supply of non-rural commodities in response to significant increases in prices over the past decade. The Treasury projections are consistent with long-run projections produced by the Bureau of Resources and Energy Economics and the Consensus of market commodity analysts, which suggest that prices of Australia’s key non-rural commodity exports are likely to fall further, but not to pre-boom levels – in part due to rising extraction costs. This suggests that the level of the terms of trade reached in 2029–30 (that is the end point of the medium term projections) under the assumption used in the Commonwealth Government’s Budget Papers is another plausible assumption for the new structural (or long-run) level of Australia’s terms of trade.”<sup>21</sup>

In his recent CEDA discussion paper, *Australia 2022*,<sup>22</sup> Dr John Edwards also appears to be in this intermediate camp. He argues that the expected slowdown in China's demand for minerals and energy will require faster growth of non-resource exports if foreign liabilities are to be stabilised and prosperity sustained – “contrary to the widely held notion that Australia's future is all about resource exports”. Yet he assumes that commodity prices will be “flat” in nominal Australian dollar terms out to 2022. He does not discuss his exchange rate assumptions, but some moderate further fall in international prices would be consistent with flat Australian dollar prices if the Australian dollar also falls moderately.

## Conclusion

In the end, the Australian economy will make whatever adjustment is required of it by the unfolding process of economic development in emerging-converging economies and supply-and-demand conditions in commodity markets.

If growth in converging economies stays rapid and commodity-intensive, and commodity markets encounter a rising marginal cost of supply, the Australian economy will keep the resources skew it has gained this past decade. Then again, if emerging economies slow or become less commodity-intensive, or both, and commodity prices fall back to pre-boom levels, as they have done during the two previous booms this past century, there will need to be big adjustments.

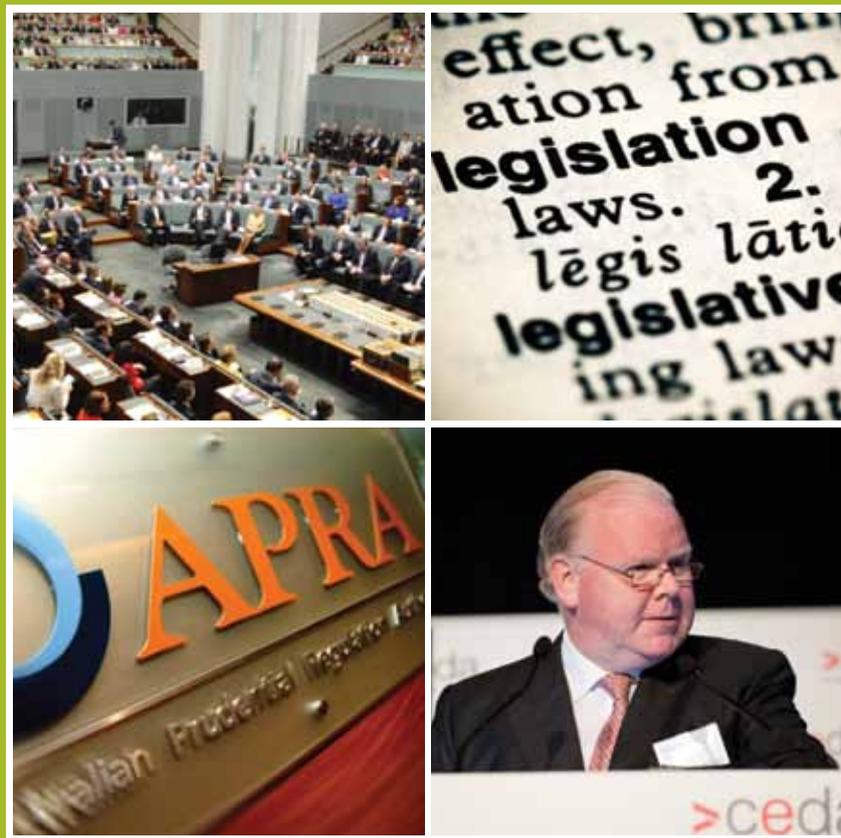
This leads to the next question: How easy will any required adjustment be? That will depend upon both the adaptability of the Australian economy and how well our supply capabilities mesh with the evolving demands of the converging economies. If we are adaptable and our capabilities are in high foreign demand, we will be able to make any required adjustment easily and in response to only small real exchange rate adjustments. But if we are sluggish, the adjustments will be difficult and will necessitate large currency depreciation, and corresponding real wage cuts.

Luckily, we can influence our adaptability. Better still, the expanding Asian middle class seems to be demanding many of the goods and services we produce well, at least with the right price incentives.

*The views in this article are those of the author and should not be attributed otherwise.*

## Endnotes

- 1 'Great Convergence' is a term coined by the Singapore scholar, Kishore Mahbubani, to refer to the rapid convergence of per capita incomes in many poor countries on those of rich countries. Professor Ross Garnaut calls this period of widening participation in rapid economic growth (in the 21st century) the Platinum Age, following what economists came to call the Golden Age of the immediate post-war decades. See his book 'Dog Days: Australia After The Boom', Redback, 2013, p. 28
- 2 OECD Perspectives on Global Development 2010: Shifting Wealth, [www.oecd.org/dev/pgd/45451514.pdf](http://www.oecd.org/dev/pgd/45451514.pdf)
- 3 'The Challenge of Prosperity', [www.rba.gov.au/speeches/2010/sp-gov-291110.html](http://www.rba.gov.au/speeches/2010/sp-gov-291110.html)
- 4 Jim Minifie, 'The mining boom: Impacts and prospects', July 2013, Grattan Institute, <http://grattan.edu.au/publications/reports/post/the-mining-boom-impacts-and-prospects>
- 5 Australia and Africa, [www.dfat.gov.au/geo/africa](http://www.dfat.gov.au/geo/africa)
- 6 Roger Donnelly and Ben Ford, 'Into Africa: How the Resource Boom Is Making Sub-Saharan Africa More Important To Australia', [www.lowyinstitute.org/publications/africa](http://www.lowyinstitute.org/publications/africa)
- 7 Sarah Martin, 'Winery blooms with Chinese equity', *The Australian*, October 29, 2013
- 8 Calculations by Dougal Crawford of EFIC using export credit agency and project finance sources
- 9 I thank Luhua Tang of Austrade for alerting me to these cases. [www.austrade.gov.au/Invest/Doing-business-in-Australia/Success-Stories/Australian-manufacturer-drives-innovation-for-Chinese-automaker](http://www.austrade.gov.au/Invest/Doing-business-in-Australia/Success-Stories/Australian-manufacturer-drives-innovation-for-Chinese-automaker)
- 10 Gerard Kelly and Gianni La Cava, 'Value-added Trade and the Australian Economy', [www.rba.gov.au/publications/bulletin/2013/mar/4.html](http://www.rba.gov.au/publications/bulletin/2013/mar/4.html)
- 11 Australian outward foreign affiliates trade, 2002–03, ABS 5495.0
- 12 Australian outward finance and insurance foreign affiliates trade, 2009–10, ABS 5485.0
- 13 I am indebted to Austrade's Mark Thirlwell for pointing this out to me.
- 14 Deloitte, 'Positioning for prosperity: Catching the next wave', October 2013, [www.deloitte.com/view/en\\_AU/au/news-research/luckycountry/prosperity-next-wave/index.htm](http://www.deloitte.com/view/en_AU/au/news-research/luckycountry/prosperity-next-wave/index.htm)
- 15 Ross Garnaut, 'Dog Days', op cit
- 16 I picture a 'Swan diagram' as I make this point. See for instance [www.wiley.com/college/econ/salvatore364584/pdf/ch18.pdf](http://www.wiley.com/college/econ/salvatore364584/pdf/ch18.pdf)
- 17 Bureau of Resources and Energy Economics, 'Resources and Energy Major Projects, October 2013', p. 1, [www.bree.gov.au](http://www.bree.gov.au)
- 18 Garnaut, 'The New Pattern of Chinese Growth', 14 May 2013, [www.rossgarnaut.com.au](http://www.rossgarnaut.com.au)
- 19 Garnaut, 'Dog Days', op cit, p.10
- 20 For a discussion of the various terms of trade scenarios noted on pp 5-6 of this paper, see Box 1 in Treasury Working Paper 2013–01, 'Estimating the Structural Budget Balance of the Australian Government: An Update', [www.treasury.gov.au](http://www.treasury.gov.au)
- 21 Ibid
- 22 John Edwards, 'Australia 2022 – CEDA Discussion Paper', 23 May 2012, [www.ceda.com.a](http://www.ceda.com.a)



# Red tape in finance and its discontents



**Dr Rodney Maddock** has worked in government, universities and business. He is currently Vice Chancellor's Fellow at Victoria University and an Adjunct Professor at Monash University where his main research interest is on the role of the finance sector within the Australian economy. Rod's books include *Rational Expectations*, *The Australian Economy in the Long Run*, and *Unlocking the Infrastructure*. His PhD is from Duke University.

## Introduction

Red tape exists as a bureaucratic device to restrict how individuals, businesses and other entities behave. Its whole purpose is to change people's behaviour. As such it is always a nuisance: it is designed to be a nuisance. The irony is that regulation is normally intended to advance the common good by this restriction imposed on the action of others. The debate about red tape reflects this tension, a tension which arises by restricting someone's freedom of action in order to advance somebody else's wellbeing.

Clearly regulation has wide application. All organisations impose some rules which allow certain behaviours and disallow others. Anyone who has worked in a large organisation will be familiar with rules which have to be obeyed but seem to be of little purpose, or even actively encourage wrong-headed behaviour. But at the same time, it is clear that rules often work to coordinate behaviour in socially advantageous ways, for example drive on the left, or right, but not both.

Undoubtedly government regulation is the main cause of concern. Government has the power to force us to comply, but is remote, impersonal, and difficult to influence. Kafka's *The Trial* and Heller's *Catch 22* provide classic literary examples of the sense of helplessness people can face when confronted by the vagaries of state bureaucracies.

## How expensive is red tape?

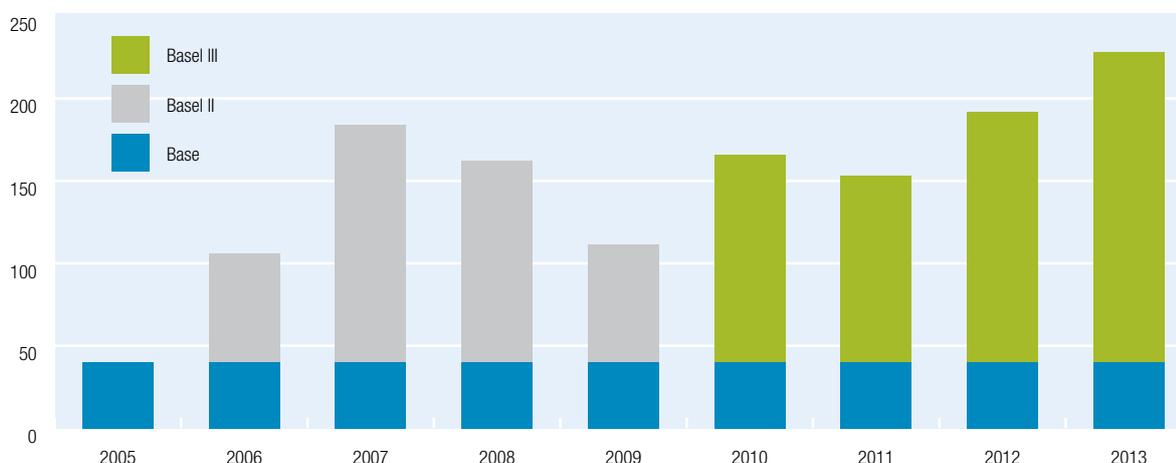
The economic effect of red tape can be large. The National Australia Bank (NAB) in its most recent report suggested that it was spending \$236m this year on technology related to compliance and operational risk, and this is just the technology spend. The Commonwealth Bank of Australia (CBA) spent \$228m in 2013, again just on the direct technology spend without any allowance for ongoing maintenance, training etc. As is clear from Figure 1, the CBA investment on compliance and risk projects peaked as it adjusted to Basel II and similar regulation in 2007, and has since surged to new heights as it confronts Basel III and related regulation.

It is not clear yet what the ongoing costs will be: the data below just relates to investment costs.

We can get some idea of the split between implementation costs and ongoing costs from work done in the European Commission.<sup>1</sup> The table on the following page compares the cost of implementing a set of European Union (EU) regulations, with the ongoing cost of complying with them.

The crucial observation is that the initial cost of setting up the new systems, training etc can be up to six times the ongoing cost of compliance. Once a financial institution has complied with a new regulation, it is often far cheaper to continue with it than to incur the whole new adjustment cost of getting rid of it and having to go back to the old approaches, re-train the staff, re-write the documentation etc. Staff members also have to be trained to explain to customers why the rules keep changing.

**Figure 1**  
CBA annual investment on compliance and risk projects (\$m)



Source: CBA Annual Report presentations.

Note: The figure is clearly based on the idea that 2005 represents the natural level of investment in new compliance and operational risk systems. The 2004 level was lower.

**Figure 2**  
**Cost of compliance with EU financial directives (% of operating expenses) 2009**

	Banks and financial conglomerates	Asset managers	Investment banks	Financial markets
Implementation cost	2.41	1.43	2.14	2.74
Ongoing cost	0.43	0.68	0.32	1.14

Source: Study on the Cost of Compliance with Selected Financial Sector Assessment Program (FSAP) Measures, Final Report by Europe Economics for the European Commission.

Any regulation which requires implementation on a large scale will be just as expensive to remove as to implement. A government which pledges to remove regulation will impose large transaction costs: leaving regulation in place and promising not to implement any more is likely to be far cheaper than trying to remove it.

Equally it is important to realise that training large numbers of retail staff in compliance is very expensive. It is a necessary cost of business but complicated rules and regulation which specify how a particular regulation should be implemented can add considerably to the costs. Well-designed regulations should be discussed with businesses to make sure that they can be implemented in the lowest cost manner while still being consistent with the policy objective. Since bureaucrats do not know how businesses actually operate, this requires extensive discussion.

## What are the current hot topics?

I want to call out the issues and difficulties which arise in managing red tape from five areas of current concern.

The *Foreign Account Tax Compliance Act (FATCA)* is an act of the United States (US) Congress, due to come into effect in mid-2014, and with major cost implications for Australian institutions. Under it, all Australian financial institutions are required to identify accounts held by US citizens and residents of the US for tax purposes and entities controlled by US individual persons.

Since most institutions do not know if their clients are US tax residents, they need to implement new procedures for all their clients. Failure to do so would be costly: a withholding tax of 30 per cent on US source income and proceeds from all sales of US assets. To make matters worse, there is still no inter-governmental agreement on exactly what is required.

The *Future of Financial Advice (FOFA) Reforms* are designed to improve the quality of advice and the professionalism of the financial planning industry. Like most regulation, this seems desirable but the current FOFA legislation includes a number of reforms which are unnecessary and impose deadweight costs on the economy. Some examples are:

- The ban on conflicted remuneration is unnecessarily broad. It should only apply when advisors are giving personal advice to retail clients, and not cover general advice or sophisticated investors; and
- The range of products captured is excessive including basic banking products like transaction accounts and term deposits. Again the implementation date of July 2014 is very close.

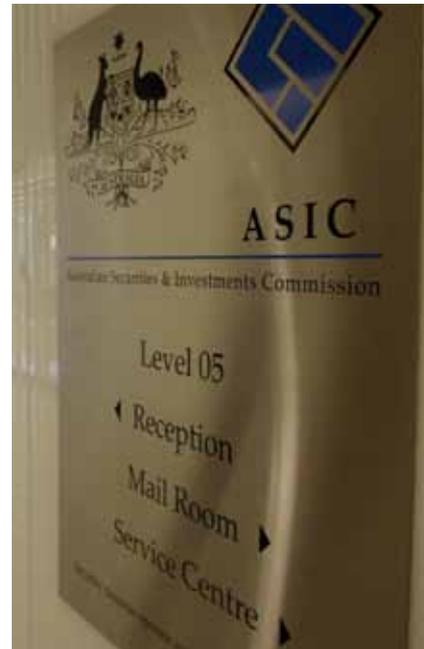
The *Tax Agent Services Act (TASA)* creates regulation for all forms of tax advice, irrespective of whether it is provided by a tax agent or a financial adviser, and brings financial services licensees within the regulatory regime administered by the Tax Practitioners Board.

The Coalition and the Parliamentary Joint Committee inquiry have acknowledged that there are legal and technical problems. These arise from the duplication of recognition required and create inconsistencies between the requirements of registering with the Board and the licensing and regulatory guidance framework of the Australian Securities and Investments Commission (ASIC). Again, the deadline of 1 July 2014 nears.

There are also problems with *Policy on Term Deposits*. Under Basel III banks have been encouraged to promote term deposits that require a minimum 31 day notification period.

Unfortunately it is unclear whether they qualify as basic deposit products for purposes of the Corporations Act and hence remain simple to sell. This is a case where regulations managed by one regulator (ASIC) and those promoted by another (the Australian Prudential Regulation Authority [APRA])

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need to be aligned if an unnecessary regulatory burden is to be avoided.

The *National Electronic Conveyancing System* faces a different regulatory hurdle. Shifting conveyancing to a national electronic system will produce significant productivity gains. This is a Council of Australian Government (COAG) initiative involving the major banks and a number of states. The second phase is to commence in mid-2014 when the remaining jurisdictions will participate together with legal practitioners and licensed conveyancers.

The extent of the productivity gains depends on nationally consistent legislative modifications to land titles laws. This requires continuing focus from

COAG particularly to establish consistent Anti-Money Laundering/Counter Terrorism Financing processes to verify parties to conveyancing transactions. Currently each state has different standards leading to operational and compliance differences and unnecessary costs.

These examples provide a sample of the red tape issues arising from:

- Extra-territorial regulation;
- Unintended consequences of excessive regulatory scope;
- Need for coordination between regulators; and
- Regulatory complications arising from federal systems.

## Why do we tolerate red tape?

By red tape we just mean a set of rules, a set of rules which govern the procedures we must follow in pursuing our activities. Since we might take the same action without following the procedures set down in the red tape, the red tape often seems expensive and redundant. A bank might sell a loan to a client based on a verbal explanation, with a short document explaining it, or with a 100 page document setting out all of the possible eventualities, the same outcome in each case but with entirely different costs. If the client does not read the 100 page product disclosure statement (PDS) then the requirement on a bank to produce the document can be a waste of resources.

The example is not trivial. Some of the PDSs produced in support of agricultural investment schemes were actually over 100 pages long. One really wonders is anyone other than the regulators and bank compliance officers actually read them. Onerous disclosure requirements can have the perverse effect of almost certainly ensuring the customer will not read the document.

In defence of red tape we must say that it can change the outcomes. Seeing that the product needs a 100 page PDS, the client might decide the product is riskier than he or she imagined, and decide not to buy it. The intention behind a regulation which resulted in a 100 page PDS is clearly to make sure that the buyer is aware of all of the risks associated with a product, and that such information might change behaviour.

So red tape can ensure both parties to a transaction are well informed. It might also ensure that fair procedures are followed as in contract negotiations, in merger regulations, in recruitment, and in wage negotiations, and it may provide a reporting device by which controls can be implemented.

Even famous scientists and entrepreneurs feel the tension.

In a discussion with John D Rockefeller Jr, Albert Einstein claimed that the strict regulations Rockefeller had set for his educational foundations stifled genius:

“Red tape,” the Professor exclaimed, “encases the spirit like the bands of a mummy!”

Rockefeller, on the other hand, pointed out the necessity for carefully guarding the funds of the foundations.

“I,” Einstein said, “put my faith in intuition.”

“I,” Rockefeller replied, “put my faith in organization.”

*Quoted in Roth and Sornert (2011)<sup>2</sup>*

## Recognising there is a trade-off – the failure of controls

Since there is a trade-off, we will always have arguments about the appropriate balance between the Einsteins who just want to get on with the business, and the Rockefellers who want to impose some accountability or control. But in the case above Rockefeller had to be careful: he expected to benefit from Einstein’s insights so he had to be careful not to over-regulate.

Governments, public officials and politicians do not face the same direct concern about over-regulation. Often their incentives work in the opposite direction. When an unregulated financial institution collapses (as with the recent example of Banksia Securities) and people lose money, politicians face an immediate public outcry of concern for those who suffered. They call an inquiry which invariably results in new regulations being proposed: a process which gets politicians off the hook but results in more regulation. When politicians weigh up the personal benefits against the increased regulatory cost they impose on the industry, regulation usually wins. This creates a huge in-built bias to regulate.

In an attempt to counter-balance this pro-regulatory bias, Australia now requires the costs and benefits of any such regulatory intervention to be evaluated through a regulatory impact statement (RIS).

Let us look at an example of the RIS done by APRA in its analysis of the impact of the Basel III regulations.<sup>3</sup> APRA conducted a review of its own proposals to change the following prudential and reporting standards: *Prudential standards – APS 110 Capital Adequacy; APS 111 Capital Adequacy: Measurement of Capital; APS 112 Capital Adequacy: Standardised Approach to Credit Risk; APS 113 Capital Adequacy: Internal Ratings Based Approach to Credit Risk; APS 116 Capital Adequacy: Market Risk; 117 Capital Adequacy: Interest Rate Risk in the Banking Book; APS 120 Securitisation; APS 330 Capital Adequacy and APS330 Public Disclosure of Prudential Information and a new reporting standard, Reporting Standard ARS 111 Fair Values*. It also made minor changes to many other prudential and reporting standards.

APRA made no attempt to quantify either the benefits or the compliance costs of the regulations: “APRA does not expect that Authorised Deposit-taking Institutions (ADIs) would incur materially higher compliance costs under APRA’s Basel III proposals (than under Basel II)”. It did refer to some work done by public agencies offshore about the impact on



“It is possible that APRA was correct and the big increase in bank spending is because of factors other than implementing Basel III but it is difficult to accept the assertion that the incremental costs were not ‘materially higher’.”



borrowers without pointing out that those estimates had been hotly disputed by the industry. APRA also decided to advance the timing of implementation without any analysis on the benefits and costs of doing so.

Not everybody agrees with APRA's view on costs. Andrew Haldane of the Bank of England put the costs of implementing the Basel III requirements much higher:

“In Europe, the cost of implementing Basel III is estimated at over 70,000 full-time private sector jobs ... In the US, the cost of Dodd-Frank is estimated at tens of thousands of jobs. As these resources might otherwise have been profitably deployed in other industries, these are deadweight opportunity costs borne by society.”<sup>4</sup>

We can also see from Figure 1 that the CBA is spending about \$150m more per year in increased investment in compliance and risk systems than it was a decade ago, and while the available time series is not as long for the NAB it too seems to have increased investment by a similar amount. Across the system investment in compliance is probably above \$500m per year and cumulatively the banks will spend an extra \$2b more on something APRA

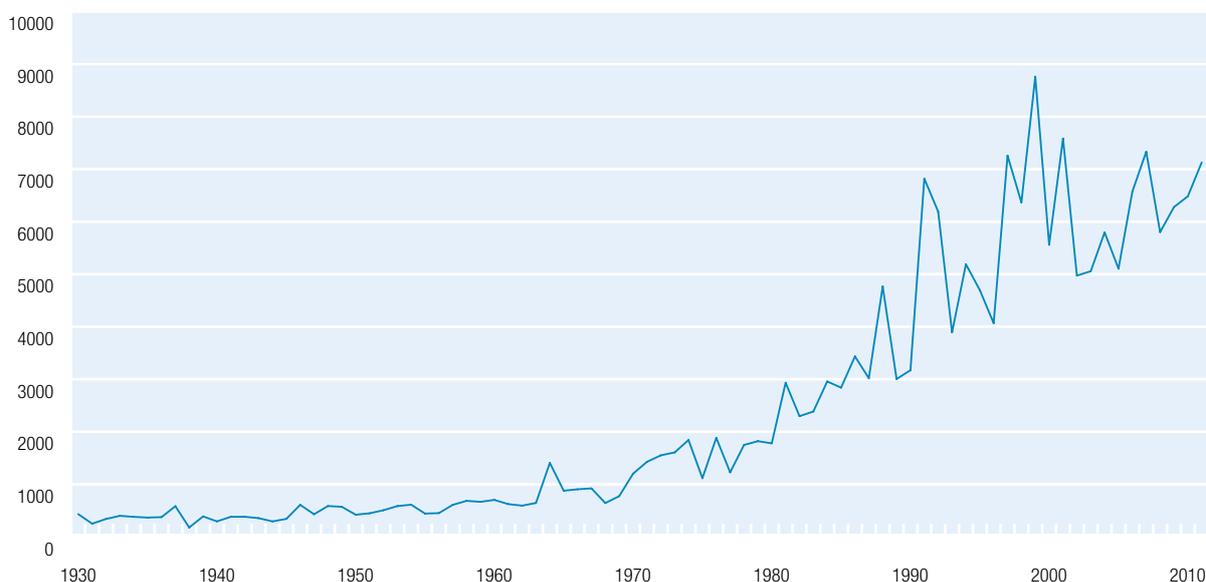
suggested was not likely to be “materially higher”. It is possible that APRA was correct and the big increase in bank spending is because of factors other than implementing Basel III but it is difficult to accept the assertion that the incremental costs were not “materially higher”.

There seem to be two lessons:

- It is a bad idea to allow a regulator to do an impact statement on a regulation it is proposing – there is a fundamental conflict of interest; and
- It is essential to have sensible cost and benefit estimates of regulatory changes.

APRA is not alone in these failings. The Government's own inquiry into the RIS process found that “there is a vast gap between what the Regulatory Impact Assessment (RIA) Framework requires and the practices too often followed at the Commonwealth level of government”<sup>5</sup>. The Productivity Commission in its review of red tape found that only 10 per cent of Commonwealth Government RISs had extensive quantification and that 60 per cent had none at all. Only Victoria appeared to take the process seriously with some 50 per cent of RISs involving a proper costing.<sup>6</sup>

**Figure 3**  
Pages of new legislation introduced by Australian governments



Source: Novak, J (2013) "Australia's big government, by the numbers", *Institute of Public Affairs*  
[http://www.ipa.org.au/library/publication/1367829888\\_document\\_paper\\_-\\_australias\\_big\\_government\\_-\\_may\\_2013.pdf](http://www.ipa.org.au/library/publication/1367829888_document_paper_-_australias_big_government_-_may_2013.pdf)

At the Australian Government level there are about 109 regulators or regulatory functions that operate to enforce or oversee regulations; some big like the Australian Taxation Office, down to the relatively small regulators with a specific focus. Nationally there are some 1400 regulators. It is little wonder that red tape envelops us like Einstein's Egyptian mummy.

So essentially, the control process has failed. Governments, notably the Federal Government which has responsibility for most financial sector regulation appears to pay little attention to the whole RIS process.

### The need to encourage natural predators

There is an underlying structural bias to increase regulation and red tape more generally. By the Business Council of Australia's count the Federal Parliament produced 6000 pages of new rules each year for the last decade.<sup>7</sup> This builds on a strong long term trend for all governments as is clear from the below graph. So while ANZ Chief Executive Officer, Mike Smith once famously asserted that "regulators have no natural predators"<sup>8</sup>, parliaments are as much a part of the problem as regulators.

Almost every government that gets elected comes with a promise to reduce red tape. We have also introduced regulatory hurdles in the form of requiring RISs. Despite this, red tape grows in an uncontrolled way.

Clearly what is required is to develop a set of "natural predators" on red tape in government. One solution would be to subject all regulators and government departments to a periodic red tape audit, one which looks at their performance over the previous five years, and which would have bearing on the performance of public sector managers. These reviews should involve extensive engagement with the parties which are regulated.

The parties being regulated are the natural predators of red tape, what we need is a process to give them a voice.

*The views in this article are those of the author and should not be attributed otherwise.*

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## Endnotes

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# acknowledgements

CEDA would like to acknowledge the following members and individuals who have contributed to CEDA's general research fund between 1 January 2013 and 1 January 2014.

CEDA undertakes research with the objective of delivering independent, evidence-based policy to address critical economic issues and drive public debate and discussion. It could not complete its research agenda without the support of these contributions.

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QLD

AGL Energy  
 Arrow Energy  
 Bank of Queensland  
 Civil Contractors Federation  
 Energex  
 Ergon Energy  
 FA Pidgeon & Son  
 GHD  
 Hastings Deering Australia  
 Ian Davies  
 Ipswich City Council  
 Leyshon  
 Logan City Council  
 Lutheran Community Care  
 McCullough Robertson Lawyers  
 Morgans  
 National Australia Bank  
 New Hope Group  
 NOJA Power  
 Port of Brisbane  
 QIC  
 Queensland Competition Authority  
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 Queensland Motorways  
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Santos GLNG Project  
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SA

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 Adelaide Casino  
 Adelaide City Council  
 BDO  
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TAS

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VIC

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La Trobe University	Victorian Department of Transport, Planning and Local Infrastructure	Pilbara Development Commission
Lanier Australia		Public Sector Commission
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Monsanto	WA	WA Department of Regional Development
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Open Universities Australia	ATCO Australia	WA Department of Water
Oppeus International	Australian Bureau of Statistics	Wesfarmers
Oracle Corporation Australia	Bankwest	Western Australian Treasury Corporation
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PwC Australia	City of Perth	
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