BREAKING THE AUSTRALIAN GREAT COMPLACENCY OF THE EARLY TWENTY FIRST CENTURY

Ross Garnaut
Professor of Economics
Research School of Pacific and Asian Studies
The Australian National University

Paper presented at the conference, "Sustaining Prosperity, New Reform Opportunities for Australia", 2005 Economic and Social Outlook Conference, Melbourne Institute and *The Australian*, Melbourne, 31 March, 2005.

BREAKING THE AUSTRALIAN GREAT COMPLACENCY OF THE EARLY TWENTY FIRST CENTURY[1]

I. The Great Complacency

The first Australian-Melbourne Institute conference, three years ago, was to a considerable extent premised on the favourable outcomes of a period of sustained economic reform in Australia. Australia after the 1990-91 recession had experienced stronger growth in output than any other advanced economy—after trailing its peers through the preceeding nine decades of the twentieth century. This had established a base from which Australians could reasonably aspire to continued productivity-raising economic reform and strong economic growth, alongside equitable income distribution. We talked about hard heads and soft hearts, which were concerned with combining economic efficiency with equitable distribution of the fruits of growth. I noted in my opening address to the conference that Australia through the early twenty first century was likely to experience all three of continued economic reform, equitable distribution and strong economic growth, or none of them. [2]

In March 2005, Australia is in serious danger of getting none of them. Output growth over the year to the December quarter at 1.5% was close to the lowest of the developed countries. One year's data does not make a new trend, but analysis of the data confirms that there are grounds for concern. The slowdown was entirely on the side of supply capacity. Domestic demand, led by consumption on the back of the housing boom, was still rising rapidly. An exceptional proportion of the demand growth was being supplied by imports.

---

[1] I am grateful for Sam Hill for assistance in preparation of the charts, and for discussions with Sam, Warwick McKibbin and other colleagues at The Australian National University, Ian Macfarlane, David Vines, Max Corden and Don Stammer on the lines of economic analysis.

[2] See Peter Dawkins and Paul Kelly (eds), *Hard Heads, Soft Hearts; A New Reform Agenda for Australia*, Allen and Unwin, 2003 and Ross Garnaut, "Equity and Australian Development: Lessons from the First Century", in *The Australian Economic Review*, pp.227-243, Vol. 35, No. 3 September 2003.

The imbalance between growth in domestic demand and supply capacity was being reflected in shortages of labour, goods and services that threatened the re-ignition of inflation. It was being reflected in extraordinarily high current account deficits and rapidly increasing net external liabilities as a share of GDP, despite external circumstances that in the past had been associated with lower external deficits—exceptionally favourable export prices and terms of trade.

What went wrong? What is the remedy? And what are the prospects if Australia now takes corrective action?

The deterioration had its origin in a Great Complacency that descended upon the country after a decade of exceptional economic growth. As a community, we accepted the excellent economic performance as evidence that we had changed enough. Our community had never been comfortable with the application of professional economic analysis to policy choice—so-called "economic rationalism"— but for a while, from 1983 to the turn of the century, had been persuaded of its necessity. Now Australians had reverted to their traditional preference for having popular politics in command of resource allocation and economic policy-making. The links were forgotten between earlier economic reform and the contemporary prosperity.

Economic analysis was banished to the periphery of many areas of policy-making. Endorsement by business interests and economists hired to argue a case for politically preferred policies again became more important than transparent analysis in trade and industry policy and to some extent in fiscal policy. The exception was in monetary policy, where the reform era had left a legacy of independence at the Reserve Bank of Australia, which so far has not been endangered by an apparent recent re-politicisation of interest rate policy.

The return to traditional approaches to economic policy-making, favouring the ad hoc and expedient over the economically rational, has had broadly based support within the Australian polity and across the organised political spectrum. It is as evident in State as in Federal Government. The return to populism in economic policy-making has had bipartisan support at Federal level, with the Labor Party voting in favour of damaging decisions of the Coalition Government and in at least one area of policy promising to do worse.

Much remains from the reform era, to help in the rebuilding of support for economic policies that generate strong economic growth alongside equity. The most important legacy from the reform era is the recent reality, that a far-reaching program of economic reform can make a large difference. This is an advantage of the present over two decades ago, when leaders promoting productivity-raising reform had to argue against powerful and longstanding prejudice without the support of practical examples of benefits.

Most of the transformative policy changes of the reform era have remained intact, although backsliding in some areas of public finance and trade policy will turn out to be costly. In most areas of policy, the problem is that the reforms stalled before they had gone far enough to deliver their full benefit. For these, the problem of the Great Complacency is that opportunities have been lost when highly favourable circumstances had been established for them—for example on taxation and social security reform. In a few areas of policy, there has been continued improvement despite the complacency, strengthening the opportunity for restoration of strong economic performance. Here the outstanding example is the large and continuing expansion of the skills component of the immigration programme.

The first step towards restoration of reform and good national economic performance is to break the complacency. This must start with realisation of the extent of the deterioration in our economic outlook. My contributions to the public debate on macro-economic policy through 2004, culminating in the Melville Lecture at The Australian National University on December 3, were meant to help that step. Over recent months the Reserve Bank of Australia and the Treasury have added their warning messages, and this has contributed to a significant change in public mood on the economy. The change has been accelerated by the publication of new data in March 2005 on real output and the external accounts, and by some monetary tightening by the Reserve Bank.

The second part of this paper updates the Melville Lecture, noting that new data confirm the cautions embodied in that earlier statement.

The second step towards restoration of reform and good national economic performance is to build community confidence that a new programme of bold reform has reasonable prospects of restoring strong economic growth. This requires a return to bold and comprehensive discussion of reform, of the kind that laid the basis for policy change in the 1980s. Optimal policies will be found on territory that is taboo to the professional political advisers to our major political parties. The political advisers will argue for the incremental adjustment that has been electorally so successful over the past four years—as they argued for caution in the early years of reform. The case for major change will have to be made by independent analysts who derive their authority from their professional standing. Regrettably, Australia is less well endowed with authoritative, independent public sources of analysis than it was in the early stages of the reform era. It is important that the contemporary weakness be corrected—including through the maintenance and development of fora like this.

The third part of the paper updates some perspectives presented in a paper that I prepared for the Business Council of Australia in the years before the reform era was replaced by the Great Complacency. It focusses on one of the two areas that are potentially most productive in expanding growth opportunities in the years ahead, in which policy developments over recent years have reduced incentives to efficient resource allocation, that is, on taxation and social security reform. The fourth part of the paper focuses on issues in the relationship between State and Commonwealth Governments. Reform of taxation and social security is crucial to more effective utilisation of Australia's labour including skill resources. Reform of Federal relations is at the heart of any efforts to raise effectiveness of education and training, and provision of infrastructure.

The focus on two critical issues is not meant to suggest that other areas of reform are unimportant. An effective reform program in the early twenty first century, as in the late twentieth century, will utilise a large range of opportunities to raise productivity, expand the resource base of the economy, and raise rates of growth. But tax and welfare and Commonwealth-State relations would be at the centre of any contemporary reform programme.

The paper concludes with discussion of the timing of reform measures. Productive reform of tax and welfare, training and education and infrastructure would be facilitated by utilisation of the large fiscal surpluses expected for the immediate future, especially as the recent and prospective increases in terms of trade flow through into Commonwealth and State revenues. This has become an element in discussion of tax reform in particular. But the current imbalances in the economy, and concerns about the temporary nature of part of the improvement in the terms of trade, argue for larger short-term fiscal surpluses. If effective reform is to proceed alongside the maintenance of economic stability, itself essential for strong long-term growth, the ground must be prepared now for fundamental change. But any drawing down of fiscal surpluses to facilitate structural reform should be delayed until the weakening of demand eases inflationary pressure over the one or two years ahead.

II. The Imbalances Threatening Economic Stability

The Melville Lecture presented a large amount of data to demonstrate the similarity of the boom in domestic expenditure in recent years to the debt-funded expansions of domestic demand that had preceded a number of earlier recessionary episodes in Australia. The audience and the reader were invited to note the comparisons between macro-economic developments from the December quarter of 1998 to the present, with those in the quarters from December 1984 through to and beyond the onset of recession in 1990.

There are, of course, differences between the two periods. One is the much stronger financial system in the early twenty first century. The professional weakness of Australian financial institutions after deregulation in the mid-eighties left them vulnerable to shocks, and their responses magnified the large shock to demand that followed the extreme tightening of monetary policy in the late eighties. The monetary authorities are unlikely to repeat the error of excessive contraction that precipitated recession in 1990. The early twenty first century boom in domestic demand has been concentrated much more intensely in a single sector, housing, than the earlier debt-funded boom, and had a much smaller component of general business investment. This raises some special challenges to demand management.

The following nine charts update the data presented in December. Mostly the additions confirm the similarities between the two periods covered in the charts.

Chart 1 allows comparison of real GDP growth in the 25 quarters leading to the present, with the comparable expansion in the late eighties.

Chart 2, read with other data, reveals that domestic demand contraction led the decline in GDP in the earlier episode, but not in the early twenty first century.

The recent decline in real growth is entirely the result of the economy running into capacity constraints.

The capacity constraints in the early twenty first century have caused continuing strong domestic demand growth to be manifested in a large, sustained negative contribution of net exports to output (Chart 3). In the late eighties and early nineties, the period of extreme negative contributions from net exports was brief, before the reduction in domestic demand and depreciation of the real exchange rate induced rapid correction.

The trade and current account deficits as a share of GDP in the early twenty first century have turned more strongly negative for longer than in the late eighties—indeed, than ever since national accounts have been maintained in a comparable form (Charts 4 and 5). In the absence of substantial correction through monetary policy, the deficits continued to grow in the December quarter. There is debate about the conditions under which deficits on this scale might be sustainable. What is broadly agreed is that Australia now faces risks that would be realised suddenly and with recessionary consequences if there were a significant deterioration in external business conditions while the external accounts remain in their present states.

One exceptional feature of the current account deficit is that it is so large at a time when international interest rates remain low by historical standards. Australia's net external liabilities (Chart 6) and net external debt are far higher in proportion to GDP than they were when they were the subject of considerable domestic concern in the late eighties. The size of the current account deficit ensures that the ratios will grow beyond the levels of December 2004. The burden of servicing the dominant debt component of these external liabilities will become increasingly burdensome with the movement of international (and, less dramatically, Australian) interest rates towards more normal levels. The failure to anticipate the effect of rising global interest rates on the cost of servicing external debt contributed to the market surprise on the release of current account data in the September and December quarters of 2004.

A second surprising feature of the current account deficit is that it has reached the recent depths despite terms of trade that are extraordinarily high (Chart 7). The high export prices that have been the dominant element in the recent lift in terms of trade are correctly attributed to the strength of Chinese demand for energy and metals at a time of reasonably strong global economic growth. They are vulnerable to correction, either with any setback to Chinese economic growth (and we would be prudent to expect China, like all market economies, to have cyclical downturns from time to time), or in other major economies.

One special feature of the recent lift in the terms of trade is its concentration in the prices of mineral products. The fiscal arrangements for these products taken together generate for the State and Federal public revenues a high proportion—approaching one half—of the gross increase in export revenues from high prices. Thus, high export prices alone, above long-term average levels in real terms, will soon be contributing more than two percentage points of GDP to the public revenues. Prudence argues for this windfall to be saved in fiscal surpluses, at least until there are grounds for presuming the sustainability of the higher export prices. This makes the recent surpluses in public budgets seem far too low in the context of the stabilisation requirements, at a time of booming domestic demand (Chart 8).

Capacity constraints and associated competitiveness problems have contributed to a sharp deceleration of export growth since 2000 (Chart 9a). Explanations have been sort for this poor performance in the international slump of 2001-2002, following the US " tech-wreck"—but this does not acknowledge the reality of continued buoyant import growth in Australia's major markets in Asia through this period. Explanations have been sought in the drought that was at its depths in 2002, and the SARS epidemic (affecting trade in services) of 2003. But the weakness extends across all categories of exports over the past four years (Chart 9b), and in time beyond the effects of drought and SARS. Explanations are sometimes sought in the high exchange rate of recent times—but the real effective rate is currently short of its highs from the time of floating the dollar, and the weak export performance began when the exchange rate was exceptionally low.

The weak growth in export volumes since 2000, after 15 years of strong and diversified growth (Charts 9a and 9b) were early warnings of the emerging imbalances in the Australian economy. That it took so long for the imbalances to become a subject of public concern speaks eloquently of the complacency of recent years.

III. Raising Growth Capacity: Labour Supply

The growth in the productive capacity of the economy depends on the rates of growth in productivity, the employed labour supply, and the capital stock. Each of these contributed to the exceptional growth in the Australian economy through the 1990s to 2003, although the concentration of investment in housing limited its impact on output growth.

In the absence of a return to far-reaching reform, labour supply and productivity growth are unlikely to make comparable contributions in the period ahead.

Real labour productivity has fallen sharply as capacity constraints have interrupted the supply of a range of necessary inputs to production (Chart 10). The amount of labour employed has expanded steadily through the period of strong growth. Unemployment has fallen steadily and participation rates have increased. But limits on expansion of labour supply are approaching, at a time when the proportion of the Australian population in employment remains well below comparable countries.

The recent Australian discussion of labour and skill shortages has focussed usefully on immigration, training, and incentives to greater labour force participation by the Australian population.

Higher levels of skilled migration would be helpful to Australian growth and to the standards of living of established Australians. However, the lead-times to significant expansion of the immigration programme are considerable, and the economic effects long-lasting. Attempts at cyclical variation in the migration levels to mesh with short-term macro-economic conditions are likely to be destabilising. The economic contributions would be more favourable if skilled immigration levels were set at higher levels on a long-term basis, and the programme held steady through the business cycle.

The emigration of young, talented and well-educated Australians—the "brain drain"—has accelerated in recent years (Fullilove and Flutter, 2004), and is now a significant contributor to supply constraints within the Australian economy. High tax rates—augmented for recent graduates by HECS obligations, which are avoided or postponed by residence abroad—are one factor influencing decisions to leave, and, more powerfully, decisions on whether to return to, Australia.

For a number of years, if favourable incentive structures were established, the most important source of expanded labour supply could be higher labour force participation and higher rates of employment from the resident Australian population.

Charts 11 and 12 indicate the potential for expansion of domestic labour supply from greater participation of the established population. The ratio of employment to population in Australia was once much higher than in either the United States or New Zealand (Chart 11). It is now lower, after 14 years of strong economic growth unbroken by recession. The United States at the end of its long boom of the 1990s, in 2000, had much higher employment rates than Australia after an even stronger boom, although US employment fell in the 2001-2 recession and by 2003 had yet to recover to earlier levels. The New Zealand ratio had moved decisively ahead of Australia by 2003, although Australia had a stronger record of economic growth. The share of part-time in total employment was similar in Australia and the United States in 1980. By 1980, much more than 100 per cent of the growth in the employment to population ratio in Australia was part-time, whereas in the United States part-time and full-time employment grew at similar rates (Chart 12).

Why have Australian employment rates fallen so much relative to two countries which are similar in many ways that affect labour market behaviour? The answer lies in the different and changing incentive structures for labour force participation and employment of labour. Australian legal minimum relative to other wages are much higher than American or New Zealand (Chart 13). And the effective marginal taxation rates created through interaction of the social security and income taxation systems are much higher in Australia, diminishing incentives to labour force participation (OECD, 2005).

The other side of the coin is that Australia makes better provision for the needs of people who are in a weak position to earn high incomes in the market. As Prime Minister Howard has recently observed, the high minimum wages and generous provision for social security—both extended considerably over the past decade of Coalition Government─have deep roots in Australian social preferences, and will not be diminished lightly.

The most important reform task at present is to improve the trade-off between generous provision for the disadvantaged and economic efficiency. To fail in this task will lead to continued economic underperformance as well as poor outcomes on employment and equitable distribution.

These matters have been discussed at length at this conference on two earlier occasions. The capacity constraints in the economy and the considerable extension of the social security system over the past several years make the issue more important than ever.

The most urgent task is to reduce considerably the effective marginal tax rates for social security recipients, the high levels of which contribute to relatively low labour force participation and high levels of part-time employment. High taxation rates are also significant elements in labour force participation, and attraction and retention of skilled personnel, at higher levels, and probably at all but the highest levels, of the incomes range.

At the highest levels of incomes, personal income tax rates tend to be relatively unimportant in determining levels of taxation. Current taxation treatment of corporate income and capital gains provide opportunities for high income earners to convert most of their potential personal income into forms that attract taxation at rates at or in most cases below 30 percent.

A reform of taxation rates that established a flat 30 percent marginal effective tax rate for all corporate and personal income, including capital gains, would be most advantageous for people at the bottom of the income range, and most disadvantageous for Australians on the highest incomes and with the greatest wealth. Contrary to popular perception, it would be progressive, as well as being highly advantageous to incentives for greater labour force participation within Australia. It would have the additional advantage of removing the gains from conversion of personal into corporate income, which is at the origin of much of the complexity and perception of unfairness in the current taxation system. The raising of the rate of taxation on capital gains (and it would need to be on real rather than nominal gains), would have the incidental effect of greatly reducing the distortions in capital allocation that have spurred the housing and associated consumption boom of recent years.

It would only be possible to establish uniform and moderate effective marginal tax rates throughout the income tax range within a version of a “negative income tax” arrangement, for which individuals would receive payments related to their objective circumstances and unrelated to income, for participation in the labour force (subject to “mutual obligation” tests), age, participation in formal education and training (independently of age), disability (calibrated for degree), and responsibility for dependent children. All payments would be subject to an assets test cutting in at considerable wealth, and would be withdrawn when income reached some high threshold.

The biggest beneficiaries, proportionately to current after-tax and after-social security income, would be Australians who were now on social security and who had some opportunity to work, and those on low incomes who currently fall outside Australia’s extensive social security framework. Losers would include people who were succeeding in converting large potential income into capital gains, and non-members of the labour force who were utilising the current tax-free threshold.

The large benefits to low-income workers would provide the context in which it would be feasible and reasonable for the Government to ask the Industrial Relations Commission to take taxation and social security arrangements and employment considerations into account in setting minimum wages, and to suggest a freeze on minimum wages for a number of years. Success in this effort, in combination with the taxation and social security reforms, would be likely to move Australian employment ratios back to and beyond those in comparable countries. Over a period of four or five years, this could raise total employment in terms of hours worked by 5 percent or more, and raise potential rates of economic growth considerably over this period. The expanded economic output and incomes would make a significant contribution to the financing of the taxation and social security reform.

Eight years ago in a paper for the Business Council of Australia I suggested a reform of the tax and social security systems along these lines. The proposal was built around reducing to 30 percent the effective marginal tax rate on all income, while preserving and augmenting incomes for low-income Australians (Garnaut 1997, reproduced in Garnaut 2001). Two versions of the "negative income tax" were discussed; a comprehensive version, where the basic payment would be made to all adult citizens who were not in receipt of another benefit; and the constrained version presented here, in which the basic payment was confined to members of the labour force, and subject to a "mutual obligation" test. The analysis at that time suggested that, within the constrained version of the reform, the top effective marginal tax rate would have been reduced to 36 percent by mid-2003 and to 30 percent by about mid-2005.

Some element or other of the Australian polity would find some part of the proposed reform completely unacceptable. The trade union movement would find the downward pressure on real minimum wages unacceptable. Parts of the business community would reject outright the return to taxing capital gains at the (albeit greatly reduced) income tax rate. No doubt citizens concerned with perceptions of equity would object to the reduction in notional tax rates on high incomes. Every Australian will be able to think of an alternative tax reform that is superior to the one proposed, because it gives more to her or him.

But while each element of the package is unacceptable to some influential group, it may be that the package as a whole is electorally attractive, because it removes a major impediment to continued strong economic growth in Australia, and is recognised as being broadly equitable.

It could be said that the time for introduction of such a system has passed. We have had our eight years of strong economic growth and extraordinarily rapid growth in government revenues. We now face less expansive times, and cannot so readily fund a major tax and social security reform from the fiscal dividends of growth.

But while it is true that a great opportunity has been lost through the years of strong growth, the opportunity has not gone away. I return to the funding issue in the final section of the paper.

IV. Raising Economic Growth: Infrastructure and Other State Services

The second critical and urgent area of reform is Commonwealth-State relations on fiscal matters and the regulation of economic activity. The recent discussion on infrastructure and on education and training as constraints on economic growth, has moved into issues of State responsibilities and Commonwealth-State relations.

The Australian constitution formally specifies a limited range of Commonwealth responsibilities, leaving other matters to the States. The High Court's interpretation of the constitution (most importantly in the second Uniform Income Taxation Case decision of 1957) has given the Commonwealth an overwhelmingly dominant role in revenue collection. The introduction of the GST and its replacement of several minor States taxes compounded the vertical taxation imbalance within the Federation.

The Commonwealth-State agreement on introduction of the GST has extended and entrenched a dysfunctional element of Federal fiscal relations—comprehensive fiscal equalisation through the Commonwealth Grants Commission.

The combination of Commonwealth domination of taxation powers and the use of conditional grants in more and more areas in which the States have constitutional responsibility has over time turned virtually all States powers into joint responsibilities. The resulting overlapping of responsibilities in the absence of effective coordination, has exacerbated the dilution of responsibility of State Governments for economic outcomes.

The dysfunctional Commonwealth-State fiscal relations and overlapping responsibilities contribute to poor management and funding of a wide range of services that are essential to continued strong economic growth. First amongst these are the provision of business infrastructure, and education and training.

The strongest short-term electoral gains for both State and Federal Governments lie in the deflection of public blame for imperfections in supply of services onto the other party. To solve the problems rather than deflect blame, would be more difficult and take time beyond the four or three year electoral cycle. As a result, in this even more than other areas of policy, it is essential that a strong base for productivity-raising reform is established in community opinion.

The Prime Minister has been reported recently as expressing the opinion that an optimal Australian governance system would not have States in their current form. He may well be right. He is certainly right in adding that the States are part of the Australian reality for the foreseeable future. There is no satisfactory alternative to making the Federal arrangements work efficiently.

An efficient system of Commonwealth-State relations in economic affairs would require an agreement on reallocation of responsibilities, leaving one or other level of Government unambiguously responsible for policy decisions wherever this is feasible. The clear-cut allocation of responsibility is generally more important for efficiency than the final location of powers between Commonwealth and State. Where decisions clearly have large national implications—as for example with regulation and funding of major infrastructure—it is more efficient for responsibility to lie with the Commonwealth. However, it is by no means clear that the national interest would be served by uniform industrial relations and wage regulation: there would be benefits from differentiated minimum wages, taking into account regional differences in living costs and supply and demand conditions. Australia would be more likely to have this differentiation within a decentralised than a uniform national system. Where responsibilities continue to be shared, as may be inevitable at least in some areas of education, health and aboriginal community development, it is important that a clear basis be agreed for cooperation between the Commonwealth and the States.

It is unlikely that a new definition of responsibilities can be agreed without revision of the system through which GST revenue is allocated, which is in itself the source of major deadweight costs (Garnaut and FitzGerald, 2003). It is likely that the macro-economic adjustment which is required in Australia in the period ahead will provide both motivation and opportunity for revision of the fiscal equalisation arrangements.

V. Financing Reform and Economic Stability

The resumption of bold, productivity-raising reform contains large potential for restoring economic growth to the levels enjoyed through the 13 years to late 2003. Australians in the recent past have demonstrated an ability to embrace change on the scale that is required.

Part of the challenge of reform is to integrate the timetable of design and implementation of policy change with the budgetary requirements of stable economic growth.

Some important reforms, for example in Federal-State financial relations, are in their essence institutional, and can be commenced without net calls on budget surpluses.

On the other hand, the budgetary costs of fundamental tax and welfare reform are considerable. Significant room could be made for commencement of reform by reducing government expenditure in the many areas where increases in recent years have contributed relatively little to either equity or to economic efficiency.

It is tempting to see the substantial current fiscal surpluses—soon to become larger still as the effects of higher minerals and energy prices flow through into public revenues—as an opportunity for making additional early progress in cutting some tax rates. Ultimately the current and prospective fiscal surpluses can make important contributions to funding the tax reform. But not yet.

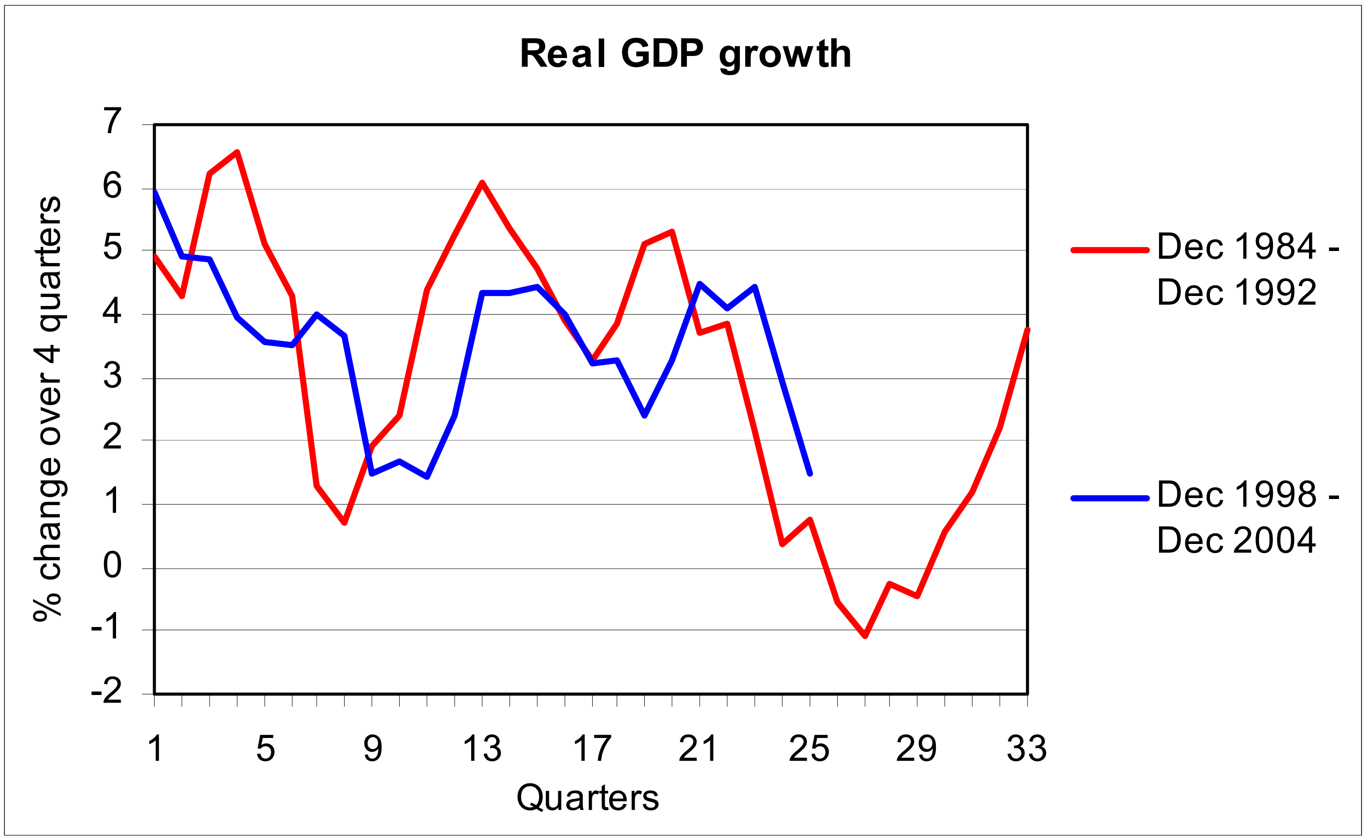
The contemporary supply constraints on Australian economic growth are tight. The Reserve Bank of Australia has emphasised in recent statements that domestic demand is running well ahead of those constraints. Any delay in reducing demand to levels within those constraints will be reflected not in higher growth, but in increased inflationary pressure. The greater the increase in Government spending or reduction in tax revenue in the period ahead, the larger the requirement further to tighten monetary policy to contain that pressure.

It is always difficult to judge how much fiscal and monetary tightening is required to bring excessive demand expansion back within prudent limits. However, the extent of excess demand is currently so large that several more interest rate increases of similar dimension to that of early March may be required. Further to raise the requirement of monetary tightening through additional fiscal expansion at this time would increase the risk of recession. Recession would be damaging for all of long-term reform, long-term growth and equity.

It is much better to save the growing budget surpluses until the growth in demand has fallen back below the growth in productive capacity. By then we will have a clearer view of the extent to which the recent improvements in the terms of trade can be expected to continue for a long period. By then, there will be scope for some fiscal stimulus, helping to finance taxation and social security reform in ways that are beneficial to stable economic growth.

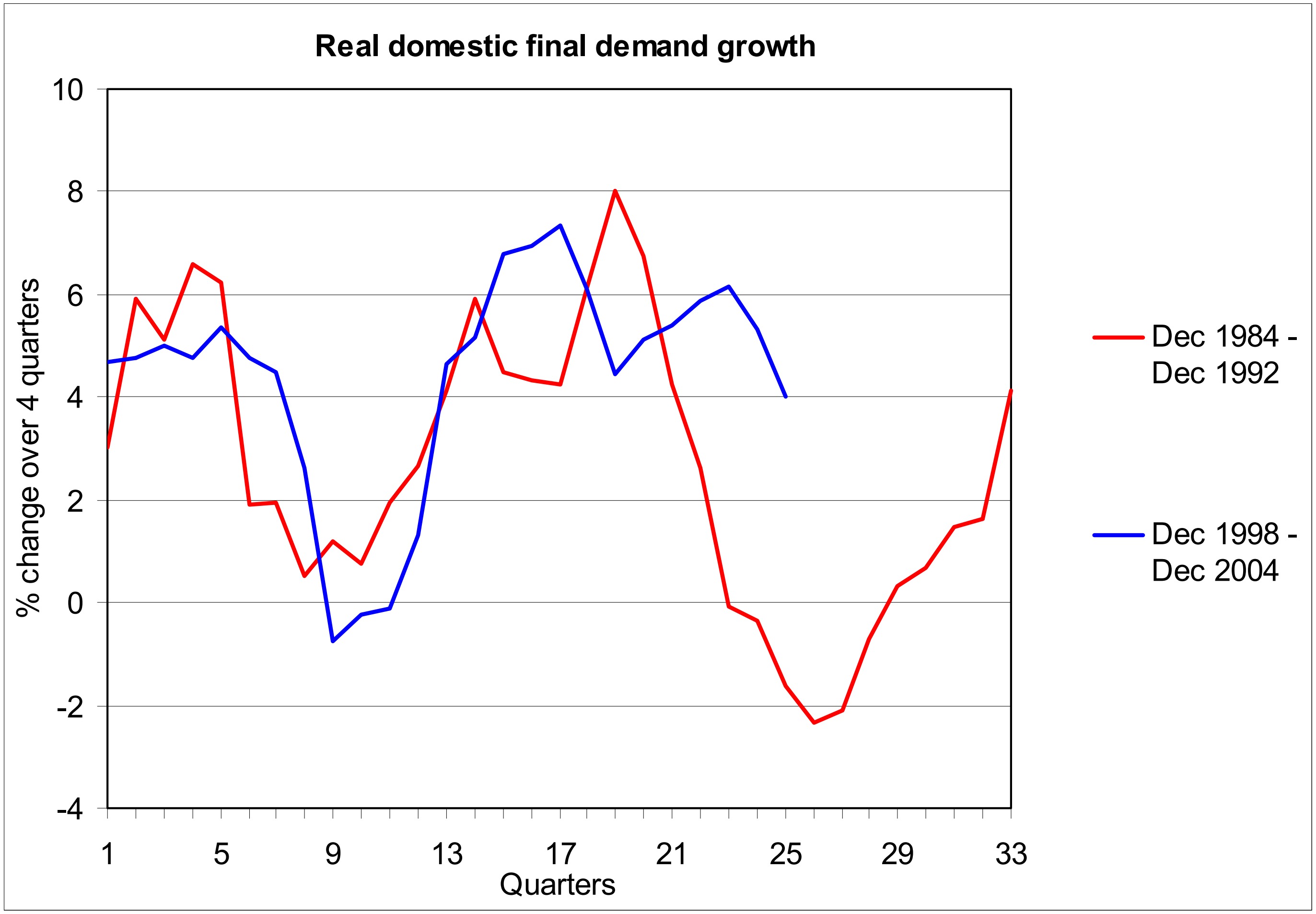
The most likely trajectory of the economy suggests that there will be room for a decisive step towards fundamental tax and social security reform within the life of the current Parliament. Or, if this new chance is missed, there will be an opportunity for an alternative Government to foreshadow reform early in the life of the next Parliament.

Chart 1



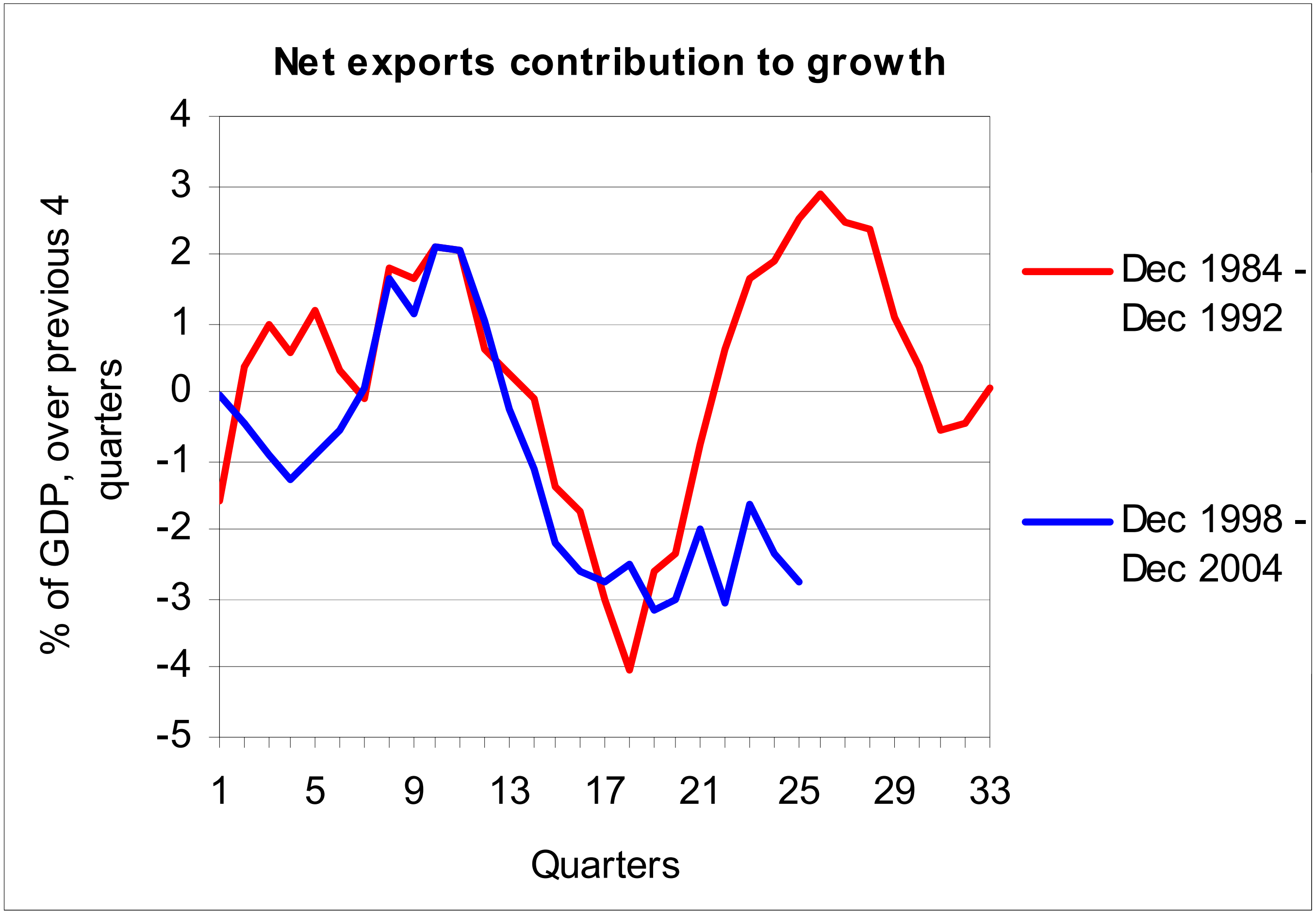
Source: RBA Bulletin database, ABS

Chart 2



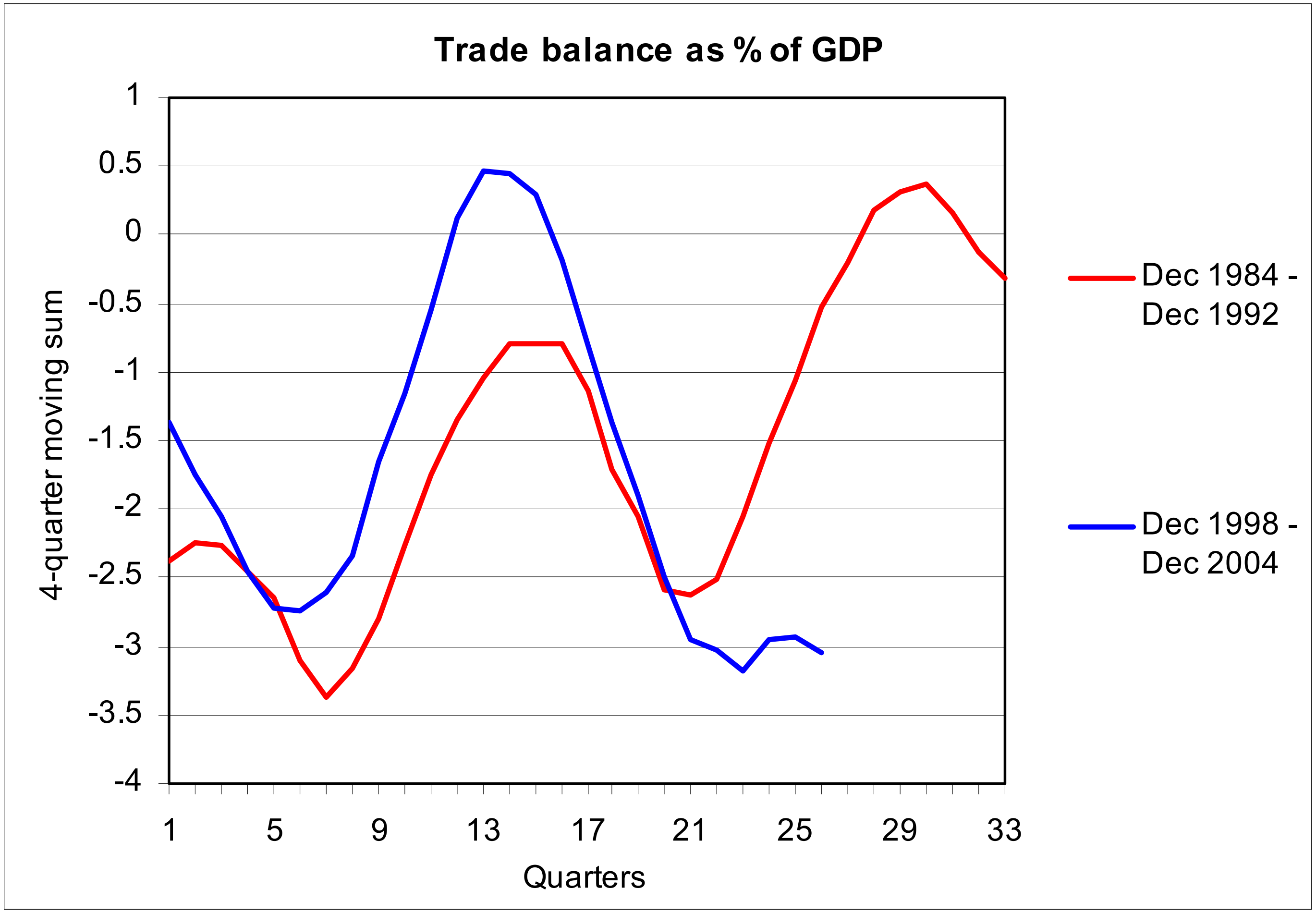
Source: RBA Bulletin database, ABS

Chart 3



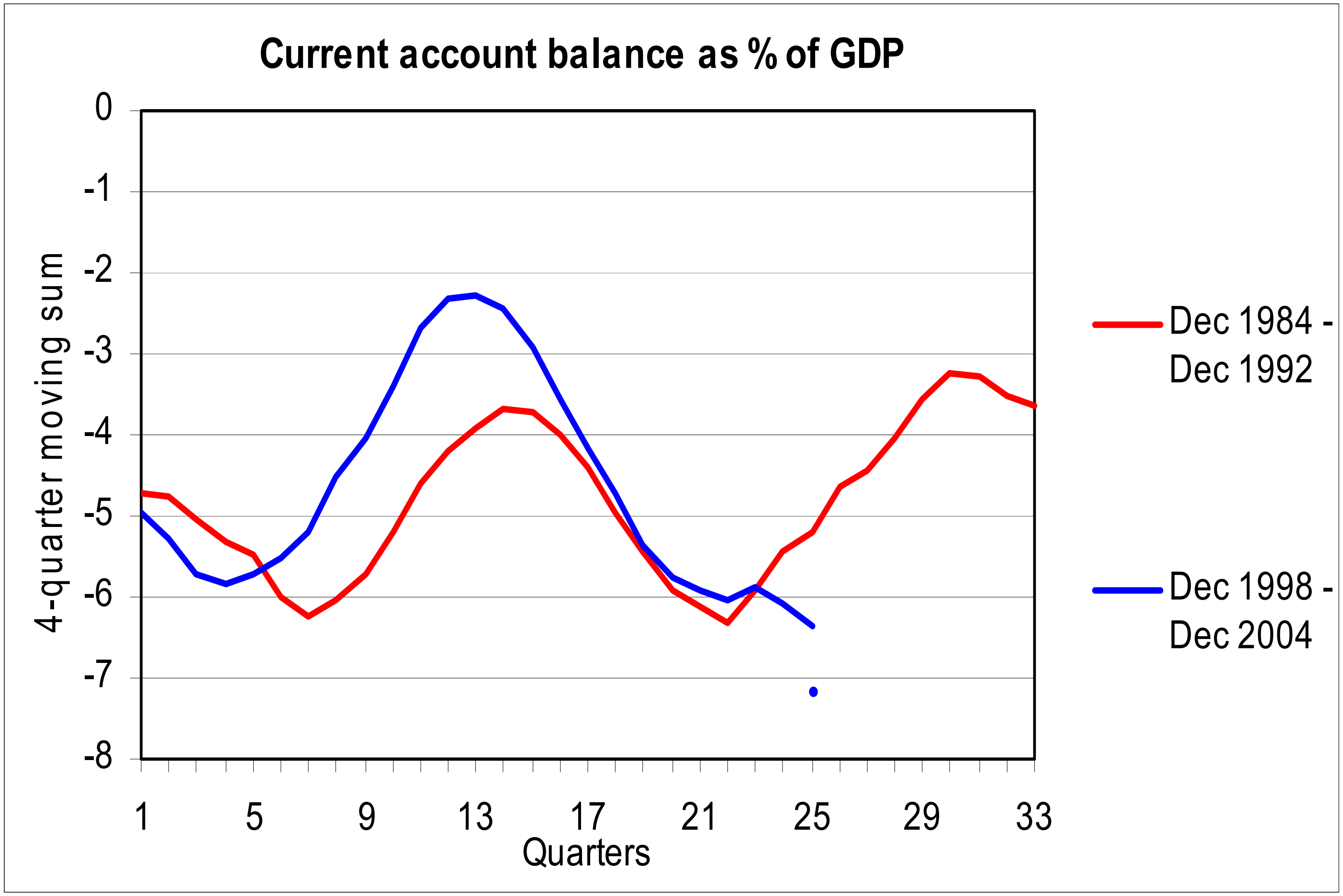
Source: RBA Bulletin database, ABS

Chart 4



Source: RBA Bulletin database, ABS

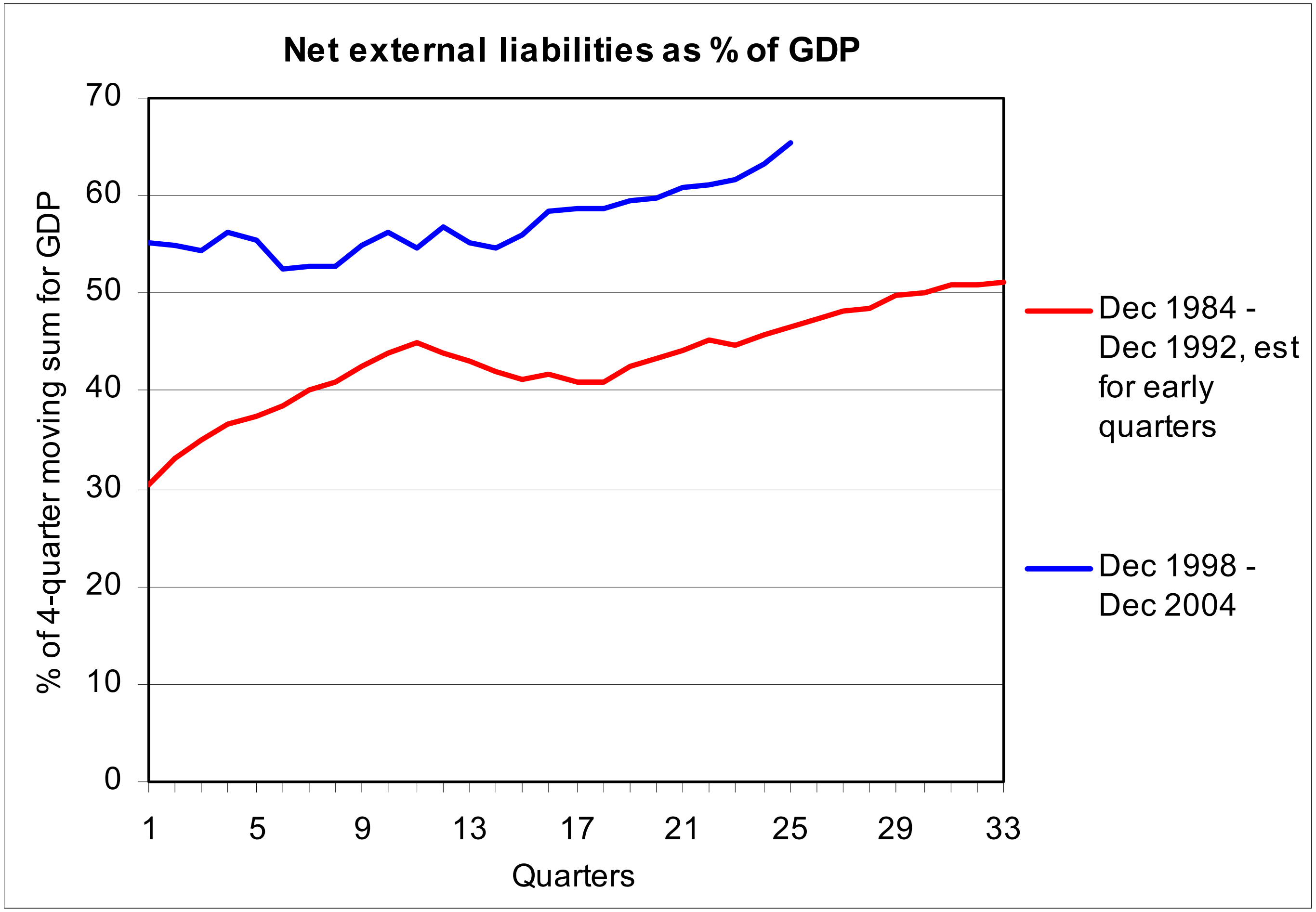
Chart 5



Note: bullet denotes December 2004 quarter

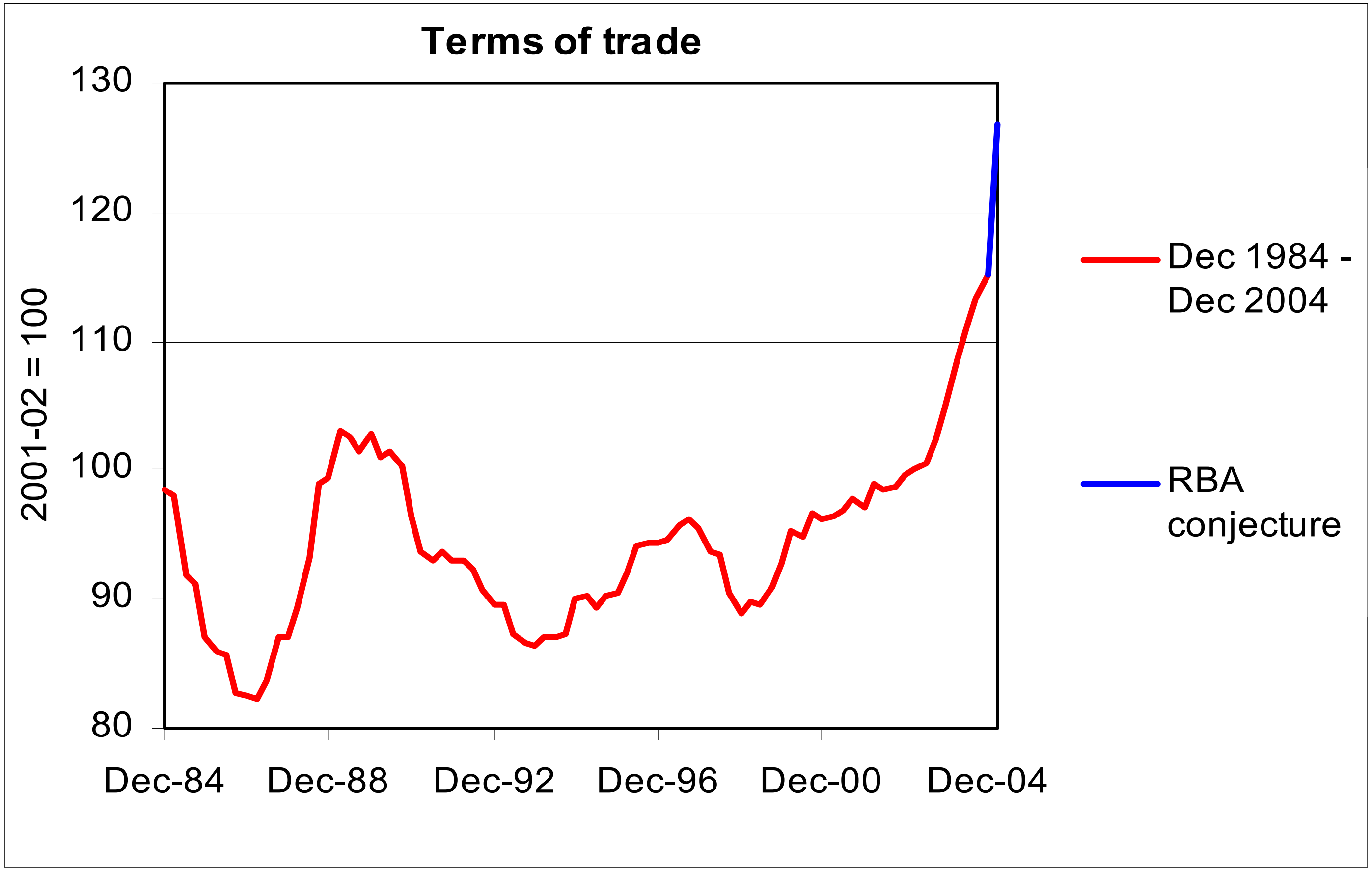
Source: RBA Bulletin database, ABS

Chart 6



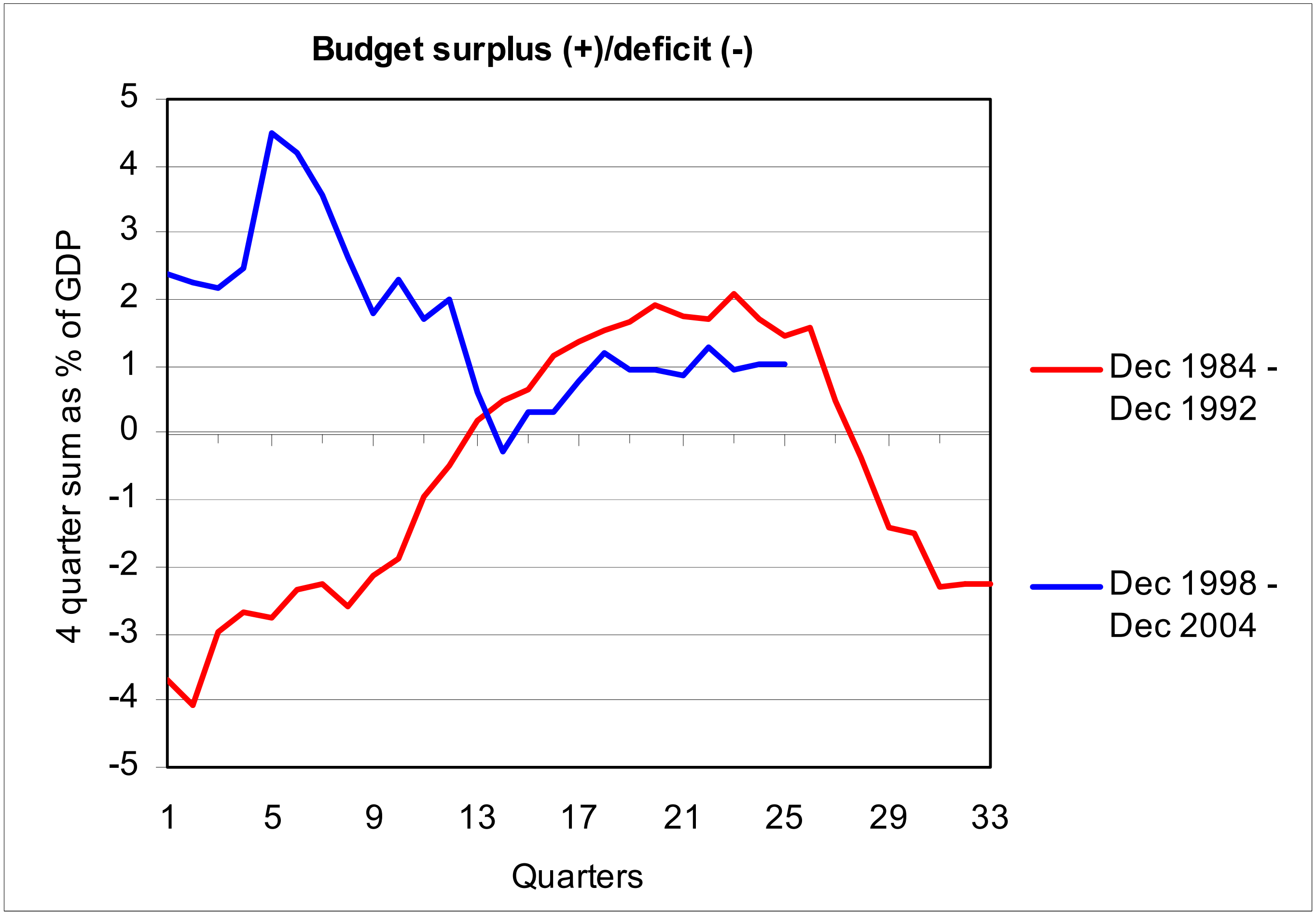
Source: RBA Bulletin database, ABS

Chart 7



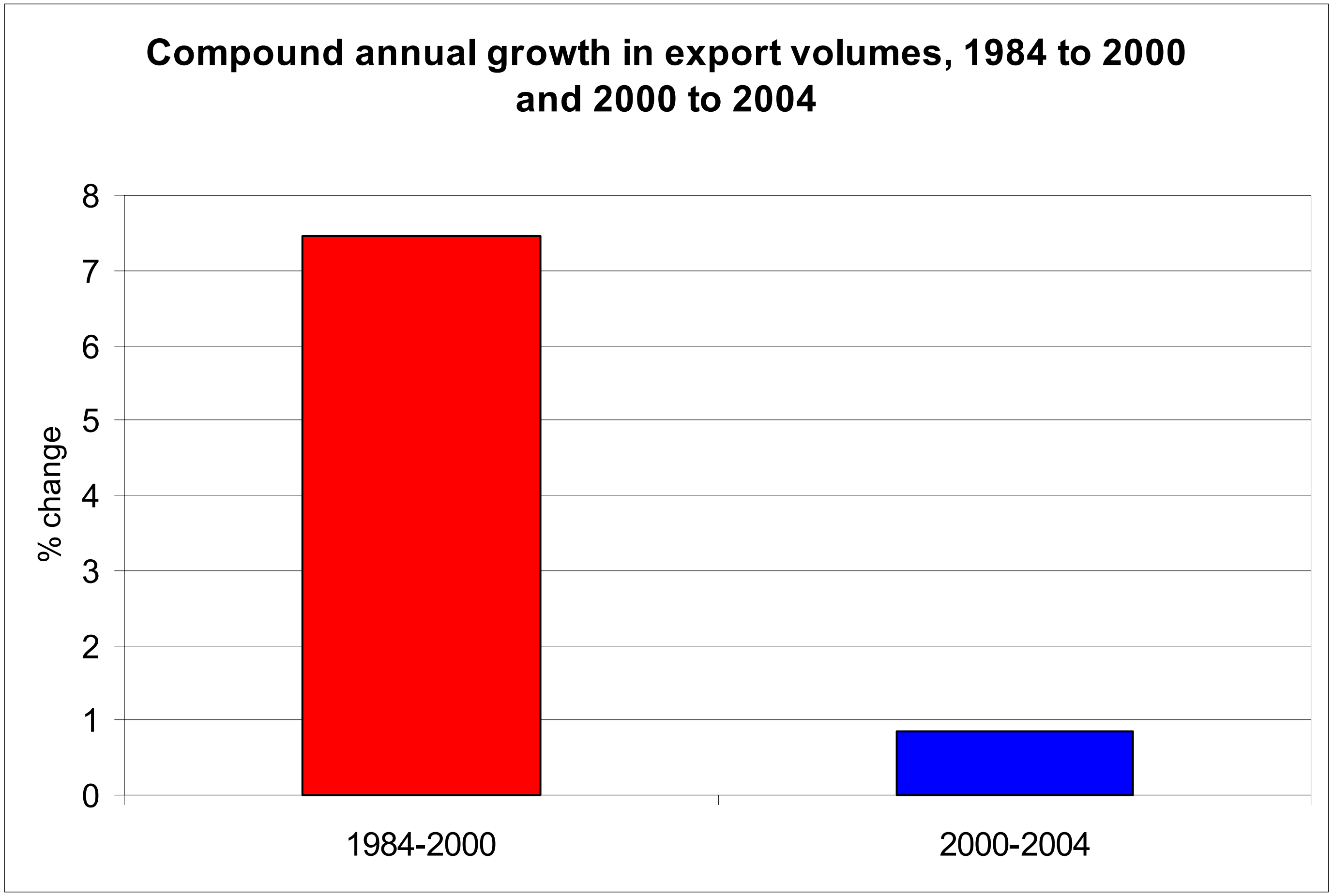
Source: RBA Bulletin database, ABS

Chart 8



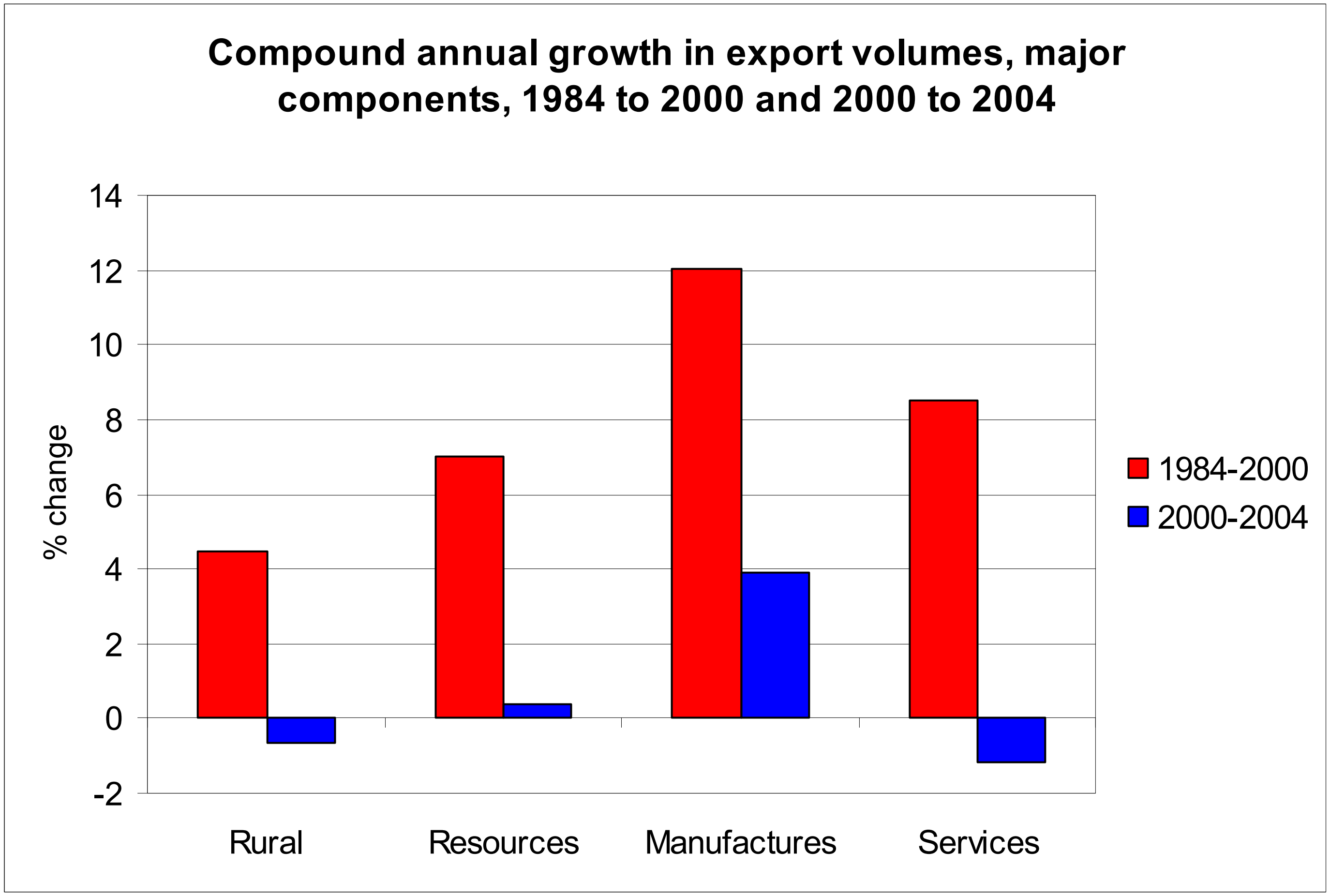
Source: RBA Bulletin database

Chart 9A



Source: RBA Bulletin database

Chart 9B



Source: RBA Bulletin database

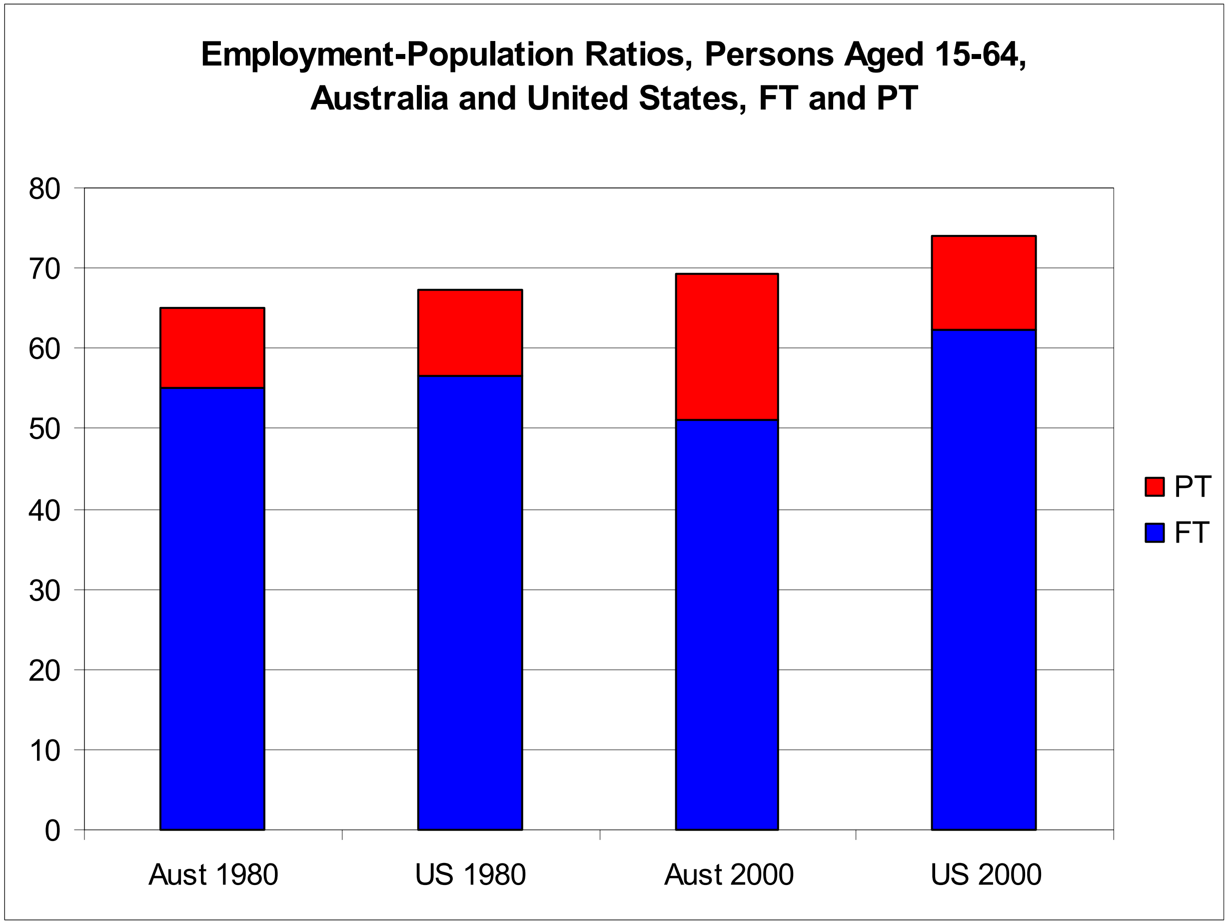
Chart 10

Source: ABS

Chart 11

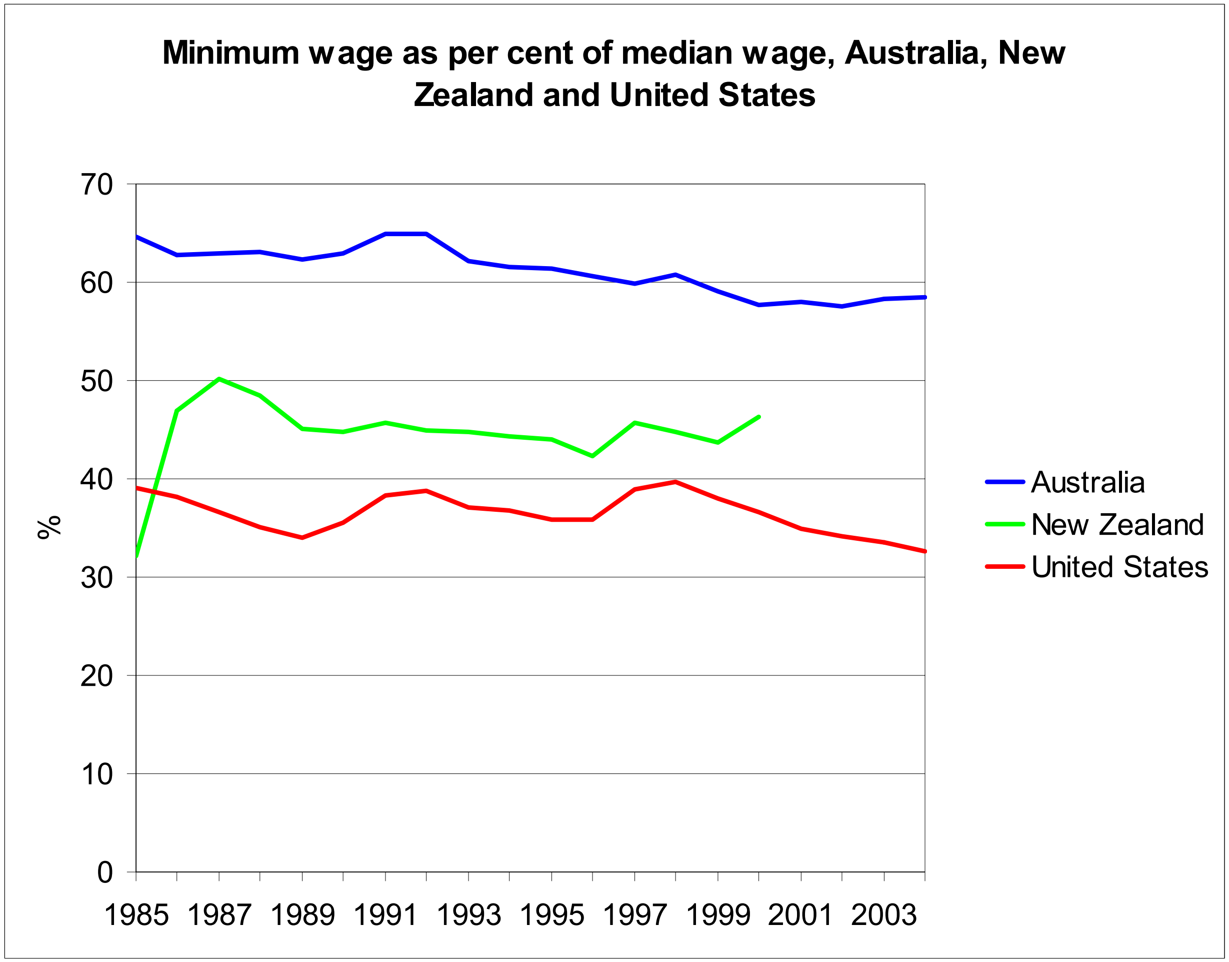
Source: OECD

Chart 12



Source: ABS, OECD

Chart 13



Note: Federal minimum wage applies for United States

Source: ABS, OECD, RBNZ, US Bureau of Labor Statistics