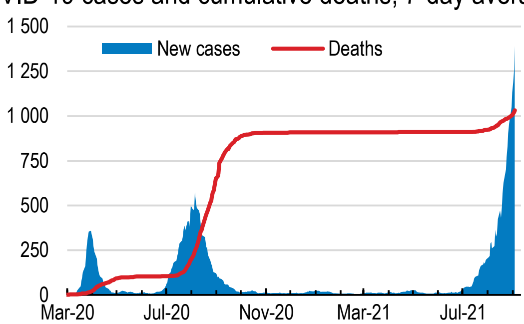
Executive Summary

Australia's zero-tolerance approach is shifting to virus containment.

At the onset of the pandemic, well-coordinated policies across different levels of government sought to suppress COVID-19 transmission. As a result, the rise in deaths from the virus was temporarily halted (Figure 1). Control of the public health situation facilitated the reopening of the economy. However, recent COVID-19 outbreaks have meant much of the country has returned to a strict lockdown. The vaccine rollout started slowly but has picked up pace in recent months as the country begins transitioning from zero-tolerance to a containment approach to the virus.

Figure 1. The virus was suppressed for a period but cases have risen in recent months

COVID-19 cases and cumulative deaths, 7-day average



Source: Refinitiv.

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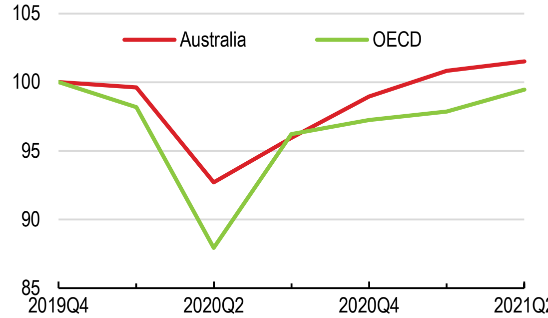
The downturn in 2020 was less significant than in the majority of other OECD countries (Figure 2)**.** Real GDP bounced back over the year to June 2021, to be above pre-pandemic levels. The unemployment rate fell to 4.6% in July 2021, after peaking at 7.4% in 2020. Nonetheless, high frequency indicators suggest that the current containment measures are having a significant negative impact on economic activity.

OECD projections envisage annual output growth of 4% in 2021 and 3.3% in 2022 (Table 1). The economy is expected to contract in the third quarter of 2021, before state-based restrictions can begin to be eased as higher vaccination rates are achieved. The ensuing recovery may be more gradual than in previous episodes, given it will occur in an environment of higher community transmission of COVID-19.

Figure 2. The initial downturn was relatively mild

Real GDP, index Q4 2019 = 100



Source: OECD Economic Outlook database

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Risks and uncertainties remain large. On the upside, a substantial quickening in the pace of vaccine rollout could enable an early relaxation of containment measures. Once the economy reopens, household consumption could also pick up surprisingly rapidly given a high stock of excess savings. In contrast, significant new COVID-19 outbreaks in other states may deepen the economic shock. Furthermore, problems with the vaccine rollout or vaccine hesitancy could delay reopening. A ratcheting up of diplomatic tensions with China could also further weaken trade activity.

Table 1. Macroeconomic projections

Annual growth, unless specified	2019	2020	2021	2022
Gross domestic product (GDP)	1.9	-2.5	4.0	3.3
Unemployment rate (% labour force)	5.2	6.5	5.4	4.9
Core inflation index	1.6	1.3	2.2	1.7
General government gross debt (% of GDP)	45.9	65.4	68.5	72.6

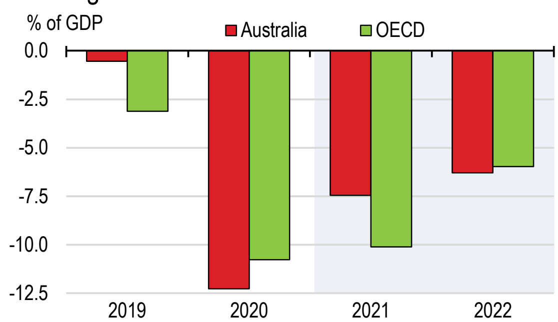
Source: OECD Economic Outlook 109 Database, projections revised as of 8 September 2021.

Macroeconomic policies must remain responsive to changing conditions

Macroeconomic policy support was delivered swiftly and with appropriate force at the onset of the pandemic. The immediate fiscal expansion was one of the largest in the OECD (Figure 3) and the Reserve Bank of Australia cut official rates and embraced an array of new policy tools, including purchases of government bonds. Legacies of the pandemic in the form of higher public debt and limited monetary policy space will present challenges for macroeconomic management going forward. While the institutional framework has supported the strong economic response to the pandemic, there are some areas that could be improved. A review into the monetary policy framework should be undertaken and the fiscal framework buttressed. At the same time, tax reform can help make public finances more growth-friendly and sustainable.

Figure 3. Fiscal policy has been supportive

General government financial balance



Source: OECD Economic Outlook 109 Database, projections revised as of 8 September 2021.

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In the short-term, fiscal policy should continue to be highly responsive to developments in economic conditions, such as the impact of further COVID-19 containment measures. At the same time, there is scope for the RBA to further expand the asset purchasing programme and consider other less conventional monetary policy tools as needed. As the recovery becomes entrenched, the RBA should also remain cognisant of potential upside risks to inflation stemming from factors such as labour shortages.

Over the longer-term, fiscal spending pressures will grow. Under current policy settings, ageing related costs will cause public debt to rise to 2060. In addition, further investment in the social safety net is needed, not least to complement reforms that promote business and labour market dynamism. For example, the unemployment benefit rate should be raised further.

Tax reform is needed. Australia's heavy reliance on taxation of personal incomes adds to the vulnerability of public finances to an ageing population. Fortunately, there is a clear path for tax reforms that will provide a more sustainable tax base, enhance economic growth and promote other government priorities like improving housing affordability and reversing the trend toward rising income and intergenerational inequality common to many countries. The authorities should increase the Goods and Services Tax rate or broaden the base, offsetting any regressive effects through additional personal income tax cuts (especially for low and middle-income workers), reducing private pension tax breaks and reducing the capital gains tax discount. In addition, more state governments should replace stamp duty with a well-designed recurrent land tax.

The government entered the pandemic from a strong fiscal position. Its newly revised fiscal strategy is to support the economy until the recovery is well entrenched and the unemployment rate is back to pre-pandemic levels (5%) or lower and then to switch focus to stabilising and then reducing public debt in the medium-term. As this transition draws nearer, the government should provide a medium-term fiscal strategy with targets that are associated with specific timeframes or conditional on measurable economic outcomes.

Looking forward, the government's fiscal strategy should be regularly evaluated and monitored by an independent fiscal institution. The Parliamentary Budget Office (PBO) is a credible and independent institution that could fulfil this task within its current mandate. Through explicitly assigning such responsibilities to an independent fiscal institution, the authorities will be enhancing the transparency and accountability of fiscal policy.

Stronger productivity growth is needed for a sustainable recovery

The economy was exhibiting signs of structural headwinds when the pandemic hit. As in many OECD countries, productivity and wages growth had slowed notably. This partly reflected weaker business dynamism and labour market mobility. Small young firms were then hit particularly hard by the pandemic. Looking forward, prospects for this cohort of firms are particularly important given they have typically accounted disproportionately for job creation and investment in Australia.

Regulatory procedures are relatively complex and the licensing and permit system is cumbersome compared with other OECD countries. This can slow necessary resource reallocation. The ongoing reforms to the occupational licensing system are welcome, a first step being the broadest possible adoption by the states of automatic mutual recognition of licenses across jurisdictions. Furthermore, broadly based reform to land use regulations are well overdue. As well as harmonising and simplifying the land zoning system at the state level, giving local authorities more fiscal autonomy can encourage them to allow the entry of new businesses or households.

The financial sector will continue to be of central importance to the recovery

Financial institutions provided an important buffer against the economic shock. To promote a sustained recovery, reforms that improve access of small young firms to credit and protect the financially vulnerable will be key.

The digital revolution in financial services can improve lenders' ability to assess credit risk in the absence of collateral or business history. This can facilitate new sources of finance for young businesses. Extending open banking to facilitate switching of providers could inject much-needed competition to the lending market and improve access to finance.

The Personal Property Securities Register provides a good foundation for supporting the use of intangible assets as collateral. This is especially important for young innovative enterprises. However, the register is considered difficult to use and lacks visibility. Streamlining the system, reducing compliance costs and making better use of available technology (including regtech) would help realise its potential.

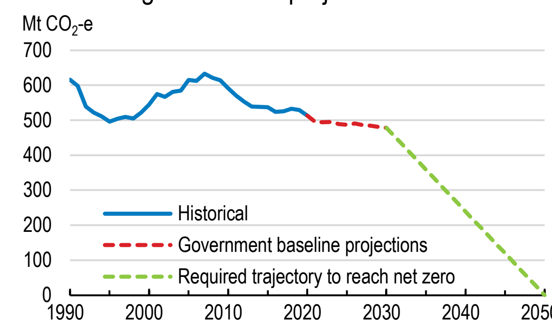
The financial sector also has a role to play in ensuring an inclusive recovery. The Royal Commission into misconduct in financial services highlighted a range of practices that led to mistreatment of vulnerable customers due to poorly designed incentives. The government should complete the implementation of the reforms arising from the Royal Commission.

Climate change policy needs to be strengthened

The Federal government is now aiming to achieve net zero carbon emissions as soon as possible and preferably by 2050. All states and territories have now committed to achieving net zero carbon emissions by 2050. However, emissions will need to decline at a significantly faster pace if this goal is to be met (Figure 4). The government's forthcoming Long-term Emissions Reduction Strategy is an opportunity to articulate a more co-ordinated, ambitious and stable climate-change policy that defines clear goals and corresponding policy actions to achieve their goal.

Figure 4. Faster progress in reducing carbon emissions is needed

Greenhouse gas emission projections



Source: DISER; OECD calculations.

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The authorities are focused on the development of clean energy technologies as the path to lower emissions. Australia has world class public institutions for supporting renewable energy research and the commercialisation of low emissions projects. Yet, there has been a trend decline in environmental innovation over the past decade and stronger incentives for innovation and adoption of new low emission technologies are needed. While a national carbon price would be the most efficient means of achieving this, political considerations may instead require the scaling up of existing market-based instruments, such as the Safeguard Mechanism (a baseline-and-offset system for large emitters). This should be accompanied by policies that support the transition of workers out of fossil fuel generating industries.

The financial sector can also play a key role in the transition to a low carbon economy. Creating a roadmap for improving the consistency, comparability and quality of reporting of climate-related risks by listed companies and financial institutions would improve capital allocation and support investment in emission abatement projects.

MAIN FINDINGS	KEY RECOMMENDATIONS
Ensuring a sustained recovery in output and jobs	
International borders remain closed, negatively impacting education exports and bilateral tourism. Labour shortages are arising in some sectors traditionally reliant on foreign workers and there are many Australian citizens stuck abroad because of hotel quarantine caps.	Ensure all eligible adults are able to receive COVID-19 vaccination and open international borders at the earliest possible date.
The substantial fiscal response at the onset of the pandemic was enabled by the country's strong starting fiscal position. The stimulus measures were front loaded and temporary. Additional targeted measures were announced with the reimposition of containment measures in some states.	Restore fiscal sustainability in a gradual manner and adopt a more expansionary stance of fiscal policy if further containment measures have a significant negative impact on economic growth.
Fiscal policy is now being conducted in an environment of higher public debt, with fiscal costs from ageing in prospect. The independent fiscal authority (the Parliamentary Budget Office) fulfils a narrower role than counterparts in many other OECD countries.	Task an independent fiscal institution, such as the Parliamentary Budget Office, with both formal evaluation and monitoring of the government's fiscal strategy. Implement a medium-term fiscal strategy with targets that are associated with specific timeframes or conditional on measurable economic outcomes.
Young and low-wage workers experienced the greatest job losses through the pandemic. The unemployment benefit replacement rate remains close to the lowest in the OECD and below estimates of the relative poverty line. This partly reflects prior indexation to consumer price inflation.	Further increase the unemployment benefit rate and consider indexing the rate to wage inflation.
Australia's tax mix remains tilted towards income taxes. With an ageing population over the next 40 years, revenue streams will come under significant pressure under current policy settings. In addition, some inefficiencies and distortions in the tax system remain.	Further shift the tax mix away from income taxes (especially personal income tax) and inefficient taxes (including real-estate stamp duty) and towards the Goods and Services Tax and recurrent land taxes.
The Reserve Bank of Australia has added new instruments to its toolkit. In particular, a government bond purchasing programme, which could be expanded if needed. The central bank's preferred measures of underlying inflation have undershot the target since 2015.	As in other OECD countries, undertake a review into the monetary policy framework that is broad in scope, transparent and involves consultation with a wide variety of relevant stakeholders. Keep monetary policy expansionary, but stand ready to tighten policy if underlying inflation risks sustainably rising above the target or inflation expectations risk becoming de-anchored.
Raising productivity growth to boost future living standards	
About one fifth of Australian workers require a license to perform their work. Most need distinct licenses in each Australian state and territory. This unnecessarily raises economic costs, including by slowing resource reallocation.	Legislate automatic mutual recognition of occupational licenses.
Land needs to be repurposed to take into account structural changes, not least those induced by the pandemic. However, there is limited incentive for local authorities in desirable locations to attract new businesses or expand dwelling supply.	Allow local authorities to raise more of their own-source revenue, at the same time as reallocating the minimum Financial Assistance Grant from wealthier local authorities to those in more disadvantaged areas.
Ensuring the financial sector supports a sustainable and inclusive economic recovery	
The register of security interests over personal property (Personal Property Securities Register) is considered difficult to use and lacks visibility.	Overhaul the Personal Property Securities Register then increase awareness among small businesses and lenders.
Comprehensive credit reporting and the new consumer data right in banking can help improve competition in lending for start-ups and smaller businesses by allowing borrowers to share information with other service providers.	Extend open banking to facilitate switching of providers and other actions ("write access") with appropriate protections.
Disclosure of climate-related risks by listed companies and financial institutions has increased but progress is uneven and there are still large data gaps.	Create a roadmap for improving the consistency, comparability and quality of reporting of climate-related risks by listed companies and financial institutions.
A Royal Commission found serious misconduct in the financial sector. The Government has implemented a significant number of the Commission's recommendations, but some reforms remain outstanding.	Complete the implementation of the reforms arising from the Royal Commission into the financial sector.
Reducing greenhouse gas emissions in a cost efficient way	
All states and territories have now committed to achieving net zero carbon emissions by 2050. National carbon emissions need to decline on a significantly steeper trajectory if this goal is to be met.	Develop a national, integrated Long-term Emissions Reduction Strategy that defines clear goals and corresponding policy settings for the path to achieving net zero emissions as soon as possible and preferably by 2050. Scale up the Safeguard Mechanism that exists as part of the government's Emissions Reduction Fund to appropriately price carbon emissions across sectors.


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