

STATEMENT 4: PROSPERITY AND SUSTAINABILITY

Australia's successful economic performance over the last decade provides a sound basis for future national prosperity if the right decisions are made for the future. Importantly, that performance also provides valuable experience to help us determine what policy measures need to be implemented to expand opportunities for all Australians.

Over the next 40 years the number of people over the age of 65 is projected to double. However the number of people of traditional working age will hardly increase. This presents a challenge to the sustainability of economic growth. The demand for greater availability and higher quality aged care, and the rising cost of health care – only partly due to population ageing – will put pressure also on fiscal sustainability. Those concerns and others, such as maintaining the environment, will become more pressing over time. Solutions will require longer planning horizons than have been employed in the past.

Policy choices will have little effect on the numbers of people of traditional working age. Solutions will therefore need to focus on facilitating further productivity improvements and increasing labour force participation for those of working age. This will involve some difficult tradeoffs.

The task will be made easier if there is widespread understanding of policy drivers and an environment where firms and individuals are able to respond positively to the opportunities that sound policy can create.

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This statement examines the evolution in policies and institutions most likely to contribute to further increases in Australia's prosperity and the wellbeing of all Australians over the medium to long term. Those same policies and institutions are also those most likely to enhance Australia's ability to deal with future economic shocks. While further policy evolution will not be easy, the cost of failing to do so would be significant.

Australia's very successful recent economic performance provides valuable insights into the types of decisions needed to enhance opportunity for all Australians, while providing a solid foundation for continued national prosperity.

Our continued prosperity relies on making better use of our natural, man-made and human resources. This is not a simple task and necessarily involves some difficult tradeoffs. Subjecting policies to the following tests will inform decision-making.

- Do they improve prospects of sustaining and improving the quality of our natural, man-made and human resources?
- Do they improve the prospects of public and private resources being used more productively?
- Do they promote participation in the paid and voluntary workforce?
- Do they make the economy more resilient and adaptable to possible shocks and challenges?
- Are they cost effective and sustainable in the long term, irrespective of whether their objective is achieved through taxation, expenditure or regulation?

MAINTAINING A STRONG ECONOMY

Over the past decade Australia has performed very well against the measures of income, wealth, human development and employment. This strong performance is based on a set of sound policies, institutions and investments that have enabled Australia to make better use of its resources.

The strength of the economic performance, and the Australian Government's sound fiscal position, present a unique opportunity to implement a cohesive policy agenda that will underpin strong economic growth now and over the decades to come.

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Just as the decisions of the past have created our prospects today, so too, the decisions made today and into the future will influence our long term prosperity and opportunity.

Those decisions will be taken against the background of population ageing, rising health and aged care costs, and threats to the quality of the natural environment that will challenge the sustainability of our recent impressive performance. Policy improvements implemented now can help to soften the downside risks of the future.

Realistic changes to rates of fertility and immigration would have little discernible impact on the rate at which the population is projected to age over the next half century. Therefore maintaining the per capita growth rates to which Australia has become accustomed will require ongoing improvements in productivity growth and labour force participation.

Strong, sustainable economic growth is needed to generate the public and private wealth to meet growing demands, not only to support the growing proportion of elderly people in the community, but also to fund increased expenditure on health care which will be driven not just by ageing but by technological improvements as well. Without strong, sustainable economic growth Australia would eventually be forced to adopt new or higher taxes to meet recurrent demands. High taxes and debt repayments would, in turn, act as a drag on economic growth.

The discussion in **Building on a strong foundation** focuses on the public and private decisions, and other domestic and international factors, that have produced the strong economic performance of the past decade or so. Policy has focused on improving the efficiency of the private sector and establishing a stable medium-term macroeconomic framework through a series of coordinated and complementary reforms. In combination, those policies have helped Australians benefit from favourable domestic and international influences and overcome adverse economic shocks such as global slowdowns.

The subsequent sections examine those policy reforms that, in light of the ageing population, are most likely to contribute to increased future prosperity. Such reforms could underpin productivity growth and increase levels of participation in both the paid and voluntary workforce.

As **Being more productive** discusses, that will require:

- further and ongoing improvement to infrastructure investment decisions;
- increasing competition through continued reform of domestic labour and product markets and enhanced international engagement;
- improving the cost-effectiveness of government;

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- avoiding unnecessary regulatory complexity; and
- taking better account of costs and benefits in decision-making, particularly in making sound decisions on the use and maintenance of the natural environment.

With the ageing of the population it will be important that more Australians be given the opportunity of **Improving participation and sharing Australia's prosperity** through policies that support participation in the labour force and society more generally. They include strengthening the capacity to participate through improved education and health, improving the balance of incentives to shift from welfare-to-work to avoid cycles of dependency, and enhancing the flexibility of working arrangements. Decisions to participate in paid or unpaid employment, and tradeoffs between work and leisure, are inherently personal ones. However, government policies can and do influence those choices.

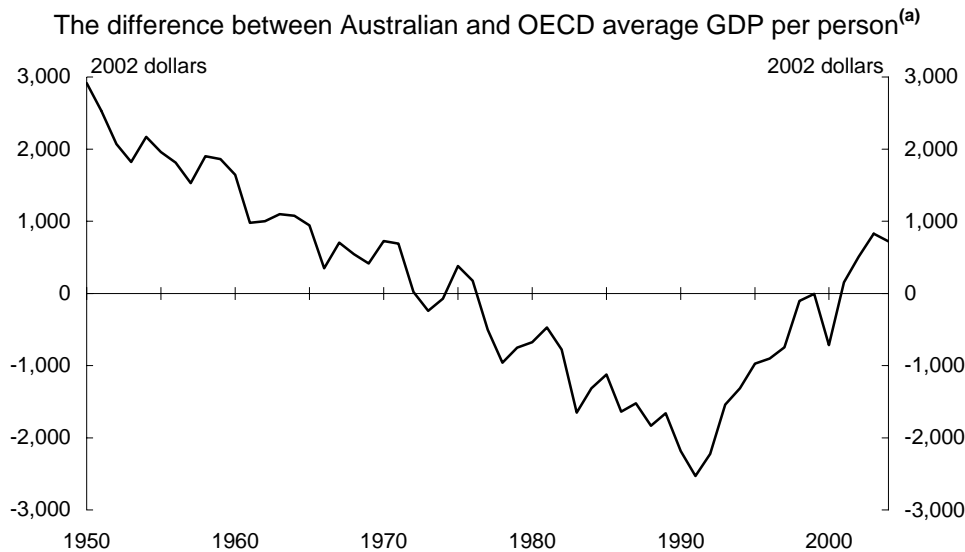
Australia does not face the public debt problems of many countries. However, we will face stark choices in the future if we do not act pre-emptively to address emerging fiscal pressures from an ageing population. This requires **Maintaining a disciplined approach to fiscal policy**, including new strategies that take a broader view of the Australian Government's balance sheet and address future pressures on the tax base.

BUILDING ON A STRONG FOUNDATION

Australia's recent economic performance is impressive, both compared with other developed countries and by historical standards. In the four decades from 1950, growth in GDP per person – one indicator of improvements in living standards – usually fell below the OECD average rate of growth. However, in the past decade or so Australia's performance has improved dramatically (Chart 1). GDP per person has grown much faster, on average, than in both the United States and the OECD, raising Australia from 18th highest GDP per person among OECD countries to 8th today.

This section highlights the main drivers of Australia's new prosperity and discusses the ways in which Australians have benefited.

Chart 1: Australia's economic revival



(a) OECD data are for the 24 longest standing OECD member countries.

Source: Groningen Growth and Development Centre and The Conference Board (2005).

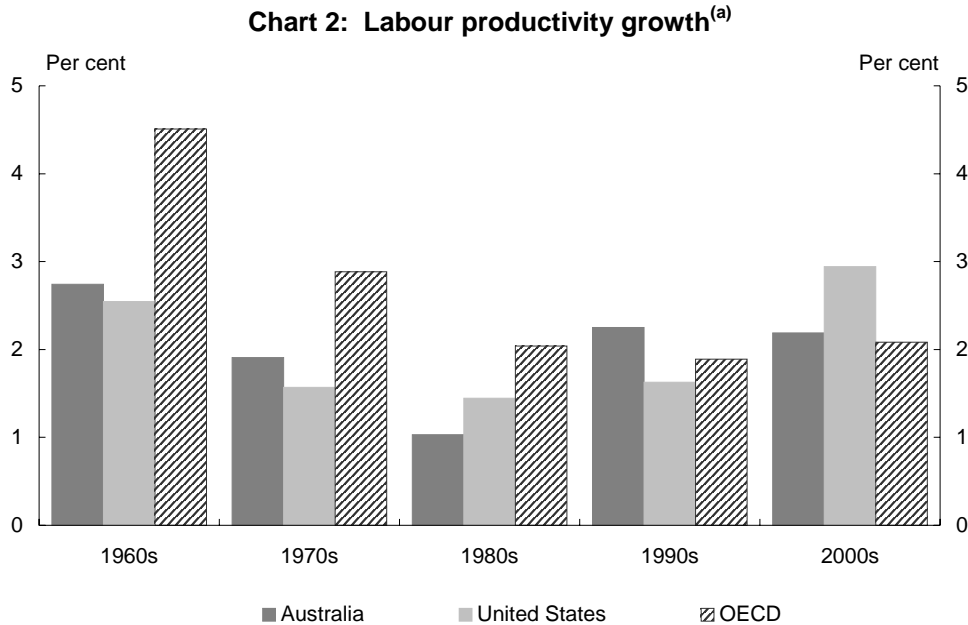
The reasons for Australia's prosperity

One approach to understanding the drivers of economic growth is to consider trends in population growth, labour force participation and productivity (see the detailed discussion in Budget Paper No. 1, *Budget Strategy and Outlook 2003-04*, Statement 4). Improvement in living standards, as measured by GDP per person, is the result of growth over time in the proportion of the population that is of working age, the number of hours worked by each person of working age, and the volume and quality of goods and services produced during those hours of work.

From the early 1990s, higher rates of labour productivity growth, rather than more favourable changes in the population age structure, or labour force participation rates, have driven Australia's strong economic performance. Labour force participation, as measured by the combination of average hours worked and the rate of employment among those aged 15 years and older, contributed little to growth in output and average incomes over the last four decades. While the increase in the participation of women in the workforce has more than offset the gradual decline in the participation of men, increased aggregate participation has been largely offset by the decline in average hours worked, largely reflecting the increase in part-time work (ABS 2005f; Reserve Bank of Australia 1997).

Beginning at the start of the 1990s, Australia's rate of labour productivity growth revived following decades of lagging other major developed countries. Productivity grew more rapidly during the latter half of the 1990s than during any comparable period in the past forty years. Australian labour productivity even grew faster than the 'new economy' of the United States (Chart 2). The revival since the 1990s is especially

remarkable in that it did not accompany a worldwide productivity boom. Indeed the average rate of labour productivity growth was slower across the OECD during the 1990s than in the previous decade. This suggests that additional circumstances unique to the Australian economy were responsible.



(a) OECD data are for the 24 longest standing OECD member countries. Data are average annual growth rates.

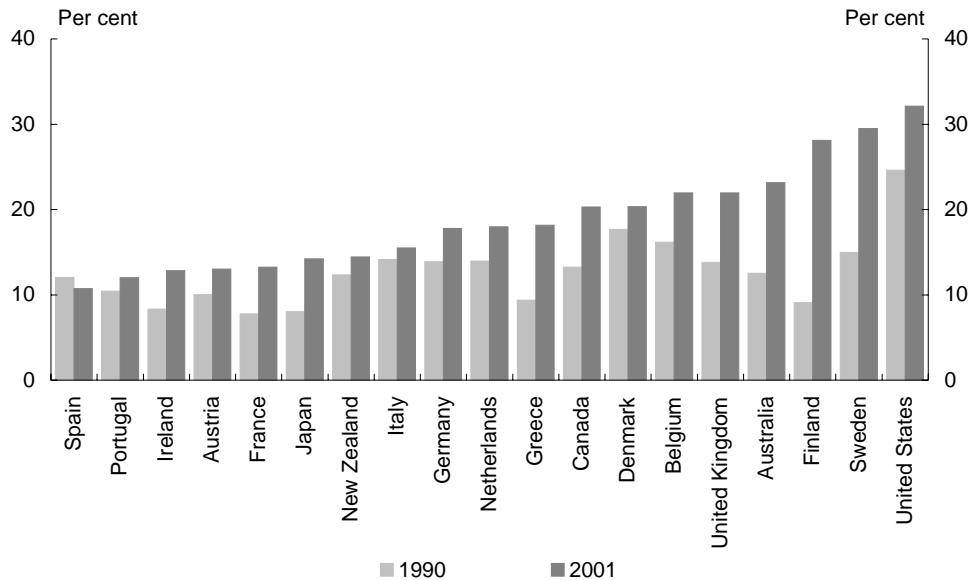
Source: Groningen Growth and Development Centre and The Conference Board (2005).

Labour productivity growth over time reflects:

- increases in capital per worker (that is, capital deepening);
- improvements in labour quality through education and experience; and
- improvements in the efficiency with which labour and capital are used, through innovative work practices, the achievement of economies of scale and technological developments.

In the 1990s, the rate of capital deepening accelerated from the slow pace of the 1980s (ABS 2004a). The rapid investment in, and use of, information and communication technology was particularly important. Australia has been among the world's leading users of information and communication technology (Chart 3).

Chart 3: Investment in information and communication technology
Share of non-residential fixed capital formation



Source: OECD (2005b).

However, improved efficiency (often referred to as multi-factor productivity) was the predominant driver of Australia's productivity revival (ABS 2004a). Australia's multi-factor productivity growth during the 1990s was stronger than for all other OECD countries for which data are available, except Finland and Ireland (OECD 2005b).

Central among the drivers of this improved efficiency was the broad and deep programme of mutually reinforcing reforms implemented during recent decades (IMF 2004; OECD 2005a; Parham 2004). Key reforms included: liberalising trade, foreign investment, financial markets and workplace relations regimes; tax reform (including reforms of the indirect tax system and targeted incentives to work and save); corporate law reform; and implementing a broad-ranging National Competition Policy agenda.

The resulting increase in domestic and international competition encouraged both a more efficient allocation of resources and a more vigorous pursuit of productivity improvement. More flexible labour markets permitted the reorganisation of work practices to take advantage of improvements in technology and skills. More flexible financial markets improved access for new, developing industries to the capital they required.

Microeconomic reforms and changes in behaviour have worked to raise the level of output the economy is capable of producing. They have been complemented by the Australian Government's macroeconomic reforms in the mid-1990s which placed both

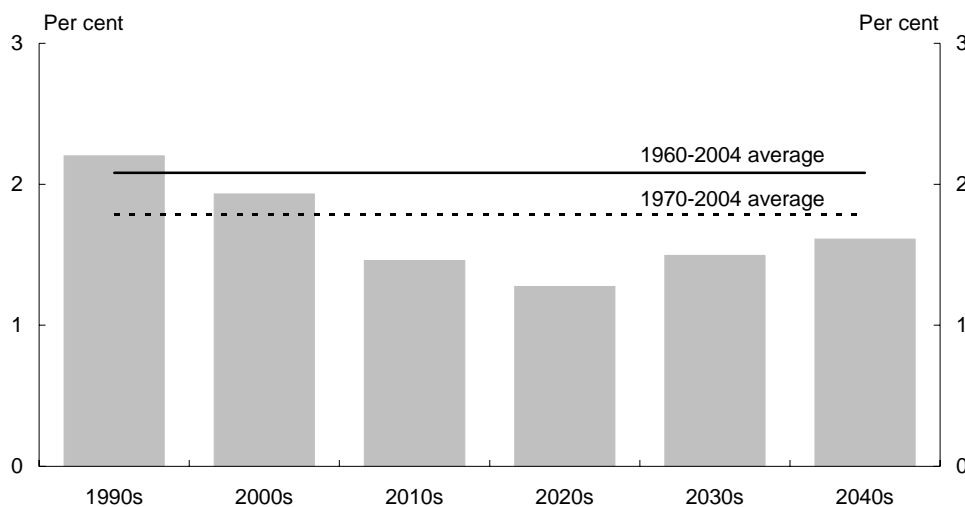
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fiscal and monetary policies within sustainable medium-term frameworks. Sound and sustainable macroeconomic policies have delivered a smoother pace of economic growth. They have helped avoid inflationary pressures while accommodating a steady decline in the unemployment rate. The resulting stable, low interest rate environment has provided security for firms to innovate and invest.

In recent years, Australian incomes have been bolstered by favourable changes in the relative prices of our imports and exports. Rapid economic development in China and India raised global demand and prices for the resources that Australia exports, while reducing the world price for manufactured imports. This has continued previous trends that resulted from rapidly declining prices for information technology and communications equipment. Shifts in the terms of trade will influence the direction in which Australia's manufacturing, mining and service sectors develop and contribute to ongoing prosperity.

The challenge will be to continue to improve living standards as the baby-boomer generation moves into retirement and causes a decline in the proportion of the population of traditional working age (15 to 64 years, that is, between compulsory school and age pension age). This will tend to reduce the proportion of Australians participating in the labour force and slow economic growth (Chart 4).

Chart 4: Projections of average annual growth in GDP per person



Source: ABS (2004a); and Productivity Commission (2005a).

The benefits of increased prosperity

The benefits of Australia's greater prosperity have been widely shared.

More Australians are now able to find work, with more than 1.5 million jobs created since 1996 (ABS 2005g). This has permitted a record high proportion of people of traditional working age to be engaged actively in the workforce. The unemployment

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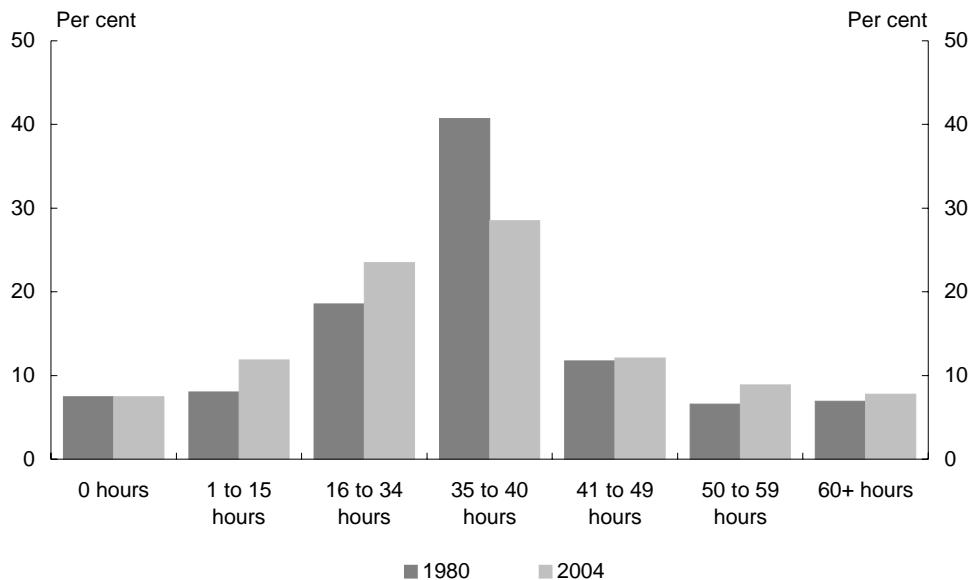
rate has fallen from a peak of almost 11 per cent in 1992 to around 5 per cent, the lowest rate since the mid-1970s.

The disposable incomes of Australian households have increased. Strong productivity growth has allowed real wage rates to increase. On average, adults working in full-time jobs earned around \$200 more per week in 2004 than they did in 1990 in 2004 dollars (ABS 2005b, 2005c). The benefits of real wage growth have been shared with Australians on a wide range of pensions, including the Age Pension, as those pensions increase in line with male total average weekly earnings.

Australian households now also have greater flexibility to manage their work, study, personal and leisure time. This is illustrated by the broader distribution of working hours (Chart 5). Part-time and casual work enables people to tailor their work to the demands of personal commitments and enables employers to meet better the demands of their customers. Almost half of the jobs created in the past decade have been part-time (ABS 2005a). While the majority of part-time workers are satisfied with the number of hours they work, a minority would prefer to work more hours.

This flexibility has allowed more Australians to study beyond the compulsory school age while managing work commitments. Almost two-thirds of those enrolled in post-secondary education or training are participating in the labour force, with a majority working part-time (ABS 2004b).

Chart 5: Employment by hours worked per week
Per cent of employed persons



Source: ABS (2005f).

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Australians also have more flexibility to choose the time at which they retire. Although Australians are living longer than a generation ago, many are retiring earlier from full-time work. Some have moved into more flexible work arrangements, while others are involved in caring and other voluntary roles, or simply enjoying more leisure. Others have chosen to continue to work beyond age pension age.

Economic growth also has strengthened Australian household balance sheets. Household wealth has doubled over the past decade (ABS 2004a). This has been assisted by increased coverage and rates of saving into superannuation over the past two decades. Reliable employment also has provided households with greater capacity to save, borrow and invest for their futures.

Economic prosperity has allowed the Australian Government to expand the provision of public services while lowering tax rates. In addition, sound fiscal management has contributed to a reduction in Australian Government debt levels to among the lowest in the OECD (OECD 2004b).

Australia's economic development has also allowed the achievement of broader social objectives. The United Nations measures such achievements using a Human Development Index (United Nations 2004). It considers improvements in human capabilities and opportunities by incorporating indicators of health and education together with output per person. By this measure, the wellbeing of Australians ranked the third highest of 177 countries in 2002. This is 11 places higher than in 1990 and nine places higher than rankings based on output per person alone.

The challenge is to maintain and further improve the policy and institutional environment for future prosperity.

BEING MORE PRODUCTIVE

Productivity growth is central to determining future living standards. Productivity growth is about getting more out of the finite resources available – working smarter, not harder. Increased productivity will provide more and higher quality goods and services and greater choice for Australians.

Australia's productivity growth will depend both on the development of technology throughout the world that expands the productivity potential for all countries and continued improvement in domestic performance that will see Australia move closer to the productivity potential inherent in world best practice.

There is good reason to be optimistic about future productivity growth. International productivity potential may continue to expand rapidly through ongoing improvements in technology, including information and communication technologies. Strong competition and increasing openness to international trade and investment will encourage Australian businesses to make best use of such developments. Such growth

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can be supported through appropriate infrastructure provision, sound governance arrangements in both the private and public sectors and efficient management of our natural resources.

Despite recent strong productivity growth, Australia remains well below international productivity potential. In aggregate, Australian workers produce only around 80 to 85 per cent as much per hour as their peers in the United States (Groningen Growth and Development Centre and The Conference Board 2005). While the aggregate data mask significant sectoral differences, it is clear that a range of policy reforms could help Australia close this gap further.

However, it needs to be recognised that a number of factors peculiar to Australia are likely to hinder the ability to close the gap entirely. Geography affects economic success. Australia's small and dispersed population limits our exploitation of economies of scale, reduces the intensity of competition and increases transport costs compared with larger and more concentrated markets (Box 1). Distance and population will inevitably constrain Australia in achieving world-leading productivity performance in at least some industries and, hence, in aggregate GDP per person. Nonetheless, significant improvements can still be made with the right policies and economic environment.

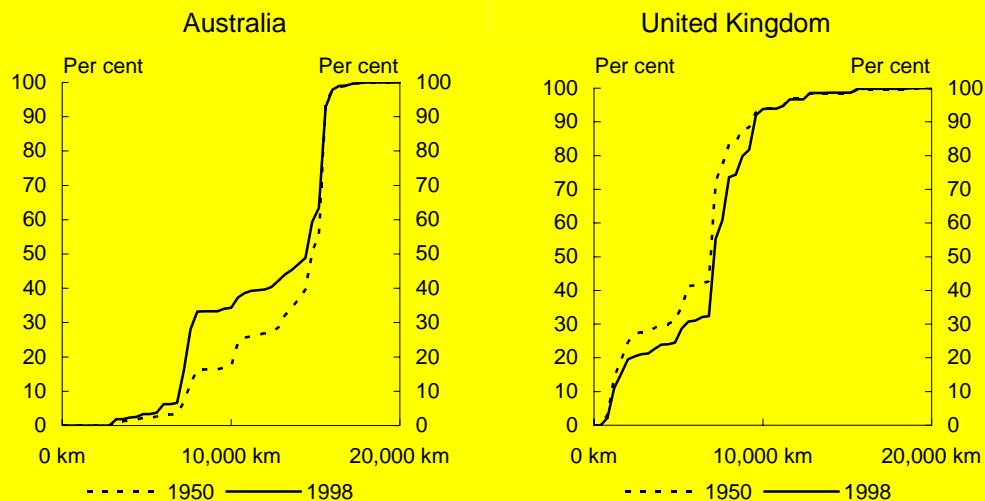
Box 1: Australia's economic remoteness

Australia has a small and dispersed population and is remote from the majority of the world's economic activity.

Australia has only 20 million people spread around the world's sixth largest land area. No two cities of more than one million are closer than 600 kilometres apart. In comparison, California has around 34 million people in a land area one-twentieth of Australia's (McLean and Taylor 2001).

Australia is second only to New Zealand in the OECD as the most remote economy from world economic activity. This is despite the recent rapid economic development in Asia. From the 1950s to the 1990s, the proportion of world GDP within 10,000 kilometres of Sydney increased from 17 per cent to 34 per cent (Chart 6). In comparison, 94 per cent of world GDP was within 10,000 kilometres of London in both the 1950s and the 1990s.

Chart 6: Distance to world GDP from Australia and the United Kingdom^(a)



(a) Charts show the percentage of world GDP within certain distances of Sydney and London. Source: Ewing and Battersby (2005).

Enhanced international integration and engagement

Higher productivity can be achieved by specialising in the industries to which Australia is best suited and by achieving economies of scale and scope. A small population and the costs of trading both within Australia and with major international markets constitute key economic hurdles to Australia achieving world-best levels of productivity (Box 1). Effective international integration can help reduce the limiting effects of Australia's geography and relatively small population.

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Australia has taken significant steps to liberalise cross-border movement in goods and services, capital and people. This has resulted in:

- access to cheaper and better inputs and final goods and services;
- more efficient allocation of natural, man-made and human resources, with greater specialisation in areas of comparative advantage;
- access to international financial markets to fund investment, smooth consumption and expenditure over time, and share risks;
- transfer of skills and technology; and
- increased competition, promoting innovation and dynamic efficiency.

While increased global integration opens new opportunities for exchange, it also raises the need to manage new risks, including international economic and financial shocks, international crime, terrorism and contagious diseases.

As a small, open economy, Australia has a strong interest in the development of rules-based multilateral systems governing such areas as trade, investment, taxation, financial regulation, terrorist financing and money laundering. However, bilateral and regional integration is becoming increasingly important within East Asia. This region accounts for around half of Australia's trade (ABS 2005e) and its importance to the world economy has increased considerably over recent decades. The trend will continue as China and other emerging Asian economies continue to develop rapidly.

For Australia, the shift toward regionalism and bilateralism within Asia, most notably in trade policy, raises difficult questions about the appropriate balance between multilateral, regional and bilateral engagement. Nevertheless, a well-considered approach to regional and bilateral engagement can complement multilateral arrangements. When entering bilateral and regional agreements, it is important to focus on maximising potential gains and not adding unduly to the complexity of international trade and investment rules. The benefits of international trade and investment are best achieved when accompanied by reductions in behind-the-border barriers to new entrants, whether foreign or domestic.

Maintaining and investing in Australia's infrastructure

Infrastructure plays a key role in facilitating economic activities and contributing to Australia's general wellbeing. Both labour and capital rely upon access to efficient infrastructure to underpin their productivity. Over the past 20 years, Australian governments have implemented wide-ranging reforms to boost productivity in infrastructure sectors and contribute to economic growth. The recent Review of National Competition Policy Reforms (Productivity Commission 2005b) found that productivity gains in the six major infrastructure sectors that underwent most reform

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since 1990 permanently added 2.5 per cent to GDP. For example, output per worker in electricity, gas, urban water, telecommunications and rail freight more than doubled over the 1990s. Productivity gains have lowered prices and raised average incomes.

In the process of reform, governments have had to grapple with complex issues of ownership, regulation and contract arrangements, and to develop sound decision-making frameworks to encourage appropriate investment decisions. Despite significant progress, challenges remain in many areas.

Given its nature, infrastructure often requires some form of government involvement – this may be in the form of direct provision, planning and coordination of networks, or regulation of monopoly assets. Where government provision is necessary, effective investment decision-making should involve sound cost-benefit analysis.

Many governments here and abroad have privatised some infrastructure businesses, such as in the energy, transport and communications sectors, that generated sufficient revenue to be financially viable. In those cases, the focus for governments has shifted from that of ownership to facilitating vigorous competition or, where that is not possible, regulating prices charged by monopoly networks.

Some governments have retained ownership of assets in key sectors together with regulatory responsibility and political accountability. The conflict between those roles can put at risk effective pricing and investment decisions. Government intervention is still preventing prices from reflecting the true economic cost of production in some infrastructure service markets.

For example, some state governments in Australia are discouraging potential new private-sector investors by continuing to own electricity assets, cross-subsidising their generators and retailers, and capping retail prices (Productivity Commission 2005b). Few infrastructure facilities utilise time of day or congestion pricing for infrastructure services. Further, most rural and urban water prices currently do not take account of the value of water in alternative uses and water trading regimes are in their infancy.

Regulated price setting at the appropriate level is always a difficult process. Depending on how prices are set, suppliers may invest too much or too little in infrastructure. Either case can lead to inefficient use of scarce resources – reducing the resilience and reliability of networks and lowering overall productivity and economic growth. Moreover, infrastructure choices can be distorted between competing industries. Promoting competitive infrastructure markets is desirable, where feasible, as it promotes efficient use of, and investment in, infrastructure and reduces the need for regulated pricing. New entrants and effective competition between existing players also can play a critical role in lifting productivity and stimulating the introduction of innovative new technologies, services and practices in the provision of infrastructure.

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As noted in Statement 3, global demand for resources has increased significantly over recent years. Supply responses typically have lags because of the large fixed costs inherent in mining projects and significant volatility in commodity prices. There has consequently been little spare capacity to meet increased demand and prices have increased significantly. In response to rising prices, Australian mining investment has surged and the resulting increase in output has begun to lift export volumes.

As a result, the resource boom has put pressure on the capacity of some key east coast rail lines and ports. However, concerns have also been expressed about systemic, long-term capacity constraints emerging in electricity, rural and urban water and interstate freight and urban passenger road and rail networks (Business Council of Australia 2005; Productivity Commission 2005b).

Despite the many productivity and cost gains delivered during the past two decades, a further set of initiatives could build on these gains. Such initiatives could encourage competition, improve incentives for investors to install appropriate new infrastructure facilities and encourage their more efficient use. Successful reforms could boost national productivity significantly. In 2005 the Council of Australian Governments will review ongoing arrangements for National Competition Policy. The Australian Government initiated the Productivity Commission review to inform this process.

The role of government

Governments alone cannot resolve every problem and achieve every political, economic and cultural objective of society. In most cases private markets, individuals and communities will be better placed to meet the objectives they are seeking. In some instances governments are best placed to act, while other cases will require public and private cooperation.

As such, governments face a continuing challenge in defining the scope of their roles and in performing efficiently and effectively. Yet Australia's prosperity depends on the sound use of scarce resources in both the public and private sectors.

Governments can support productivity growth in the broader economy through efficiently managing public sector agencies to deliver services to the public in an effective manner. They also have a role in improving the efficiency of private markets by setting regulations that provide a framework for, and secure confidence in, market operations. Competitive forces will continue to drive ongoing productivity improvements. In Australia's federal system of government the rate of productivity growth in both the public and private sectors also depends on the effectiveness with which the three levels of government work together.

By establishing sound frameworks for decision-making and resource allocation, well-governed institutions and markets reduce the risk of economic instability and the vulnerability of the economy. They help contain the shocks to which an economy is exposed, making it easier for firms and households to adjust. Despite being exposed to

the large negative external shocks of the East Asian financial crisis, for example, Singapore and Australia fared relatively well. This was due partly to sound governance arrangements within public institutions and domestic economies (Johnson et al 2000; de Brouwer 2003).

Governance

Governance is one key area where governments can act to improve productivity. Governance covers the set of arrangements by which those managing an organisation are accountable to those with a legitimate interest in the organisation.

Improving governance standards for companies is the focus of the Corporate Law Economic Reform Program (CLERP). The objective is to boost investor confidence that boards and management will make sound decisions and increase the return on shareholder funds for the ongoing benefit of shareholders, employees and the wider community.

In the public sector, governance is about how parliaments, governments, boards and public service managers relate to each other and are answerable for the cost-effective performance of public functions and the delivery of public services. Reforms have strengthened financial and accountability arrangements and sharpened the focus on effective public service delivery. The reforms have included introducing the Charter of Budget Honesty, new financial management legislation, whole-of-government budgeting, reporting on an accrual basis, and strengthened performance reporting and benchmarking requirements.

That said, the best policies in the world will not deliver the intended outcomes if government agencies do not implement them in the manner governments intended. While some steps have been taken to improve arrangements between the Australian Government and its agencies, the Review of the Corporate Governance of Statutory Authorities and Office Holders (Department of Finance and Administration 2003), also known as the Uhrig Review, found governance could be enhanced by providing greater clarity in the relationships between Ministers, their departments, the Parliament, the public, statutory authorities and office holders.

The Uhrig Review developed templates of best practice governance principles. The application of those principles is intended to provide statutory authorities and office holders with clear purpose and guidance about government expectations and objectives. The governance arrangements of Australian Government statutory authorities and office holders are to be assessed against the templates by March 2006. Assessments are continuing, with implementation of the recommendations to occur on a rolling basis by March 2007.

Australian Government and state relations

The effective and productive delivery of government services also is affected significantly by the relationship between the three levels of government, and

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particularly between the Australian Government and the states. This is because they are jointly involved in almost every functional area of government, with the exception of defence.

The Australian Government has sound reasons for involvement in many functional areas. They include promoting national standards, ensuring coordination and achieving national objectives such as enhanced productivity and participation. Similarly, state governments have sound reasons for involvement. However, joint government involvement in the same functional areas raises significant challenges including complexity for the public, cost and blame shifting, and possible duplication or gaps in service delivery.

In the medium term, all tiers of government will face significant pressure from the ongoing effect of cost drivers including demographic change. The Productivity Commission (2005a) projects that the aggregate fiscal pressure for all governments associated with the ageing population could be over 6 per cent of GDP by 2044-45 with the bulk of this expected to be borne by the Australian Government, but state governments face pressures as well. Growing spending pressures in key areas of service delivery accentuate the need to ensure that service provision is as effective and efficient as possible.

Some recent progress has been made in improving the allocation of the roles and responsibilities of governments. In addition, the introduction of the GST provided the states with a growing source of revenue. This enabled states to abolish a range of inefficient taxes and provided them with more funding certainty to meet their responsibilities.

Going forward, it will be important for the Australian Government and the states to clarify roles and responsibilities in order to improve productivity in the provision of services to the public while sustaining government finances. Clarification of roles will require consideration of national strategic priorities and judgements as to the tier of government that is likely to discharge those priorities most effectively.

Complexity and uncertainty

Complexity and uncertainty increase as markets expand beyond state and national borders. This can add to the cost of transactions and thereby limit the potential opportunities for increased investment and consumption.

Government intervention through the rule of law provides a framework to reduce uncertainty by providing greater confidence that private transactions will be completed satisfactorily. Through regulation, revenue raising activities and spending decisions, governments may add to or reduce the complexity faced by market participants. For example, governments might reduce complexity by requiring providers of similar products to promote or advertise them in a consistent, easily comparable manner.

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On the other hand, contradictory regulations across sub-national levels of government can add to the difficulty of doing business. Addressing such issues was behind the Australian Government's drive to set consistent regulation of corporations and the securities and financial systems. It is also an important driver of the Australian Government's intention to develop a uniform approach to workplace relations.

In many cases, market participants can assist in managing complexity, thereby helping individuals to deal with complex information, procedures or regulation.

Governments may add unnecessarily to complexity by over-regulation, by setting ineffective or inappropriate regulation or policies, or by too frequently changing them. Over-regulation might arise, for example, when government decision-making is heavily influenced by the demands of the most risk averse, or where the concern being addressed is not fully understood by regulators. The Australian Government has sought to reduce the likelihood of such outcomes through the establishment of a number of consultative arrangements, including the Board of Taxation and the Financial Sector Advisory Council, and by consulting with business and consumer groups when developing legislation.

The design of policies and the way that laws and regulations are crafted also can add unnecessarily to complexity. For instance, attempts to cover in detail all current possible treatments in the law may require constant updates and additions as society and markets continue to evolve. In such circumstances principle-based drafting of laws and regulations may be more appropriate. Policy measures also can be incremental, adding one layer of complexity to another. On occasions more comprehensive policy redesign may overcome decades of built up complexity.

Australia's tri-level system of government and our need to integrate with the global community influence the levels of complexity Australians face and the impact of this complexity on market efficiency. For example, recent reports by both the Productivity Commission (2005b) and the Business Council of Australia (2005) have concluded that differing greenhouse policies between jurisdictions are imposing costs, creating uncertainty and impeding investment in Australia's infrastructure. As another example, businesses that operate across states and self-insure for workers' compensation face added costs from complying with different related financial and prudential requirements in each jurisdiction.

Maintaining our natural environment

Continued economic growth and prosperity require sound management of the natural environment. Clean water, clean air, arable land and sustainable timber stocks for example are essential to the productive capacity of almost all sectors within the Australian economy. The natural environment also provides important recreational and other benefits that, despite being less tangible in a financial sense, still make a valuable contribution to the wellbeing of Australians.

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Until recent decades, there has been a lack of understanding of the role that Australia's unique environment plays in supporting the economy. The seeming limitless nature of Australia's natural environment meant it had sometimes been undervalued. Pressures on the environment are manifest in problems such as salinity, concerns over water quality and quantity, and issues surrounding greenhouse emissions.

Over time Australians have increasingly come to value the environment more highly and to seek solutions to environmental challenges. In response Australian Government expenditure on the environment has increased substantially in recent years and is budgeted to reach \$3.2 billion in 2005-06. This budget builds on flagship environmental programmes such as the Natural Heritage Trust and the National Plan for Salinity and Water Quality. It establishes the \$2 billion Australian Water Fund, commits an additional \$181 million to protecting Australia's fisheries in the Southern Ocean from over-fishing and provides an additional \$100 million for environmental research.

Unlike most other scarce commodities, there are no effective markets for many environmental goods and services. This reflects factors such as a lack of clear property rights, the existence of externalities and the public good characteristics of the environment. As a result, users of the goods and services provided by the natural environment often have faced little incentive to recognise the costs that they have imposed, given the alternative uses to which natural resources could have been put. Where this has occurred, it is likely that environmental resources have been used in ways that have not been economically efficient and which have failed to recognise their potential contribution to community amenity. In many instances, inefficient use of environmental resources has contributed to environmental degradation.

The inefficient use of environmental resources can constrain economic productivity and prevent future generations from enjoying the same high levels of environmental benefits that Australians enjoy today. A commonly cited example where this could occur is if water catchments were allowed to become degraded. The 'free' water filtration provided by the environment then would need to be replaced with expensive water filtration plants, thereby diverting workers and capital from alternative productive activities.

With demographic factors placing increased pressure on government budgets, sustainable resource use will need to be governed mainly by market incentives and regulatory approaches rather than by direct government spending. A key benefit of market-based approaches is that they seek to correct the underlying market failures that lead to environmental degradation. Market-based approaches provide a clear incentive to use environmental resources efficiently and to seek out more innovative production techniques.

By using markets to solve environmental problems, economic growth and higher living standards need not be at odds with improved environmental outcomes. Internationally, markets are increasingly likely to be used to manage the

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environmental impacts of nitrous oxide, sulphur and greenhouse gas emissions and to support conservation. Reflecting Australia's particular circumstances, opportunities for the innovative use of environmental markets are being examined on a case-by-case basis in areas such as fisheries, native vegetation and salinity.

A significant example of a market solution is the National Water Initiative (NWI), which was agreed in June 2004 by the Australian Government and most states. A key objective of the NWI is to establish a clearly defined property rights framework for water and the creation of effective water markets. The price signals created by such markets will provide incentives for water to be transferred to its highest value use. This will encourage investment in water-efficient technology and infrastructure that will be needed to sustain Australia's future economic growth. At the same time, the property rights and water planning frameworks included in the NWI will be based on best available scientific knowledge so that water use is more consistent with environmental sustainability.

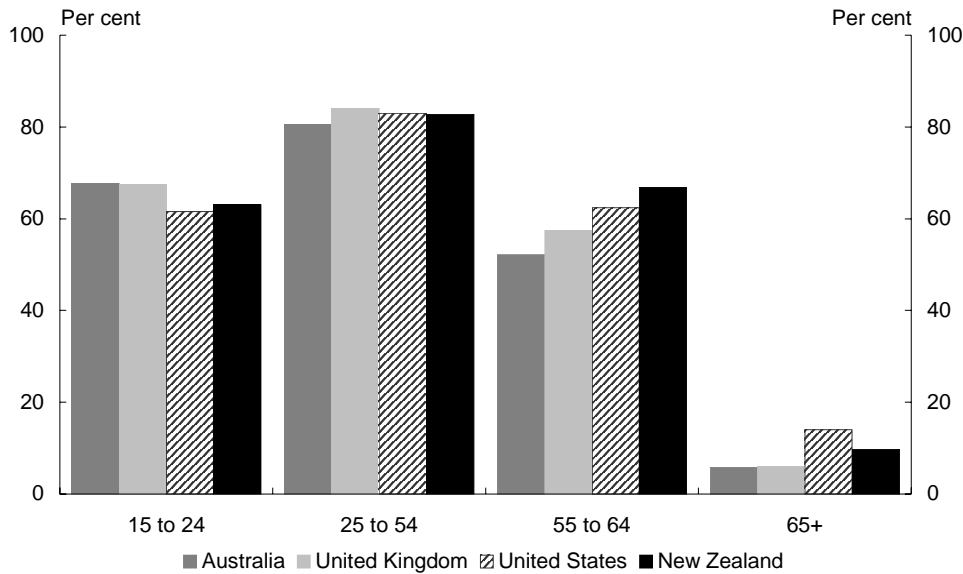
IMPROVING PARTICIPATION AND SHARING AUSTRALIA'S PROSPERITY

Households contribute to and share in the benefits of an increasingly prosperous Australia.

The entire community benefits from the output produced through work. This is true whether work is for an income or not. Many people gain a sense of worth from their work and enjoy greater opportunities for social engagement, which enhance both mental and physical wellbeing. Though not normally recorded in economic statistics, unpaid work within the home and by unpaid carers and volunteers contributes significantly to the community. Voluntary work is also an important path to paid employment for many people. Almost one-third of Australian adults undertake some form of voluntary work, contributing an average of more than 3 hours per week (ABS 2001). It is through paid work, however, that most people support their pre-retirement lifestyles and save for retirement, while contributing to measured economic growth.

The ageing of the population will slow the growth in living standards in coming decades unless productivity growth and labour force participation rates increase. Australia's overall labour force participation rate, the 12th highest in the OECD, remains modest by international standards (OECD 2004a). Labour force participation in Australia decreases markedly in older age groups. Some people retire or leave the workforce in their forties and fifties. While declining participation is consistent with the trend in other OECD nations, total participation in Australia for those aged 55 years and older is lower than the OECD average and well below that in the United States, United Kingdom and New Zealand (Chart 7).

Chart 7: Labour force participation rate by age, 2003



Source: OECD (2004a).

While the nature and extent of workforce participation is largely a matter of individual choice, such choices may be distorted by disincentives or obstacles to participation that impose unnecessary costs on individuals and society. Since 1996, the Australian Government has implemented a range of policies to support an individual's choice to engage in the labour force and remove disincentives to such participation. Among those policies are workplace relations reform, increasing assistance with child care, reforms to the income support and family assistance systems, income tax reductions and changed superannuation arrangements. Those reforms have helped improve participation rates.

Going forward, the ageing population will require even higher rates of participation. The Australian Government has identified three broad categories of policy reform that should promote higher participation rates:

- strengthening an individual's capacity to work through better health and education;
- improving incentives and removing barriers to undertake work, through welfare reform and creating more flexible and adaptable retirement income arrangements; and
- increasing the flexibility of the labour market, to facilitate greater employment options and encourage job creation.

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While the full benefit of many of those reforms may not be measured for some time to come, they underpin and set the tone for ongoing efforts required to sustain current growth rates in Australia's standard of living.

Strengthening capacity

Education and training systems provide the skills and flexibility the workforce needs to meet the requirements of an increasingly dynamic and complex economy. Illness and injury, on the other hand, reduce workforce participation and limit lifestyle choices and overall wellbeing.

A skilled workforce

Education plays a critical role in allowing people to participate more fully in society. Education also has costs in terms of both the financial cost of acquiring the education and the time that students otherwise could have spent working or enjoying leisure. As with any investment, more is not always better. Education will be most effective when individuals and societies invest in the right people, the right skills and at the right time.

Australians have been investing steadily more time and effort into education (Box 2). Surveys suggest that higher levels of education and training are likely to increase labour force participation over time. In 2001 the labour force participation rate for people aged 25 to 64 with post-school qualifications was 85 per cent, but only 63 per cent for people who had no post-school qualifications (ABS 2003). Unemployment rates are also far lower for people with post-school qualifications.

Box 2: Australia’s qualifications profile

Australians have become more highly qualified over the past few decades (Table 1). While older Australians are less likely to have been educated beyond lower secondary school than their peers within the rest of the OECD, the qualifications profile for younger Australians is very similar to their OECD counterparts.

Australia’s overall qualifications profile is hollow in the middle. Fewer Australians complete upper secondary education than in the rest of the OECD, while more Australians hold either tertiary or only lower secondary qualifications. However, the qualifications profile for 25 to 34 year olds suggests this may be changing. Current upper secondary retention rates suggest that younger cohorts will be at least as well-qualified as 25 to 34 year olds are today.

Table 1: Highest qualification obtained, per cent by age group, 2002

	Age group				Total
	25-34	35-44	45-54	55-64	
Australia					
Tertiary	35.8	31.2	30.5	22.5	30.8
Upper secondary(a)	36.7	30.7	27.3	23.2	30.2
Lower secondary	27.5	38.1	42.2	54.3	39.1
Rest of OECD(b)					
Tertiary	30.7	26.9	25.1	19.0	26.0
Upper secondary(a)	43.8	44.1	42.7	38.3	42.6
Lower secondary	25.5	29.0	32.2	42.7	31.4
Difference(c)					
Tertiary	5.1	4.3	5.4	3.5	4.8
Upper secondary(a)	-7.1	-13.4	-15.4	-15.1	-12.4
Lower secondary	2.0	9.1	10.0	11.6	7.7

(a) Includes post-school non-tertiary qualifications.

(b) Excludes Luxembourg.

(c) Percentage points.

Source: Australian Government Treasury calculations based on OECD (2004a).

Education and training also support high levels of productivity. More highly trained employees are likely to be more innovative, developing and using new ideas and technology that can lead to new and better products or more efficient ways of working.

The Australian Government has implemented initiatives in recent years aimed at improving educational and skill attainment across all age groups. Ongoing reforms have enhanced greatly the scope, consistency and labour market responsiveness of the vocational education and training system. Participation in vocational education and training has grown strongly.

The Australian Government is building on earlier initiatives by establishing 24 Australian technical colleges, expanding school-based new apprenticeships,

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increasing pre-vocational training places and increasing income support for new apprentices.

The Australian and state governments are negotiating new vocational education and training agreements to increase the flexibility of the training system. Planned reforms include removing impediments to user choice so that employers and employees have greater freedom to choose the training organisation that best suits their needs. Reforms also are designed to improve the responsiveness of the training system to emerging skill shortages by creating 20,000 new targeted training places.

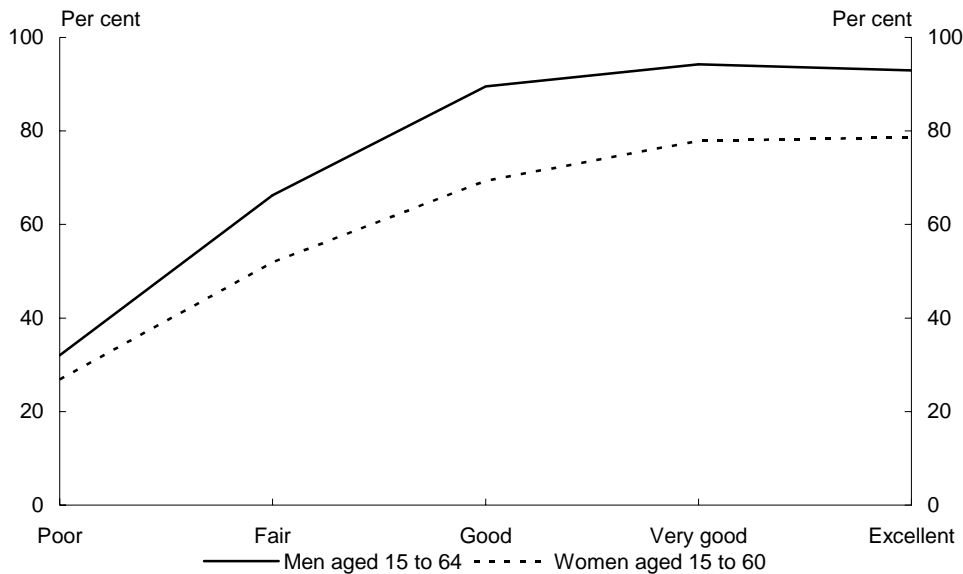
Even so, sometimes shortfalls in the supply of skilled workers may emerge for which the optimal solution may be targeted immigration. At such times, skilled migration is a useful complement to education and training initiatives. Skilled migration provides a rapid boost to the national skills pool, whereas education and training initiatives take longer to deliver skilled workers to the labour market. Accordingly, the Government will increase skilled migration in 2005-06 by 20,000, delivering a total skilled migration intake of 97,500.

A healthy workforce

In general, healthier people are likely to be more productive and have higher labour force participation rates, leading to potentially higher disposable incomes, wealth and general wellbeing (Chart 8). Healthier people are also more likely to respond positively to incentives to remain in the labour force beyond traditional retirement ages, participate in voluntary positions within the community upon retirement and require less assistance later in life. Deteriorating health is often associated with early retirement.

Employers also benefit from healthier workforces, not only through increased labour force participation and productivity, but from the reduced costs of lower rates of absenteeism due to ill health or disability. The community benefits from the fewer resources needed for health care and more widespread community engagement.

Chart 8: Labour force participation rate by health status



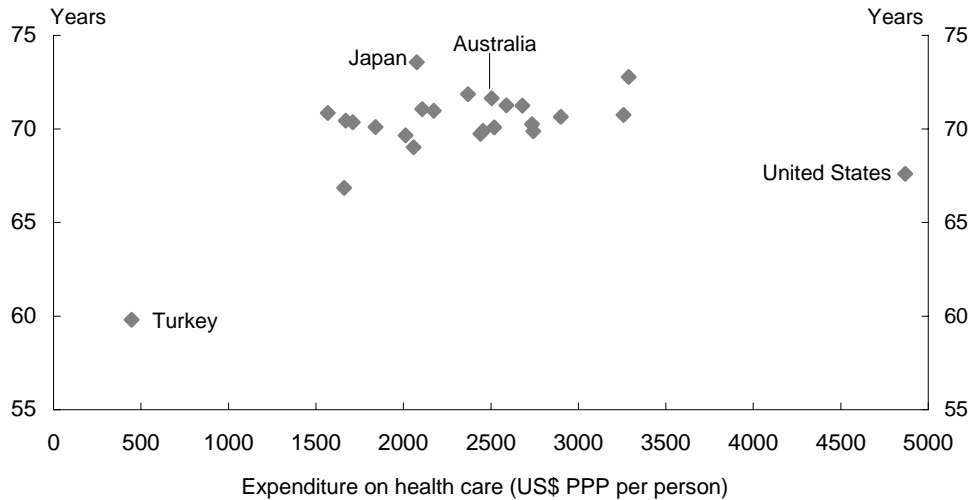
Source: Cai and Kalb (2004).

Chronic diseases, such as heart disease, cancer and diabetes directly reduce the wellbeing of sufferers and their carers, and have an adverse effect on the prosperity of the community through reduced participation and productivity. Those diseases are among the leading causes of death in Australia, yet many of them have preventable risk factors related to lifestyle, including tobacco use, excess consumption of alcohol, unhealthy diet and physical inactivity.

Australians are living longer, but have more health concerns. While life expectancy at birth increased from around 73 years in the latter half of the 1970s to 80 years in 2001, the proportion of Australians reporting long-term health conditions rose from 45 per cent to 78 per cent over this period (ABS 2002, 2004c; Australian Institute of Health and Welfare 2000). The trend is partly due to the increasing prevalence of lifestyle-related diseases and partly due to the development of treatments that alleviate previously fatal conditions.

Similar developments have increased health care expenditure in most OECD countries in recent decades. However, perhaps surprisingly, the level of health expenditure across OECD countries is not strongly correlated with the health of their populations (Chart 9). Australians enjoy longer, healthier lives than the populations of many countries, such as the United States, that spend more on health care. This suggests that better health outcomes are not necessarily the result of more expenditure and that factors such as the structure of the health system and active and healthy lifestyles can be more important.

Chart 9: Healthy life expectancy and health care in 24 OECD countries, 2001



Source: OECD (2004c); and WHO (2002).

Ultimately, individuals, families and communities make the lifestyle choices that can lead to the development of chronic disease. Governments cannot proscribe choices, but they can provide incentives and sanctions to encourage healthier lifestyle choices. For example, governments have imposed high excises on tobacco and restricted where people are permitted to smoke. In other areas there may be limited scope for incentives or sanctions, but governments have a role to provide relevant health promotion information. Governments also can aim to have a broad range of policies and programmes – including public transportation, parks, school curricula, town planning, as well as the health care system – that support healthy lifestyle choices.

The most cost-effective approach to many chronic illnesses is likely to be a population strategy that raises awareness, changes social attitudes and improves lifestyles, thereby removing or reducing the underlying causes that make the disease common (WHO 2002, 2004). With changing community attitudes, the maintenance of healthier lifestyles becomes easier for any particular individual as the healthier behaviour becomes more common place (Rose 1985, 1994).

The 2004 Building a Healthy, Active Australia package aims to promote better population health by encouraging children to adopt healthy habits for life. Analyses by Rose and the WHO suggest such programmes are likely to be even more effective in changing social attitudes were they extended to involve families and the entire community.

Improving incentives and removing barriers

While decisions to participate in the paid or unpaid workforce are necessarily personal they have impacts on the wellbeing of the nation through the relationship between

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participation, economic growth and prosperity. These decisions are influenced by provision of income support, tax arrangements, retirement incomes policies and other incentives and barriers to participation.

Income support systems provide a social safety net. They also should aim to recognise an individual's desire to work by encouraging, promoting and assisting them to seek out and participate in paid work to the extent they are able. The challenge for government is to balance the set of incentives, assistance and requirements in such a way as to avoid creating cycles of dependency, while maximising the voluntary participation of people with diverse capacities and availabilities for work.

While labour force participation is currently at historic high levels, there is room for further improvement. Of the 14 million people aged 15 to 64 years, only about 10 million are currently in the labour force. Around 2.7 million receive income support, including sole parents, the unemployed and recipients of the Disability Support Pension (DSP).

Welfare system reforms and income tax reductions have improved the incentives to participate for most income support recipients. The 2004-05 More help for families package improved incentives for people to participate in the workforce. The 2001-02 Australians Working Together package included reforms to assist out-of-work people back into the workforce. They included introducing working and training credits, mutual obligation requirements for some job seekers and initiatives targeting parents, the mature aged, indigenous Australians and people with disabilities. Many of these groups of people have lower than average participation rates.

Despite the progress to date, more could be done to match incentives with individuals' capacities to contribute. Currently, only around one in six income support recipients are required to look actively for work. While a proportion of the remainder are involved in other important activities, such as education and family-related commitments, more income support recipients could participate in the labour market. This would improve the longer-term economic and social wellbeing of the individuals concerned and add to the prosperity of the community.

The OECD (2005a) has noted that the DSP, in part due to its generosity, may be used by some as an early retirement vehicle. It is paid at the same rate as the Age Pension and is significantly higher than unemployment benefits. More than 40 per cent of all DSP recipients in June 2004 were aged 55 or older, with just over 20 per cent of all recipients aged 60 or older.

In this budget, the Australian Government introduces additional reforms to the income support system to encourage further labour force participation. The further reform of the welfare system in this budget focuses on assisting those who have the capacity to work to do so, while maintaining an appropriate level of assistance to provide a minimum standard of living. The reforms achieve this through a balance of financial

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incentives, obligations to look for work and a broad-ranging package of services to assist those who have been out of the workforce for an extended period.

An individual's decision to participate in the labour force is affected by both the additional income tax paid and the withdrawal of income support payments through income testing arrangements. Taken together, the interactions are described as effective marginal tax rates (EMTRs), although of course they are not actual tax rates.

EMTRs have fallen in recent years largely through reduced income tax rates and reduced family assistance taper rates. The changes particularly assist women wishing to re-enter the workforce after having children. In addition, the increase in thresholds for the top marginal tax rates has improved incentives for some workers to take on additional work, seek promotion and invest in further skills.

In this budget the Government has taken further steps to reduce EMTRs through relaxation of the income test for Newstart Allowance. This will reduce the current 70 per cent withdrawal rate to 60 per cent and increase the range of income over which the 50 per cent withdrawal rate applies.

With an ageing population, any improvement in the labour force participation of mature age workers will help sustain growth and prosperity. Governments can encourage and support individual choices to stay in the workforce beyond traditional retirement age.

It is very difficult to reverse retirement decisions, once taken (OECD 2003). Policy may more effectively encourage people still in the workforce to delay retirement. Consistent with this, the Australian Government has introduced a number of initiatives to encourage older workers to remain in the workforce, including tailored services to assist mature age job-seekers to find new employment and flexible assistance to help parents, carers or mature age people to find work. It also has removed the restriction on access to superannuation by those still in employment, enabling older workers to move gradually into retirement by supplementing reduced employment earnings with their superannuation entitlements. For workers older than 55 years the Australian Government has introduced the Mature Age Worker Tax Offset that provides an annual tax rebate of up to \$500 on earned income.

Together those reforms are likely to have contributed to the recent increase in the labour force participation rates of those aged 55 years and older.

Enhancing flexibility

Through reform, what was a highly centralised and regulated workplace relations system in Australia has moved to one more focused on agreement making at the workplace or enterprise level. Today, only around 20 per cent of workers have their pay and conditions set directly by awards (ABS 2005d). This significant change has

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increased enterprise flexibility and competitiveness and has contributed to the Australian economy's strong employment and economic growth over recent years.

Employees also can more easily negotiate working arrangements that suit their other commitments or lifestyle choices. The number of people choosing to work part-time has increased rapidly and this trend is likely to continue as the population ages.

The reforms provide a firm foundation, but there remains significant scope to do more. Greater flexibility in employment arrangements and conditions would promote workplace productivity and allow employers and employees to tailor wages and conditions to their specific skills and needs. This creates greater opportunities for people to find jobs, increase their incomes and respond positively to changing industry demands for labour.

The Australian Government has proposed further changes to workplace relations that reduce the degree of regulation around the termination of employment, address pattern bargaining, streamline agreement-making processes and simplify awards to promote workplace agreements.

MAINTAINING A DISCIPLINED APPROACH TO FISCAL POLICY

The challenges Australia faces in sustaining its economic performance will shape the direction of fiscal policy in the years ahead. The challenges will translate into additional pressures on public finances and will influence future decisions about the content of government expenditure programmes and the structure of the tax system.

As with households, governments must manage budgets so they can meet their financial commitments, including regular expenses and debt repayments, from current and expected future income. In many other developed countries, this will mean cutting spending or raising taxes to reduce government debt to levels that can be serviced through future tax and other government revenues.

Fortunately Australia does not face such stark choices. Responsible management of revenue and expenditure has resulted in a succession of budget surpluses. Those surpluses have been used to repay debt. Government debt is now at levels that are among the lowest in the OECD (OECD 2004b).

The task going forward is to ensure that policies safeguard the sound fiscal position and that budgetary decisions are consistent with promoting productivity and participation. This means maintaining a responsible approach to government expenditures and securing a tax base that can fund those expenditures in an efficient and equitable manner. It also means managing pressures and risks to revenue or expenditure so future governments can continue to provide essential goods and services in a manner that promotes fairness in distributing public resources between generations of Australians. Maintaining a responsible fiscal position is important to

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maintaining low inflation and low interest rates today, thereby providing a more stable environment for households and firms to make investment decisions.

The ageing population, technological advancement in health care and rising community expectations about access to the latest medical treatments are likely to place significant pressure on government finances. In addition, pressure on public finances is likely to come from increasing community expectations around maintenance of our natural and man-made environment.

Maintaining a sound fiscal position will require governments to design programmes with a view to promoting productivity and participation, thus securing the viability of their revenue base. It will also require improved allocation of functions and coordination of programme delivery across the three levels of government so that publicly provided goods and services are delivered as efficiently and effectively as possible. A particular challenge in this regard will be to coordinate an approach to the delivery of infrastructure that pays regard to the appropriate balance between public and private provision, and develops the regulatory environment needed to support the latter.

Governments at all levels also will need to take a broader view of their balance sheets, taking greater account of the need to meet contingent liabilities and future pressures on the tax base and expenditures. As discussed in more detail in Statement 2, the Australian Government is taking steps to help offset the liability associated with unfunded public sector superannuation by establishing the Future Fund, comprising financial assets built up using current and future budget surpluses.

A key outcome of funding the superannuation liability will be to improve the Australian Government's net worth and financial sustainability. It will also change the measurement of financial performance – giving more attention to the evolution of the Australian Government's assets and liabilities over time, rather than simply current receipts and payments.

An approach to fiscal policy that focuses more clearly on improvements in the balance sheet recognises that many of the fiscal pressures governments face will arise decades into the future. The production of the 2002 Intergenerational Report, which assessed expenditure pressures, was an important first step in this direction. Ensuring fiscal sustainability will require longer term planning horizons than have been employed in the past. This requires a view of the likely path of the budget aggregates and a more detailed understanding of how individual programmes may contribute to fiscal pressures over the medium to longer term.

The sustainability of fiscal policy depends not only on decisions made in the budget, but on the range of economic and social policies needed to provide higher income levels into the future. Critically, Australia needs to take advantage of opportunities to secure higher national income through trade, including with growing economies such

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as China and India. Australia's current fiscal position in part reflects the dividends of a positive international engagement strategy.

This budget has responsibly banked some of the additional revenue generated by higher export prices to help meet the fiscal challenges ahead.

CONCLUSION

The sustained strong performance of the Australian economy over the last decade has meant that Australians are enjoying increased prosperity and wellbeing. The strong performance has been underpinned by a sustained reform effort aimed at improving productivity and labour force participation.

The strong economy, combined with a sound fiscal outlook, presents a unique opportunity to develop and implement a cohesive policy agenda for making even better use of our natural, man-made and human resources, thereby locking in future growth and prosperity. The opportunity should not be wasted because strong growth and sound policies will be the best weapons against the impact of an ageing population and other future known and unknown challenges.

Some of those policies will build on and refine past reforms. Some challenges will take policy into new areas or new directions. In all areas, the challenge is to identify barriers to sustained economic growth and to engage individuals, businesses and governments in implementing appropriate solutions.

The success with which governments implement such policies, and how well individuals and businesses respond to them, will determine the extent to which Australia achieves strong economic growth and prosperity now and over the decades to come.

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