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SENATE

STANDING COMMITTEE ON ECONOMICS

ESTIMATES

(Budget Estimates)

THURSDAY, 31 MAY 2007

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SENATE STANDING COMMITTEE ON

ECONOMICS

Thursday, 31 May 2007

Members: Senator Ronaldson *(Chair)*, Senator Stephens *(Deputy Chair)*, Senators Bernardi, Chapman, Hurley, Joyce, Murray and Webber

Participating members: Senators Adams, Allison, Barnett, Bartlett, Boswell, Bob Brown, George Campbell, Carr, Conroy, Eggleston, Chris Evans, Faulkner, Ferguson, Fielding, Fifield, Forshaw, Hogg, Kemp, Kirk, Lightfoot, Ludwig, Marshall, Ian Macdonald, Sandy Macdonald, McGauran, Milne, Nettle, O'Brien, Parry, Payne, Robert Ray, Sherry, Siewert, Watson and Wong

Senators in attendance: Senators Bernardi, Chapman, Fielding, Joyce, Milne, Murray, Parry, Ronaldson, Sherry and Wong

Committee met at 9.01 am

TREASURY PORTFOLIO

Consideration resumed from 30 May 2007

In Attendance

Senator Minchin, Minister for Finance and Administration

Senator Colbeck, Parliamentary Secretary to the Minister for Finance and Administration

The Treasury
Dr Ken Henry, Secretary
Outcome 1: Sound Macroeconomic Environment
Output Group 1.1: Macroeconomic Group
Mr David Parker, Executive Director
Dr David Gruen, Executive Director
Dr Steven Kennedy, General Manager, Domestic Economy Division
Mr Phil Garton, Manager, Domestic Economy Division
Ms Nghi Luu, Senior Adviser, Domestic Economy Division
Mr David Pearl, General Manager, International Economy Division
Mr Milo Lucich, International Economy Division
Mr Paul Gardiner, Manager, International Economy Division
Mr Roger Brake, General Manager, International Finance Division
Ms Bernadette Welch, Manager, G20 and Asia-Pacific Economic Cooperation Secretariat
Mr Luke Yeaman, Senior Advisor, G20 and Asia-Pacific Economic Cooperation Secretariat
Dr Paul O'Mara, General Manager, Macroeconomic Policy Division
Mr Graeme Davis, Principal Adviser, Macroeconomic Policy Division
Mr Tony McDonald, Senior Adviser, Macroeconomic Policy Division
Mr Greg Coombs, Manager, Macroeconomic Policy Division

Outcome 2: Effective Government Spending Arrangements
Output Group 2.1: Fiscal Group
Mr David Tune, Executive Director
Mr David Martine, General Manager, Budget Policy Division
Mr Jason McDonald, Manager, Budget Policy Division
Mr Rob Heferen, General Manager, Social Policy Division
Mr Peter Robinson, Principal Adviser, Social Policy Division
Ms Peta Furnell, Principal Advisor, Social Policy Division
Mr Michael Willcock, General Manager, Commonwealth-State Relations Division
Ms Maryanne Mrakovcic, General Manager, Industry, Environment and Defence Division
Mr Geoff Francis, Manager, Industry, Environment and Defence Division
Mr Michael Burton, Chief Financial Officer, Corporate Services Division
Outcome 3: Effective taxation and retirement income arrangements
Output Group 3.1: Revenue Group
Mr Mike Callaghan, Executive Director
Mr Blair Comley, General Manager, Business Tax Division
Mr Mark O'Connor, General Manager, Individuals and Exempt Tax Division
Mr Martin Jacobs, Manager, Individuals and Exempt Tax Division
Mr John Lonsdale, General Manager, Superannuation, Retirement and Savings Division
Ms Louise Seeber, Manager, Superannuation, Retirement and Savings Division
Mr Nigel Murray, Manager, Superannuation, Retirement and Savings Division
Mr Nigel Ray, General Manager, Tax Analysis Division
Mr Damien White, Manager, Tax Analysis Division
Mr Phil Gallagher, Manager, Tax Analysis Division
Mr Colin Brown, Manager, Tax Analysis Division
Mr Anthony King, Tax Analysis Division
Mr Paul McCullough, General Manager, Tax System Review Division
Ms Brenda Berkeley, General Manager, Tax Design Division
Mr Matthew Flavel, Business Tax Division
Outcome 4: Well Functioning Markets
Output Group 4.1: Markets Group
Mr Jim Murphy, Executive Director
Mr Patrick Colmer, General Manager, Foreign Investment and Trade Policy Division
Mr Chris Legg, General Manager, Financial System Division
Ms Vicki Wilkinson, Manager, Financial System Division
Mr Trevor King, Manager, Financial System Division
Ms Kerstin Wijeyewardene, Manager, Financial System Division
Mr David Love, Manager, Financial System Division
Mr Andre Moore, Manager, Financial System Division
Mr Geoff Miller, General Manager, Corporations and Financial Services Division
Ms Marian Kljakovic, Manager, Corporations and Financial Services Division
Mr Matt Brine, Manager, Corporations and Financial Services Division
Ms Ruth Smith, Manager, Corporations and Financial Services Division
Mr Bede Fraser, Manager, Corporations and Financial Services Division

Mr Jorge del Busto, Senior Adviser, Corporations and Financial Services Division
Mr Steve French, General Manager, Competition and Consumer Policy Division
Ms HK Holdaway, Manager, Competition and Consumer Policy Division
Mr Glen McCrea, Senior Adviser, Competition and Consumer Policy Division
Mr Aidan Storer, Senior Adviser, Competition and Consumer Policy Division
Mr Brad Archer, Manager, Competition and Consumer Policy Division
Mr John Karatsoreos, Senior Adviser, Competition and Consumer Policy Division
Mr Michael Johnston, Manager, Competition and Consumer Policy Division
Ms Jane Melanie, Senior Adviser, Competition and Consumer Policy Division
Mr James Chisholm, Senior Adviser, Competition and Consumer Policy Division
Ms Jacky Rowbothom, Senior Adviser, Competition and Consumer Policy Division
Mr Peter McCray, General Manager, Financial Literacy Foundation
Ms Linda Rosser, Manager, Financial Literacy Foundation
Mr Peter Martin, Australian Government Actuary

Australian Accounting Standards Board

Professor David Boymal, Chairman
Mr Angus Thomson, Technical Director

Australian Bureau of Statistics

Mr Brian Pink, Australian Statistician
Mr Peter Harper, Deputy Australian Statistician, Economics Statistics Group
Mr Denis Farrell, Acting Deputy Australian Statistician, Services Group
Ms Teresa Dickinson, Acting First Assistant Statistician, Corporate Services Division
Mr Mark Whybrow, ABS Chief Financial Officer

Australian Competition and Consumer Commission

Mr Graeme Samuel, Chairman
Mr Brian Cassidy, Chief Executive Officer
Mr Joe Dimasi, Executive General Manager, Regulatory Affairs Division
Mr Mark Pearson, Executive General Manager, Enforcement and Compliance Division
Mr Scott Gregson, General Manager, Adjudication Branch
Mr Nigel Ridgeway, General Manager, Compliance Strategies Branch
Ms Rose Webb, General Manager, Enforcement and Coordination
Ms Lee Hollis, General Manager, Cartels and Criminal Enforcement Branch
Mr Tim Grimwade, General Manager, Mergers and Assets Sales Branch
Ms Helen Lu, General Manager, Corporate
Mr Adrian Brocklehurst, Chief Financial Officer
Mr Michael Cosgrave, General Manager, Communications Group
Mr Michael Carnahan, General Manager, Information, Research and Analysis

Australian Office of Financial Management

Mr Neil Hyden, Chief Executive Officer
Mr Michael Bath, Director, Financial Risk
Mr Andrew Johnson, Head, Compliance and Reporting
Mr Pat Raccosta, Chief Financial Officer

Australian Prudential Regulation Authority

Dr John Laker, Chairman

Mr Ross Jones, Deputy Chairman
Mr Brandon Khoo, Executive General Manager, Specialised Institutions Division
Mr SG Venkatramani, General Manager, Central Region, Specialised Institutions Division
Dr Steve Davies, General Manager, Statistics

Australian Securities and Investments Commission
Mr Tony D'Aloisio, Chairman
Mr Jeremy Cooper, Deputy Chairman

Australian Taxation Office
Mr Michael D'Ascenzo, Commissioner of Taxation
Ms Jennie Granger, Second Commissioner of Taxation
Mr Bruce Quigley, Second Commissioner of Taxation
Ms Margaret Crawford, Chief Operating Officer
Ms Raelene Vivian, Deputy Commissioner
Ms Sally Druhan, Assistant Commissioner
Mr Greg Dark, First Assistant Commissioner

Corporations and Markets Advisory Committee
Mr Vincent Jewell, Acting Executive Director

Financial Reporting Council
Mr Charles Macek, Chairman
Mr Jorge del Busto, Secretary

Inspector-General of Taxation
Mr David Vos AM, Inspector-General of Taxation
Mr Rick Matthews, Deputy Inspector-General of Taxation

National Competition Council
Mr John Feil, Executive Director
Mr Ross Campbell, Director

Productivity Commission
Mr Bernard Wonder, Head of Office
Mr Garth Pitkethly, First Assistant Commissioner
Mr Michael Kirby, First Assistant Commissioner
Ms Su McCluskey, Executive Director, Office of Best Practice Regulation

Takeovers Panel
Mr Nigel Morris, Director

Department of the Treasury

CHAIR (Senator Ronaldson)—I call this meeting of the Senate Standing Committee on Economics to order. I welcome Senator Minchin, representing the Treasurer, and officers of the Department of the Treasury. This morning we will be commencing with Treasury Output Group 1.1: Macroeconomic Group. Minister, do you or any of the officers wish to make an opening statement?

Mr Parker—I will just explain the context of why there are two people with the title 'Executive Director' sitting here at the table. For the time being in the Macroeconomic Group we have two people operating in this role. This is because of the growth in the work program around the international area with the chairing of the G20 last year and APEC this year. That is why there are two of us. For the time being, broadly as between David Gruen and me, David Gruen takes the domestic side of the house and I take the international side of the house. So for your questions today we will be answering them between us on the basis of that split.

CHAIR—We are in very capable hands, I suspect. Thank you for that. Senator Sherry.

Senator SHERRY—Just to go to this arrangement, you seem to be indicating that it is a temporary arrangement?

Mr Parker—That was always the intention, that is right.

Senator SHERRY—The best of luck between the two of you as to who ends up retaining the position. I wanted to go to some aspects of the commodity price mining boom. So I guess that is you, Mr Gruen. Firstly, could you describe aspects of the current boom as it impacts on the terms of trade and the Australian economy, and could you particularly touch on domestic incomes, consumption investment, price assets, profitability and employment? I have given you a grand agenda there.

Dr Gruen—Thank you. I am not sure that I will be able to pick up all of those things, so please remind me if I forget any ones that you want me to deal with. Broadly speaking, largely as a consequence of strong growth in developing countries, particularly China and more recently India, the worldwide demand for raw materials commodities has gone up very substantially over the last few years and Australia is a large exporter of those products. A bit over 40 per cent of our exports are mineral exports and the prices of a wide range of those commodities have gone up very substantially. That is on the export side.

At the same time, we are a big importer of manufactures and China is also putting downward pressure on the world price of manufactures, which is also tending to improve our terms of trade. So on both the export side and the import side Australia is benefiting from the very substantial continued growth in the Chinese economy and also, to a lesser extent, the Indian economy, so that the Australian terms of trade are up. One number that I could quote is the number that was in the secretary’s recent speech which is that the Australian terms of trade were up I think 37 per cent between 2001 and 2006, which is the largest increase over that period in the OECD.

That has had very substantial consequences for the Australian economy. First of all, it has meant that national income has risen very strongly because, even without any increase in the quantity of exports, we get substantially more money for the exports that we sell into international markets and so there has been a big boost to domestic incomes. There has also been a rise in the nominal and real exchange rate coming from the rise in commodity prices. That has had a range of impacts in the economy, putting some pressure on other parts of the traded sector, putting more heightened competitive pressures on other parts of the traded sector, other than those parts that are benefiting from the big rises in prices. It has also contributed to some parts of the economy growing more strongly than other parts. In particular, Queensland and Western Australia are benefiting from the big rises in resources prices and the rest of the country is growing less rapidly than it otherwise would. Let me just stop there and let you take the questions where you would like to take them.

Senator SHERRY—In your comments you mentioned the improvement in our terms of trade; 37 per cent I think was the figure you gave between 2001 and 2006, which was the best in the OECD. How does that compare historically with Australia's past?

Dr Gruen—The terms of trade are currently at the highest level they have been since the Korean War. There was a spike in the terms of trade in 1974 but we are now at a level slightly higher than that. These are highest terms of trade since we got a pound a pound for wool during the Korean War.

Senator SHERRY—You mentioned the increase in national income. How does that impact on domestic income? Could you just deal with that?

Dr Gruen—The impact on domestic incomes are that stock markets go up substantially. There has been a big rise particularly in the value of resource companies, and those shares are widely held both in Australia and outside Australia. There is increasing demand for labour, for workers, in the mining sector and the construction sector, so there is a big boost to demand for capital and labour to take advantage of these very substantially raised prices. There is a boost to the return to capital as well as an increase in demand for labour, as well as increases in government revenue at both federal and state levels.

Senator SHERRY—I wanted to get to the government revenue impact shortly, but in respect to the demand for labour do you have any estimates as to the direct growth in labour in the mining sector, not just for mining companies but obviously there is an indirect impact on construction—

Dr Gruen—Yes.

Senator SHERRY—and then as that increase in the labour force flows from other parts of the economy there is a further indirect impact as that labour transfers and there are new entrants or transfers from other parts of the economy.

Dr Gruen—Yes. I think Dr Kennedy may have more detail on this but it is certainly the case that if you look at mining and construction together the share of employment in those two industries is at its highest level for a very long time. It is about 10 per cent; is that correct?

Dr Kennedy—That is right.

Senator SHERRY—That is the total employed in mining in Australia.

Dr Gruen—In mining and construction.

Senator SHERRY—So it is about 10 per cent.

Dr Kennedy—That has risen from about 8 per cent. Construction was already quite a big share of employment. Through the year to the March quarter 2007, construction and mining employment grew by 7.6 per cent. That is quite rapid growth.

Senator SHERRY—Just to put this in some context, do you have the raw numbers? Percentages are always—

Dr Kennedy—Yes. That through-the-year number, that 7.6 per cent, represents 77,900 jobs over the year to March 2007 in construction and mining alone, and that growth has been going on for some time.

Senator SHERRY—Do you have any historical figures going back?

Dr Kennedy—Not to hand. I know over the last couple of years that mining and construction alone have accounted for about a third of all employment growth, so that is what is lifting their share. Of course we could get you more numbers if you wanted them over, say, a three-year period, or something like that.

Senator SHERRY—Isn't the general observation that average wages in this sector are the highest of sectors in the economy? Do you have any observations to make about that?

Dr Kennedy—Mining wages are metered through the wage price index as the industry with the highest wages at the moment. Construction wages were of a similar order; they eased more recently. But they have both been growing around the 5 per cent to 6 per cent mark, while wages in other industries are more around the 3½ per cent to 4 per cent mark.

Senator SHERRY—You mentioned in your remarks about the impact in terms of Queensland and WA in particular. This might be a side issue, but where do you rate the Northern Territory in that?

Dr Gruen—Good question. I am not certain I know.

Dr Kennedy—The Northern Territory has also had very good labour market outcomes and quite strong growth. It is a lot harder to measure because, being a small territory, compared to the other states there are more profound measurement issues. But they have clearly had good economic outcomes as well.

Senator SHERRY—If we look at the mining construction sector, is it true to say that the resonance of employees in that sector is now more dispersed than it was, say, 10 to 20 years ago? Let me illustrate. I know from personal experience, anecdotally to be sure, of two or three friends of mine who live on the north-west coast of Tasmania who commute in and out of WA on a fortnightly basis. We have seen that trend in the last decade. People fly in and fly out.

Dr Kennedy—Yes, that is right. I think we discussed at last estimates they will still get measured as being employed in Tasmania.

Senator SHERRY—With the impact of this growth of employment and incomes, obviously we have touched on the dispersal issue. What is the impact on consumption more broadly in the economy, not just in WA and Queensland?

Dr Gruen—To the extent that incomes rise through the channels that I talked about earlier, that would tend to support consumption growth. I guess you could also add to that the rise in the exchange rate makes imports cheaper, so the quantity of imports that you can buy with a given number of Australian dollars goes up. Having said that, consumption in 2005-06 only grew by 2.6 per cent year average, which is probably a little less than what you would expect it to. But it had grown by fours and fives in the years prior to that, which is more a reflection of the activity we saw around the housing sector. While we have had these strong income growths we have actually had reasonably modest consumption, and what we have seen is some consolidation in household balance sheets. For example, you have seen the household savings ratio in the national accounts, despite the effect on farm incomes of drought, begin to drift up more towards balance, whereas previously, in net terms, through income at least, the household sector was dis-saving.

Senator SHERRY—And what is the impact on investment?

Dr Kennedy—It has been quite profound. Investment as a proportion of nominal GDP is at a level we have not seen for 30 years for business investment. I think over the past five years the mining sector alone has invested $55 billion to expand production, so that is a lot of money.

Senator SHERRY—Yes. You almost touched excitement stage when you use that phrase 'quite profound'. That is Treasury-speak I rarely hear.

Dr Kennedy—That is as excited as we get.

Senator SHERRY—Okay, so it is quite profound. And the impact on prices and assets?

Dr Gruen—One of the impacts was the one I talked about earlier that it is good for share prices, especially in the resource sector, and it has also obviously led to very significant rises in house prices in Perth and, to a lesser extent, Brisbane. Those would be the main impacts on asset prices.

Senator SHERRY—You have already touched on the profitability of this sector at the present time?

Dr Gruen—Yes. It is very strong.

Senator SHERRY—Historically—

Dr Gruen—The share of GDP going to mining profits, I think, doubled over about three years. I think that is right.

Dr Kennedy—That sounds about right.

Dr Gruen—So the answer is yes.

Senator SHERRY—If we look at that magnitude in the increase in our terms of trade, the boost to national income over and above the more direct impact on the real economy, the national accounts provide a measure of real gross domestic income. If you look at that, I think the growth has been, what, 4½ per cent more recently?

Dr Gruen—I do not have the figures in front of me but that would not surprise me. That sounds plausible.

Senator SHERRY—That has been, as I understand it, growing more strongly than real gross domestic product?

Dr Gruen—Yes, that would be true because national income would be growing more strongly than the real gross domestic product because national income takes into account the income boost that you get from the rise in the price, whereas the real output measure takes that away.

Senator SHERRY—In outlining the difference between the two, is it correct to conclude that the difference between the two provides a broad picture of the income boost the economy has received?

Dr Gruen—I think that is correct. From the terms of trade rise?

Senator SHERRY—Yes.

Dr Gruen—Yes, I think that is correct.

Dr Kennedy—You can think of the extent to which real gross domestic income varies from real GDP as showing you how Australia's purchasing power is increasing relative to the rest of the world. It is really saying how many additional imports can we buy for the amount of exports that we have. GDP tells you how much you produce. That gives you in a sense a broader measure of the welfare, or the amount you can purchase with that income.

Senator SHERRY—You touched earlier on, I think, the year 1974. If we look back at that period it seems to me that the level of underlying strong economic growth today compared to that period—the spike you referred to in 1974—seems to be stronger, more long-lasting and more robust compared to that period in the early mid-seventies.

Dr Gruen—Because the two episodes have some similarities, we have actually looked in some detail at a comparison. You are certainly correct that the growth this time has been much steadier. There were periods in the seventies associated with the terms of trade boom when we had extremely strong growth. I am not certain of the dates but there is one year when growth over the year in the non-farm economy was 8.8 per cent. And then quite soon afterwards there was a mild recession. So the economy was on a bit of a roller coaster at the time.

Senator SHERRY—It seems to me on this occasion at least, if we look back at that period with a fixed exchange rate, capital controls, centralised labour market, high tariffs—

Dr Gruen—Yes.

Senator SHERRY—If you look at the contrast in those economic issues I have mentioned, the policy parameters compared to today, do you believe that that has impacted on the steadier, more consistent outcome that we have today?

Dr Gruen—Yes, I do. I think another part of that story is the much more deregulated nature of the labour market so that in the seventies when you had a situation where when wages in one sector rose strongly because of very high profitability, that tended to flow through to other sectors. At the time that was actually helped by a very substantial rise in the minimum wage. I think it was a 17 per cent rise in the minimum wage in 1974. But also it is true that male wages in 1974 rose by just over 30 per cent and that would have been the fastest growth of the century, apart from the fact that female wages rose even faster. But the point you make about the floating exchange rate is also important. At the time of that terms-of-trade boom, the exchange rate was in the control of the federal government and, understandably, the federal government of either political persuasion had a lot of trouble revaluing the exchange rate because that caused pain for exporters who were not getting the terms-of-trade boost. The first significant revaluation of the exchange rate occurred two days before Christmas in 1972 because the idea was to try and keep it out of the papers.

Senator SHERRY—I do recall that, actually. And the issue of tariffs?

Dr Gruen—I think the general issue is the economy being more flexible, with the decline in tariffs being part of that story, but there are many other aspects of the improved flexibility of the economy.

Senator SHERRY—It is fair and reasonable to say that the sort of reforms we have been talking about or touched on have been part of the reason we have seen a more consistent, steadier impact of the mining boom.

Dr Gruen—I think it is the closest we get to a natural experiment in economics. I think the outcome has been remarkably different and I think that tells us something.

Senator SHERRY—I would like to look at the impact on aspects of the Commonwealth budget of the 'mining boom' relating to the various issues that we have touched on here. There is obviously a direct impact on company tax revenues?

Dr Gruen—Yes, although if you are going to ask detailed questions about revenue, I am not the person to answer them.

Senator SHERRY—Who is.

Dr Gruen—The revenue group.

Senator SHERRY—I thought you would say that, but I want to get an acknowledgement that there are impacts as a consequence of the factors we have been discussing.

Dr Gruen—Yes.

Senator SHERRY—So there is an impact on, obviously, company tax revenues?

Dr Gruen—Yes.

Senator SHERRY—That extends to other sectors, obviously construction which we have talked about in the context of mining?

Dr Gruen—I guess there are indirect effects to the extent that they flow through the economy, yes.

Senator SHERRY—And there is obviously an impact on personal income tax revenues because of higher employment and higher incomes?

Dr Gruen—Yes.

Senator SHERRY—We have touched on the asset value both of direct housing and more broadly shares, for example, through the superannuation rates of return?

Dr Gruen—Yes. It is worth making the point that a boost to demand for labour will only be sustainable if the economy is sufficiently flexible to allow that labour to be employed in a way that does not generate inflationary pressures. The fact that the mining boom has generated extra demand for labour and the fact that the economy has been able to absorb that extra demand without generating inflationary pressures is not a direct effect of the mining boom. The mining boom created the extra demand but the capacity of the economy to absorb it without generating inflationary pressures says something about the labour market.

Senator SHERRY—Also, is there not a flip side in terms of government expenditure programs, for example, income support payments and family benefits? Unemployment is reduced, therefore there is a gain to budget in that area?

Dr Gruen—As I say, provided the unemployment rate can fall without generating inflationary pressures then, in a sense, if the labour market has been reformed in such a way that the sustainable rate of unemployment has fallen then, if it were not for the mining boom, in principle, monetary policy can be easier in order to allow demand to increase and take up those extra workers.

Senator MURRAY—Dr Gruen, you have said ‘unemployment’ each time. It is the fall of underemployment as well which—

Dr Gruen—That is true.

Senator MURRAY—So you would bracket those together, wouldn’t you?

Dr Gruen—Yes, I would. There is undoubtedly a substantial encouraged worker effect, which is economics-speak for the idea that when the labour market is buoyant, people who were previously out of the labour market are attracted into looking for work.

Senator MURRAY—I recall the figures indicated a substantial number of those underemployed desired more work and were unable to get it in former years—

Dr Gruen—Yes.

Senator MURRAY—Those people who desired more work now often can get it?

Dr Gruen—Yes.

Senator MURRAY—And that has the same effect on the market that you ascribe to unemployment?

Dr Gruen—Indeed it does.

CHAIR—The long-term unemployed presumably is also reflected in this as well, or the reduction in the numbers of long-term unemployed?

Dr Gruen—I think the proportion of long-term unemployed has come down very substantially along with the unemployment rate.

Senator MURRAY—Just to conclude my point, we are tracking through the statistics the unemployment rate fall very regularly. Are equivalent statistics available on the fall in underemployment?

Dr Gruen—There are statistics, of course, on the participation rate, which is the proportion of the 15- plus population that is either employed or looking for work. And it is also the case that the ABS—Dr Kennedy is going to know this in more detail than I do—does ask people questions that enable you to get statistics on underemployment. But I will let Dr Kennedy answer that.

Dr Kennedy—That is true. The ABS publishes a measure of under utilised labour, or underemployment, if you like, that captures exactly what you were talking about.

Senator MURRAY—At what frequency?

Dr Kennedy—I think that is quarterly. In the latest Reserve Bank monetary policy statement they plot with the unemployment rate a measure of hours underemployment which is the type of measure that you are talking about. That is up to date. And, as Dr Gruen said, that has come down with the unemployment rate. We also—

Senator MURRAY—At the same rate is what I am interested in?

Dr Kennedy—Yes, it has come down at much the same rate. A couple of years ago it had not quite fallen to the same extent but over the last couple of years it has fallen away quite a bit. The flip side of this is to look at measures of labour utilisation, so there would be a number of people who are employed as a proportion of the working age population, which often gives you a cleaner measure of just how much labour is being taken up or to adjust that for the number of hours they are working as well. One measure of that is full-time equivalent employment, converting part-timers into full-timers, and looking at the proportion of the working age population who are in employment. Those measures are levels that we have not seen, particularly once you take out demographic factors, for, again, about 30 years.

Senator MURRAY—Thank you for letting me intercede. To conclude, my point being I think that too little credit is given to the fall in underemployment and the greater participation in that sector, or the longer hours they are working, for its contribution to lower wage inflationary pressures.

Dr Kennedy—Certainly you could get a misread without taking into account the fact that there is excess labour, if you like, or additional capacity that can be taken up there. It was the case at one stage that about 25 per cent of people who were employed part-time said they were seeking additional hours and I believe those number have fallen away further.

Senator SHERRY—Just to recap, we have been running through the various impacts broadly on the budget and the revenue, not the specific revenue impacts because that is revenue group. But I just want to go into a little more detail, following up from Senator Murray's comments. Has Treasury actually done some analysis on the direct and indirect employment impacts? We have discussed the direct employment impacts. But clearly there must also be indirect impacts in retail, hospitality and those types of areas? Even in manufacturing, I know for example that in Burnie on the north-west coast of Tasmania there is a very substantial mining machinery components manufacturing, Elphinstones, for example. It is very, very substantial.

Dr Gruen—I think the answer to that is that we have not done any direct modelling of that aspect, although we do have employment equations which explain employment using variables such as real GDP and real unit labour costs to help explain employment, but I do not think we have done any explicit modelling of the employment effects in terms of trade boost, though we may have done some with TRYM.

Dr Kennedy—No, not specific modelling. Normally when you get strong demand in one sector, if the economy had been fully employed, if you like, it would have had to have released labour from one sector to the sector where we were seeing this strong demand. The exchange rate would help in that adjustment, which it has to some extent. We have talked about that before—the Gregory thesis or Dutch disease type effects. But, interestingly, what we have seen in this episode is the share of the amount of labour that goes to manufacturing in Australia has declined, but it just continues to decline at the rate that it has been declining at for many years now. What has happened is that we have absorbed more labour into the workforce. If you look at employment-population ratios in Queensland and WA, they are at higher levels than they are in other states. There have been these indirect effects and there has been some shifting of labour between sectors, but there has also just been a general absorption of labour that was there into the economy.

Senator SHERRY—In looking at the impacts on the budget we cannot simply quarantine it to the corporate company tax revenues, there is a much broader impact on the areas that we have been discussing?

Dr Gruen—That is correct, subject to the caveat that I made earlier which was that it is important to recognise that if demand goes up it has to be possible for the economy to incorporate that without generating inflationary pressure—

Senator SHERRY—Sure.

Dr Gruen—And that is an important caveat.

Senator SHERRY—I accept the caveat, but the areas of company tax revenue, individual revenue through increasing employment, higher incomes in that sector—not in other sectors—asset values, superannuation outcomes, reduced unemployment and reduced social security payments have had impacts on the budget. I think if I go back to the earlier comment, they have been 'quite profound' impacts?

Dr Gruen—The impacts on the economy have been quite profound.

Senator SHERRY—And quite profound impacts on the budget. Or you would not get quite that excited?

Dr Gruen—Some of us get quite excited about budgets, but then we are in Treasury.

Senator SHERRY—Would you agree the impacts have been quite profound as well on the budget?

Dr Gruen—I am not in a position to make that call, but—

Senator SHERRY—How would you describe the impact?

Dr Gruen—They have been significant.

Senator SHERRY—Advantageous?

Dr Gruen—Yes.

Senator SHERRY—Thank you.

Senator MURRAY—You are describing yourself as a man of limited profundity?

Dr Gruen—Indeed. I am willing to accept that accolade.

Senator SHERRY—I have been reading on occasions comments about the impact of the mining boom being confined to company tax revenues, and it did puzzle me somewhat given some fairly obvious issues that we have run through in the last half an hour or so. It seemed to me pretty obvious there is a broader impact beyond company tax revenues, isn't there?

Dr Gruen—Yes.

Senator SHERRY—Related to this but in regard to China and India—

Senator MURRAY—Are you moving off domestic?

Senator SHERRY—I am going to international.

Senator MURRAY—Could I just stay with domestic whilst you are there?

Senator SHERRY—yes.

Senator MURRAY—There are three areas of inquiry I just want to pick up briefly. I tend to follow the writings of Dr John Edwards a bit because he is very concise and precise. He wrote an interesting synopsis recently on the real situation with respect to mining values and volumes and export relationships. But what interested me in his analysis was that he seemed to indicate that elaborately transformed manufactures were a bit undersung as contributors to our economic strength. Is that an accurate view in your mind? Manufacturing tends to be downplayed as a contributor to our economic strength, but he seemed to think it was doing very well.

Dr Gruen—I think that is a fair characterisation, but I think Dr Kennedy knows about this in more detail.

Dr Kennedy—It was the case that in 2005-06 elaborately transformed manufactures in volume terms—I am not putting to one side the price effects—were the fastest growing exports in that year, and they also did reasonably well in 2004-05. They have not quite grown at the rates they grew through the nineties, when they were growing at seven per cent and eight per cent. The growth rates in these years would be more like four per cent and five per cent. But one thing we should be wary of when thinking about the effect that China is having on manufacturing sectors around the world is that a lot of China's manufacturing is focused around electronic goods, clothing and footwear and some household goods, whereas other types of manufactures that other countries produce, including Australia, are actually being strongly demanded from China at the moment. Manufacturing in Germany, in Japan and, to some extent, here in Australia—manufacturing that complements China's expansion—is actually doing quite well. Some sectors of manufacturing over the last few years have actually done quite well. Also, it is particularly those that support the construction sector, but some parts of exports have done quite well. For example, I believe pharmaceutical exports out of Australia, which also make it into elaborately transformed manufactures, have done quite well over the last few years.

Senator MURRAY—My other two sets of brief questions relate to pressure points. Dr Gruen, do you consider the Australian dollar to be too high? Is it a worry? I accept, of course, the doctrine that it should float and that it should be allowed to operate to market forces; but, nevertheless, it has very real effects on both our imports and our export possibilities. My instinct is that it is at the higher level that you desire in an economy like ours, but I want to know what your opinion is of it.

Dr Gruen—I worked in the Reserve Bank for an extended period and I learnt that one never comments about the Australian dollar.

Senator SHERRY—You just did.

Dr Gruen—But I am happy to say a little bit more than that. Going back to what we were talking about earlier, the terms of trade are at the highest level they have been in 50 years and the market, as well as we in Treasury and everyone else, is making assessments of how long we think this level of the terms of trade is likely to be sustained. And certainly it appears to be on the back of extremely strong growth in China, which at the moment shows no signs of slowing down, at least not significantly. As a consequence of that, that is leading to very strong conditions in the mining sector and generating a lot of employment and investment in the mining sector. Part of the stabilising effect on the economy as a whole, of dealing with a situation where one part of the economy is growing very rapidly, is the shock absorber role that the exchange rate plays by appreciating. In fact, the real exchange rate has appreciated substantially less than the terms of trade have gone up. That is quite unusual. If you look back over the history since the Australian dollar was floated in 1983, there is quite a close relationship between the real exchange rate and the terms of trade. This period stands out along with the period around 2000 as one where that relationship appears to be less strong than it was previously. I accept that it is putting competitive pressure on other parts of the traded sector, but from the point of view of macroeconomic stability that is probably for the good.

Senator MURRAY—You have no fears that its negative effects on the ability of some sectors to compete as well as they otherwise might are not greater than its benefits in terms of keeping our economy stable?

Dr Gruen—That is something on which reasonable people could disagree, but I also think that there are very substantial benefits to having a stable macroeconomy, and they flow to a lot of people, not just those who are directly affected by the strength in the mining sector. In terms of a more stable environment for investment right across the economy, the idea that the economy is growing at roughly its trend rate rather than gyrating around in response to big terms of trade rises or falls seems to me to be a significant benefit. The other thing I would say is that Australian companies have by now had a quarter of a century of experience of an exchange rate that goes up and down. One of the reasons why the Australian economy was so unaffected by the Asian crisis was that when new shocks come along and the exchange rate moves by a lot, people know that that is what happens and they have not arranged their financial affairs in such a way that when that happens it will drive them bankrupt, which is what happened in large parts of east Asia. I accept that it does put competitive pressures on other parts of the traded sector, but I guess you could use Churchill's defence of democracy; it may not be the best system, but it is better than all of the alternatives.

Senator MURRAY—Yes. Contrary to my point, it is a bit higher than desirable from the perspective of exporting industries and perhaps from the perspective of importers. Its lack of volatility at present is an advantage. I have one last brief question to ask you. How serious is the lag in infrastructure investment? Dr Kennedy indicated earlier a figure of $55 billion in largely productive capacity by the mining industry. That is not to do with distributional capacity. How serious is the infrastructure lag in holding back our economy?

Dr Gruen—One can definitely point to particular areas where infrastructure is causing a bottleneck for exports. The obvious one is Dalrymple Bay, but there are almost certainly others. I found this encouraging when we did this work. We had a careful look at the current mining boom and the previous mining boom. We lined them up with each other in terms of the first year when we had double-digit growth in mining investment. The previous time was in the late 1970s. Then we looked at what happened over the subsequent decade to mining investment and exports. We have five years of history for the current mining boom, but we have a whole decade for the previous one. Interestingly, the pattern of investment in the two mining booms looks quite similar. In other words, there is a huge rise in investment in both cases. What we found interesting and encouraging was that the pattern of export growth was also very similar in aggregate across the non-rural exports. There was a period of about five years when there was very little export growth and then over the subsequent five years in the previous case there was very substantial export growth. That led us to think that the pattern that we are seeing now is quite similar to the one we saw when we had a similar sized boom in the mining sector. To the extent that there are bottlenecks, they are somewhat similar to the bottlenecks that were facing the sector the last time when we went through a boom like this.

Senator MURRAY—I will try to interpret what you are telling me and bounce it back to you. You are suggesting that the lags in infrastructure investment—largely what I would call distributional capacity: road, rail, ports and so on—are not a major impediment to our maximising our economic good times?

Dr Gruen—All I am saying is that I was encouraged to see that the last time we went through a similar sized expansion in mining in this sector we got a similar response, at least thus far. It encouraged me to think that export growth in this sector was likely to be very substantial over the next several years. But it is hard to make any more definitive statements about it than that.

Senator SHERRY—I would like to go back to the earlier discussion you were having with Senator Murray, where you described the issues around the exchange rate and terms of trade, noting that, if there are problems, it is a problem for good in terms of an adverse impact on some sectors of Australia’s economy. What about the impact on the rural sector with agricultural exports?

Dr Gruen—It is having an impact on agricultural exports. That is clear.

Senator SHERRY—Is it favourable?

Dr Gruen—No. Do you mean the higher exchange rates?

Senator SHERRY—Yes.

Dr Gruen—No. The higher exchange rate would constrain exports.

Senator SHERRY—Have you done any examination of this impact in our rural agricultural exports/rural sector?

Dr Gruen—No, we have not done any modelling of that.

Dr Kennedy—Obviously the major constraint on rural exports over the last four to five years has been climatic conditions.

Senator SHERRY—Yes. That is another factor that accentuates the difficulties facing that sector.

Senator JOYCE—Do you think the rising dollar caused the drought?

Dr Gruen—We agree on the answer to that one.

Senator SHERRY—I must say in terms of your earlier comments I was expecting an intervention from the National Party.

Senator JOYCE—You got it.

Senator SHERRY—If the drought comes to an end we will still have the issue of the higher exchange rate and the impact that it will have on export prices from the rural sector in what is a corrupted world market.

Dr Gruen—Yes.

Senator SHERRY—Do you not believe there is any particular need for Treasury to examine the impact on this sector? You have not done any special work to date?

Dr Gruen—We have not done any special work to date. We would understand the general direction of the effect and it would be an effect operating not just on the rural sector but on all parts of exports that are not benefiting from the big rise in their prices.

Dr Kennedy—And of course we monitor the rural sector and we look at the amount of income that is being generated in the rural sector. Possibly for some parts of the rural sector it could be the case that the prices of their commodities might be rising at this time with the exchange rate. For example, wheat prices or something like that. Obviously they cannot benefit from it if they cannot get any production out because of the drought. We certainly stay abreast of it and we are certainly aware of the very large fall in agricultural income over the last couple of quarters in the national accounts, which is clearly drought related.

Senator SHERRY—What has been the evidence of the fall in income? Do you have approximate figures? Do you have anything that comes to mind?

Dr Kennedy—I will see if I can get something to hand, but the fall in agricultural income in the last two quarters was extremely large. The fall in farm production that we have for 2006-07 is of the order of 20 per cent.

Senator SHERRY—What about the income impact?

Dr Kennedy—I think it is larger. We will see if we can find it for you.

CHAIR—I have during the week been trying to give senators a reasonable run with their line of questioning. Are you happy for Senator Joyce to start?

Senator SHERRY—I am just interested in those income figures, and then I am happy. As I said, I was wondering about the lag impact on the National Party representation here.

Senator JOYCE—We thought you were doing an incredible job.

Dr Kennedy—I do not have them to hand, but they are larger than the 20 per cent fall in production.

Senator JOYCE—Never stop a good man at work.

Senator SHERRY—Thank you, Senator Joyce. We do understand the position of the somewhat gutted National Party and the government of the world today.

Senator JOYCE—I must say we have been looking trim lately. We have been looking after ourselves as opposed to the extensively gutted Labor Party.

Senator SHERRY—Coming back to the income figures.

Dr Kennedy—We do not have them here.

Senator SHERRY—I do remember looking back through some Senate estimates back in the seventies and eighties, when the National Party presence, questioning and even inquisition at these estimates was very rigorous indeed.

CHAIR—Do you want the call again, Senator Sherry, or are we going to Senator Joyce?

Senator SHERRY—Are the income figures available?

Dr Kennedy—We do not have them to hand. If any of your staff are looking for them, they are in ABS catalogue No. 5206.

Senator JOYCE—We have been talking about the manifestation of external demand factors with regard to some of the rural exports. Do you see an increase in the price of grain by reason of the current US and EU position on ethanol and their drive to be 20 per cent biorenewable by 2017? There is now the EU position, at 10 per cent, and the East Asia conference position, which has been reaffirmed last night, from listening to the minister, and their drive towards ethanol. What effects do you see that having?

Dr O'Mara—There is little doubt that the increased interest in making ethanol out of a range of agricultural products, including sugar and grain, has been a significant factor that has boosted world prices for those items over the last two or three years at least, particular since world oil prices shot up.

Senator JOYCE—Oil is a fundamental aspect of all means of production. What is the logic driving Europe, America and East Asia to go down this path?

Dr O'Mara—The logic that they should be using is assessing the cost of ethanol against the cost of oil and seeing whether it is a viable alternative. I am not sure that there is a lot of merit in highly subsidising ethanol in order to try to make it a substitute for oil, but if ethanol becomes a viable alternative in its own right simply because oil prices become so dear, it is a perfectly viable thing for those countries to be doing.

Senator JOYCE—Are there any subsidies on ethanol in Australia?

Dr O'Mara—I am not aware of any in particular at present.

Senator JOYCE—I am not aware of any, either.

Senator Minchin—It is excise free.

Senator JOYCE—That is not a subsidy, though, is it?

Senator Minchin—It is a subsidy relevant to the cost of petrol.

Senator JOYCE—What would Japan's decision to move towards ethanol be based on? It is not as though they are big grain growers.

Dr O'Mara—That is right. In their case it is an issue of oil security and looking at the impact of very high oil prices on the Japanese economy and to what extent they can diversify their energy sources.

Senator JOYCE—Do you think that is an applicable management plan that all government policies should have?

Dr O'Mara—I would have thought that it should be left largely as a commercial decision based on the relative price of the grains and the ethanol that can be produced from grain and sugar versus oil. If one becomes viable as a result of very high oil prices, then presumably commercial interests can then take over.

Senator JOYCE—That is interesting. Are there any impediments that would work against the market? We know that ethanol is out there at 75c a litre. There is obviously an economic argument for why it should be in the market, but it is not there in the prevalence that would reflect its price. Would you know of any impediments to the market operating properly and the construction of getting ethanol out into it?

Dr O'Mara—Are you talking domestically or internationally?

Senator JOYCE—Domestically. It is 75c domestically, and we are paying $1.45 today for fuel.

Dr O'Mara—No, I cannot comment on that.

Dr Gruen—I am not sure that we are the experts on this.

Dr O'Mara—We can talk in broad terms about the impact of demand for ethanol on rural prices.

Senator JOYCE—Let us talk about the flow-on effects from everywhere else on the planet except here. What effect do you think that would have on grain prices in Australia?

Dr O'Mara—It would certainly be positive. If the rest of the world, be it commercially or as a result of government intervention, demands a lot more grain and sugar in particular to produce ethanol, clearly the impact on world prices is positive and that in turn would flow through into a positive price impact for Australian exporters.

Senator JOYCE—The US is going to 20 per cent, the EU is going to 10 per cent, East Asia, Japan, China and India are all moving down this path. Is a development of markets now apparent throughout the world? Is there now a developing biorenewable fuel market that, if we are hooked into it, would have benefits for our rural exports and the price of rural exports?

Dr O'Mara—I would have thought so. As I just said, if there is a strong and increasing demand for grain and sugar around the world to convert into ethanol and that provides an additional demand for those items over and above their traditional uses for food, then clearly that is a positive development for world agricultural prices, including those received by Australia.

Senator JOYCE—I turn to the effect of prices on rural products and transport bottlenecks. This may be across all products, but is there any effect especially in places such as Queensland on the capacity to move produce at an effective tonnage and an effective rate to make the best of the markets that are currently apparent? Are we working at capacity or is there a lack of it because of our infrastructure problems?

Dr O'Mara—I am not able to comment on that specifically. Certainly we would want to ensure that we have our infrastructure working as efficiently as possible and we would want to make sure that investment decisions with regard to any additional infrastructure investment are based on sensible cost-benefit analyses and reasonable assessments of tonnage to be carried and freight rates versus the costs involved. We would like to have an environment where those sorts of decisions can be made along normal commercial lines.

Senator JOYCE—This is away from grain, but it certainly involves coal. To your knowledge, how are we going in meeting our infrastructure requirements for the markets that we are trying to supply in states such as Queensland?

Dr Gruen—I am sorry, I was distracted.

Senator JOYCE—I am referring to our capacity in supplying these markets and our transport infrastructure capacity for moving products, especially coal, in the predominant coal state of Queensland. How are we going there? Are there any problems? How are they managing their infrastructure requirements in that state?

Dr Gruen—I am not an expert on individual states and their infrastructure needs. I could go back to the previous comment that I made, which was that if you look in aggregate across the economy the export response to this surge in investment is very similar to the last time we had a surge like this. In a world where you have the sort of increase in coal prices that we have seen over the last few years that was largely unexpected, it is natural that the existing mines and infrastructure—the whole thing—will not be able to respond quickly to the huge increase in demand. There is no question that there are bottlenecks. That is clear. My impression is that people are trying to respond to those bottlenecks by increasing investment in infrastructure and clearing the bottlenecks.

Dr Kennedy—It has been clear that the iron ore response has been quicker than the coal response. For example, we have had stronger growth in iron ore export volumes than we have had in coal export volumes over the last four to five years. The extent to which people, particularly out of WA, have been able to respond does appear to have been more rapid than the response in Queensland and New South Wales. Part of the other issue at the moment is that, while they are expanding capacity, they often have to close parts of these facilities down, and we get some one-off effects.

Senator JOYCE—What about basic fundamentals/management principles such as an appropriate amount of rolling stock on the lines? How are they going with that in Queensland? Our nation is reliant on its coal exports to maintain our standard of living.

Dr Gruen—I do not think that we are in a position to answer detailed questions about the rolling stock in Queensland.

Senator JOYCE—You just said that Western Australia is managing to get online and be able to manage its markets by delivering on time. That is the fundamental thing that everybody wants, that capacity to deliver. Coal is the key resource market for Australia. I want to know how we are going and whether there is anything we could do better?

Dr Kennedy—As a general comment, it would appear that more fragmented ownership of parts of infrastructure, be it between public and private and those types of mechanisms, do not seem to have allowed quite the same response that we have seen for iron ore producers in WA.

Senator JOYCE—So they are not responsive, basically? The management expertise is not quite up to scratch. Anyway, that is Queensland Labor.

Senator SHERRY—I want to come back to aspects of the strength of the Australian economy. We have been to that area of questioning before, and I am sure the committee wants to move to other areas. I want to come to you, Mr Parker. We were talking earlier about the impacts of China and India. What about the general strength of the international economy and its impact on Australia?

Mr Parker—The international economy is presently quite strong. Last year it improved by about five per cent. If you look over a run of several years, what stands out is that we have been through a period of both high and stable international growth, of which China and India are part of the story. This links back to the commodity price discussion that we previously had. An extended period of high global demand has driven commodity markets.

Senator SHERRY—I read recently that the international economy over the last five years has experienced its strongest growth in more than three decades. Is that correct?

Mr Parker—That is right. It is the strongest period for 30 years.

Senator SHERRY—What do you see as the broad international outlook as far as economic growth is concerned?

Mr Parker—We are forecasting the international economy to continue broadly in this vein. We had growth of 5.4 per cent last year. The budget forecast for 2007 for the world economy is five per cent in both 2007 and 2008. That picture is broadly consistent with other international forecasts from the IMF and the OECD. So it is a broad continuance of that. The pattern of growth across countries changes a little. Over the last year or so we have seen improvement in growth in the Euro area and Japan, offset by the modest slowing of the US market somewhat, leading to an international picture which looks at the aggregate level. It is very stable.

Senator SHERRY—I think you alluded to this. There is also a link at the same time for these countries with China and India?

Mr Parker—That is right.

Senator SHERRY—Perhaps not as significant in the sense of mining, except perhaps possibly Canada in the OECD, which would be a big mining exporter. I am not sure of other countries.

Mr Parker—Canada is a big mining exporter, but its terms of trade have not increased by nearly the degree that we have. Canada is also a large manufacturing exporter, as with the US, and obviously those prices have not changed very much.

Senator SHERRY—Of the OECD countries, would any country be significantly impacted in terms of resource prices?

Mr Parker—Norway is, but again less than Australia.

Senator SHERRY—In terms of the developments in the Australian domestic economy over the last five years, is it correct to say that the commodity price boom along with the strong growth more generally in the international economy has been one of the key stories behind developments in the Australian economy?

Mr Parker—One of the key stories, yes. As to the other key stories, we have touched on the changed policy environment, which has had such a significant effect on the way the economy has responded to that shock. That is another part of the story. The drought conditions in the rural sector are also another significant part of the story. The rural sector is a relatively small part of the Australian economy measured in terms of its contribution to GDP. It is around three or four percentage points of GDP. Nevertheless, it is a volatile sector. In the last cycle we have seen farm production fall by 20 per cent. Although the farm sector is a relatively small part of the economy, it nevertheless has a substantial impact on the aggregate volatility in GDP.

Senator SHERRY—In terms of the nature/structure of the Australian economy, a lot has changed since, to use the expression, a pound for a pound.

Mr Parker—Yes, we would say that it has changed profoundly.

Senator SHERRY—Is it a reasonable assumption that the Australian economy will continue to benefit from the external factors that we have been discussing?

Mr Parker—Yes, that is a reasonable expectation.

Senator SHERRY—And your reasonable expectation is over what reasonable period of time?

Mr Parker—Foretelling the future is always a fraught business. There have been a number of labels attached to the present story, such as supercycles and so forth. The key to understanding the story is to understand that Australia is a very small part of the world economy and the world economy has, again, been profoundly affected by the shock of the integration of China and now India into the world economy, where you have a massive increase in both the demand for resources and also the supply of labour which goes into the manufacturing story. For both of those countries the take-off, earlier in the case of China but more recently in the case of India, has been quite substantial. If you look at the way economies develop and how they shift labour out of low productivity areas, particularly the rural area, in to high productivity areas, such as manufacturing, you will see that shift in resources tends to take place over a substantial period. There is still a lot of labour to shift in China, although there are some debates about just how quickly that will proceed and there are some demographic issues that apply in China because of past policies.

Senator SHERRY—The single child policy?

Mr Parker—That is correct. And the fact that there are progressively smaller cohorts entering the labour market. But it is not something that, barring some sort of shock emerging in financial markets or something, you would see coming to an end very quickly. That is not to say that commodity prices would stay as high as they have been in recent years forever. We have talked about this in previous estimates processes. Eventually you would expect a supply response to come through strongly from those industries, and commodity prices to come back somewhat. As we have mentioned before, we have in effect taken out some insurance in the formulation of the budget by having a commodity price assumption built in there which involves some unwinding of the terms of trade run-up that we have seen over the projection period.

Senator SHERRY—I want to come to that, but, before I do, you have mentioned the pricing outlook and the contract price negotiations. For example, would contracts for 2008-09 already have been negotiated? Presumably they would have.

Mr Parker—I might ask Dr Kennedy to answer that question.

Dr Kennedy—For iron ore and coal contracts, say, for a financial year, negotiations would start around the November-December 2007 period and usually settle around April 2008 for the prices through 2008-09.

Senator SHERRY—Is that a year-to-year contract generally?

Dr Kennedy—Yes, for the big ones, iron ore and coal.

Senator SHERRY—What about the other sectors? Is it year to year?

Dr Kennedy—It can vary a lot. For LNG it can be longer. There are a range of contracts out there.

Senator SHERRY—You started to get into the issue of the budget assumptions on commodity prices, and we have discussed the two-step down approach. The assumption taken in the budget is for commodity prices to return to their long-term run average over the first two years of the projection period, 2008-09 and 2009-10. That is the current approach, isn't it?

Dr Kennedy—It is not all commodity prices. It is a technical assumption around coal and iron ore prices.

Senator SHERRY—Yes. What economic parameters does this assumption flow through to? What impacts on the budget more broadly?

Mr Parker—It effectively reverses the effects of the run-up in the terms of trade that we have seen, and so it means it is done in a purely technical way. As we discussed, we have seen real gross domestic income and nominal GDP growing more quickly in history than real GDP, so what happens over the projection period is that you see an unwinding of that effect. You see a slowdown in the growth of nominal GDP and hence a slowdown in the tax base which feeds into the revenue numbers.

Senator SHERRY—As you are aware, we have discussed this two-step down approach at previous estimates, which was certainly this time last year and I think in November. Isn't it the case that this assumption would usually roll forward at MYEFO to 2009-10 and 2010-11, given where we are in terms of our knowledge and the cycle?

Mr Parker—I am not sure that it is possible to say what would normally happen at MYEFO, because that depends on what happens to commodity prices and the outlook for commodity prices between now and MYEFO. That is certainly what has been done in the last two MYEFOs. We first did this process several years ago. As I mentioned, foretelling the future is fraught with problems. The commodity cycle has gone on for somewhat longer than was implicit in those earlier projections, and so, as we have come to MYEFO, we have rolled that assumption forward twice now. But what we do in the next MYEFO depends on how commodity prices and the beginnings of the contract negotiations look at the time.

Senator SHERRY—Certainly at the moment the indications are that we face a third shift out of the two-step down approach?

Mr Parker—That may come to be.

Senator SHERRY—I am sure you and your colleagues will make that judgement as we get closer to MYEFO.

Mr Parker—That is correct.

Senator SHERRY—Would the assumption also roll forward if a PEFO were to precede this year's MYEFO?

Mr Parker—We would have to make exactly the same judgements in doing any PEFO.

Senator SHERRY—I would have thought they would be highly likely to be considered at almost the same time?

Mr Parker—That has been the case in the past.

Senator SHERRY—Yes. Could you comment on ways in which you believe the Australian economy would need to change to have strong growth prospects in the absence of the international factors that we have been talking about, both the mining boom and the much stronger general international growth over the last five years?

Mr Parker—That is an interesting question. It is somewhat speculative, in the sense that it is inviting me to say which bits of the economy would grow in the absence of the strong growth regionally that we have seen and in the absence of strong growth in the sectors. I guess it is fair to say hypothetically that had we not seen such strong commodity price growth things would have been different. I imagine we would have seen a lower exchange rate than we have had. That would have meant that bits of the economy that have been dampened by the higher exchange rate would have been more likely to grow at a higher rate than they have, so we could have seen a stronger performance in the manufacturing industry directed at those bits of the economy other than mining and construction. I imagine that we would have seen stronger services sectors, particularly in tourism and the like, which has been another sector that has been dampened to the extent that the exchange rate has been high and oil prices have been high, so airfares have been high and so forth.

Senator SHERRY—People are more likely to travel overseas and travel less domestically and so on?

Mr Parker—That is right. A lot of things would have been different. If you are asking me to speculate on policy changes that would be necessary, I would basically go to an extension of the story that we have seen of reform in the Australian economy over a long period, where issues around national markets—electricity, transport, water, energy and so forth—are all issues particularly around the federal axis that have been quite difficult over an extended period. There is no doubt that where we are able to make further progress on reforms in those areas we could expect strong economic growth to result.

Senator SHERRY—In the general area of productivity would you include such areas as education and training as a factor?

Mr Parker—That is right. Those issues are of course part of the COAG agenda and also in the health sector as well.

Senator SHERRY—I have completed my questions in this area. I was a little intrigued by one of your earlier comments, Dr O'Mara, and you might expand a little. When you were answering Senator Joyce you said words to the effect that an ‘artificial subsidisation’ of the sector was under discussion. What did you mean by that?

Dr O’Mara—The ethanol sector?

Senator SHERRY—Yes.

Dr O’Mara—I was simply making the point that, if we think about this globally, what we have seen is a very major run-up in oil prices and coal prices for reasons that we are very familiar with. That obviously changes the market dynamic for substitutes for those products, particularly substitutes for oil, of which ethanol is one. If it turns out that, when those relative prices change, it then becomes viable for international ethanol producers to buy grain and buy sugar to turn into ethanol and sell it at a price which they can make a profit at but which leaves ethanol competitive with oil, I presume that would be something that would be happening on the world market on a commercial basis. It is not obvious that there is a strong case for government subsidising that activity.

Senator SHERRY—You said that there is not a strong case for government subsidising that activity. Has Treasury done any analysis of the cost of the subsidy that you have referred to?

Senator JOYCE—There is no subsidy on that.

Senator SHERRY—If there were to be one?

Dr O’Mara—I am certainly not familiar with anything in our group. There may have been work done on that in other parts of Treasury but not in macro group.

Dr Kennedy—You might ask our Fiscal Group colleagues that question.

Senator SHERRY—I mentioned water—

CHAIR—Senator Milne has a question on oil. Are you happy to ask that now?

Senator MILNE—Just while we are on this discussion of oil in particular, the Australian Petroleum Exploration and Production Association believes that within 10 years Australia’s falling oil self-sufficiency will increase the nation’s trade deficit by about $20 billion per year. Can you give Treasury’s view of that? What does your modelling say about Australia’s falling self-sufficiency, global price increases and peak oil? What is your view of the peak oil argument and what is your view about the trade deficit, say, in the next decade in relation to oil?

Dr Gruen—Australia is a net importer of oil already, but we are a net exporter of energy. Our exports of energy include coal and natural gas. Over extended periods there are often big shifts in the products that countries, including Australia, export as a consequence of changes in the amount of these things in the ground or under the sea. The answer would be that, from an economic point of view, I would expect significant changes in probably both the import basket that Australia imports over the next 10 or 20 years and the export basket. That has been our history. If you go back a hundred years, we exported almost nothing but wool, and we had an extremely high standard of living by the standards of the rest of the world because wool was very valuable. The types of exports that we have exported have changed radically. That is 100 years ago, but even over the last 25 years it has changed radically. My suspicion is that

that process will continue. It is not clear to me why focusing on particular products, unless you have a specific argument for why that particular product is more relevant in our export basket than other ones, is an important thing to do. It may well be the case that Australia's net oil imports do rise over the next 20 years. That may well be true.

Senator MILNE—Given that oil is a much more significant commodity than a range of others in terms of substitution because it is so fundamental to the way the economy operates, your assumption in your answer is that you do not believe there is going to be a problem with constrained global supply or increased price such that it is going to significantly impact the Australian economy. Is that what you are saying?

Dr Gruen—There are several strands to that. I would be encouraged by the Australian economy's response to the very substantial rise in oil prices that we have seen over the last several years. The price of oil has gone up very significantly, and the Australian economy—and, for that matter, the world economy—has responded well to that. If it is the case that we are reaching the peak of global oil production, then substitutes will need to be found. Of course, this is also relevant to the debate about global warming. Oil is one of the things that produces carbon dioxide, and in the global response to global warming the price of oil will also be relevant.

Senator MILNE—Does Treasury identify this as a major issue, and what sorts of strategies or frameworks are you suggesting to address Australia at least reducing its dependency on imported oil?

Dr Gruen—Our position would be that we do not see a need to pick specific products that Australia is going to export or import. We would be in favour of well-functioning global markets so that we can buy products that we need and we can sell products where we have a comparative advantage. Economies cope much better with these sorts of changes if these changes occur gradually, which I suspect is the sort of change that you are talking about—something over a decade or two. It is much easier for an economy to cope with that than if it is required to change very rapidly from one energy source to another.

Senator MILNE—Given that oil depletion is also impacted by political instability as one of the major disruptors of supply and that in fact climate change is a major disruptor of supply in terms of hurricanes taking out production, melting ice and so on, we could well have some of these shocks. Has Treasury looked at an investment in public transport generally as a method of reducing emissions, reducing import dependence and also improving productivity in Australia's cities, health, air quality and a whole range of things? Is public transport on the agenda for Treasury as a response to this suite of issues?

Dr Gruen—It is probably best to ask Fiscal Group, which is coming up later today, those specific questions. Certainly to the extent that you wish to ask questions about climate change, Fiscal Group is the appropriate place to ask those questions. This group largely involves itself with the broad macro picture. We have not done any modelling of public transport or its contribution to reducing Australia's dependence on oil.

Senator MILNE—Just to summarise, what is Treasury's position on the impact on the Australian economy of global oil depletion? I am talking about energy security. What is Treasury's macro position?

Dr Gruen—I am not an expert on peak oil, so I do not have a considered view about the status of the scientific evidence, but let us assume for the sake of the question that it is the case that the global supply of oil is gradually going to decline. Our position would be that that is exactly the sort of situation where markets should be allowed to work and prices should be allowed to change to constrain demand and bring on extra supply. That would be our position.

Senator MILNE—The problem is that the market does not operate where oil is concerned, in the context that most of the world's oil is now controlled by countries that are signing up long-term contracts between each other, which will exclude other players such as Australia. The free trade idea does not operate in a large percentage of the oil market, so how do we respond to that?

Dr Gruen—That may well be true. There is a very well developed global oil market in which you can buy and sell oil. In response to geopolitical events which suggest that there might be disruptions to supply, that market does respond. People talk about the price of oil going up partly because of situations in the Middle East that lead people to think there may be disruptions. Even though parts of the market are controlled by governments, that does not stop the market from responding to those events.

Senator MILNE—Have you done any risk analysis on the extent of the world's remaining oil that is being bought by China, for example?

CHAIR—You are putting a set of propositions to this witness and then asking him to respond to propositions put by you without actually asking whether he agrees with your propositions. You need to frame the question so that the witness is given the opportunity to adequately explain.

Dr Gruen—I am very happy to answer that question. We have not done that sort of modelling.

Senator MILNE—Who looks at energy security as a big picture risk for Australia? Is that not something Treasury would identify as a risk?

Mr Parker—It is something that is obviously on the radar. Our response in terms of the international debate in this area has been in a variety of forms but, importantly, in the most recent G20 process it has been to promote the perspective that these markets work best if they are run in open and transparent ways; if there is appropriate governance of government entities in this area, the major players, such that there can be appropriate investment in this area and so that you have open and transparent markets. That has been a policy agenda that we have been promoting through the G20, which goes precisely to the issues that you have raised. To go back to your earlier premise about what does Treasury think of peak oil, we are inclined to be inherently sceptical about that as a hypothesis in the short term. Our view is essentially that what we are seeing in global oil markets at the moment is, firstly, a combination of geopolitical issues, obviously on which we have relatively limited influence; and, secondly, a cycle where we saw relatively low oil prices going back about four or five years, and consequently relatively weak investment in exploration and new productive capacity. We have basically a pipeline of limited capacity because of relatively weak investment in that earlier period. One would expect that as a result of high prices in the markets investment would lift, you would get more exploration, investment and so forth.

There are some constraints around that because of the geopolitical dimensions. There is an old saying in economics, which is that nothing cures high prices quite so well as high prices. In other words, you get a supply response in respect of high prices.

I would like to underline one thing that Dr Gruen said, which is that even if you were to postulate a future world of very limited future oil supplies and very high prices, that would mean that other things would happen as well. In particular, you would imagine that the price of gas reserves would be very high—higher than you might expect them to be now. Australia has very large reserves of gas, and so we would be able to export larger quantities of gas at higher prices. The effect of high oil prices on the current account would be offset by other things. This is essentially the point that Dr Gruen was making; you cannot look at just one thing.

Senator MILNE—In the Senate inquiry into Australia's future oil supplies and alternative future supplies, which I hope Treasury has looked at, there was considerable evidence that, whilst there may well be more oil out there, the cost of extracting it is getting higher and higher because it is in deeper water, more difficult terrain and so on; and that there is an argument that investment in energy efficiency measures is a cheaper and better option than ongoing subsidies for the oil and gas sector to go into less certain and more expensive and difficult terrain, because you have a more certain outcome and a better investment in terms of energy security. In terms of looking at where Australian policy might go in relation to subsidies to oil and gas companies—that is why I asked the question about public transport—is Treasury actively looking at the differential between likely outcomes from investment in new supply as opposed to investment in efficiency?

Mr Parker—I am not aware that we are. The premise of your question opens up a whole debate. Without getting into the debate, if you want to get into the microeconomics of energy, self-sufficiency and the like, then you would be better to talk to our Fiscal Group colleagues about that.

CHAIR—That point has been made a couple of times now.

Senator BERNARDI—I have one question that probably should be referred to the Fiscal Group as well. We were talking about whether you modelled carbon emissions and the impact of carbon emissions. Given that one extreme green group has claimed that methane is more dangerous to the environment and would make a greater contribution to global warming, have you modelled a methane tax—maybe on cows and pigs—to fight global warming?

Dr Gruen—That is a question for Fiscal Group. I think the warming effects of CO_2 versus methane are reasonably well established and I am sure that our Fiscal Group colleagues can bring those with them. I have seen figures on how much warming you get from a kilogram of CO_2 versus a kilogram of methane, and I am sure that our Fiscal Group colleagues can bring those numbers up for you.

Senator BERNARDI—I will look forward to asking them about that.

Proceedings suspended from 10.40 am to 11.00 am

CHAIR—The committee will resume.

Senator SHERRY—I want to go now to the issues around climate change. I want to understand what, if any, analysis has been done of the macro consequences of policy to address climate change in your area.

Dr Gruen—All the work on climate change, to the extent that there is any, is being done in fiscal group.

Senator SHERRY—Okay. That is all I have.

CHAIR—Thank you. The committee will take a short break while we wait for Senator Wong, and then we will move to the Corporations and Markets Advisory Committee.

Proceedings suspended from 11.01 am to 11.08 am

Corporations and Markets Advisory Committee

CHAIR—Welcome, Mr Jewell and Senator Wong.

Senator WONG—I am not sure if you were here on the last occasion I was asking about the long-tail liabilities CAMAC report. Where is that at?

Mr Jewell—Mr Kluver was here at that time.

Senator WONG—You can still tell me about it, though?

Mr Jewell—I can indeed. The committee is working through the submissions that were made to it when it published the government's terms of reference on this question and it is working towards a discussion paper. The work on that discussion paper is well advanced and the committee hopes to publish it very soon.

Senator WONG—What does that mean? Are we talking weeks or months?

Mr Jewell—Within months, but it could be sooner than that. The committee really is quite well advanced and it is working through its final discussion of the issues and testing people's opinions on the matters raised.

Senator WONG—This was requested in October 2005?

Mr Jewell—That is correct.

Senator WONG—It has been quite a long time coming. Is there any reason why the matter has been delayed this long?

Mr Jewell—Yes, there is. At the time we received the request we had four major inquiries, including that request. We had corporate duties below board level, personal liability for corporate fault, corporate social responsibility and long-tail liabilities. The committee developed a program for dealing with all these matters, recognising the need for expedition on this matter and the concerns of various parties. We completed the reports in a fairly good time. The corporate duties below board level inquiry was published in April last year. The committee published its personal liability for corporate fault report in September last year and the corporate social responsibility report, which was called *The social responsibility of corporations*, was published in December. The committee has been completing its matters as expeditiously as possible. The Long-tail liabilities inquiry was not left to languish in this time. Within a matter of months, we published the government's reference to us and asked for people's submissions and those came in over the course of the first part of 2006. During the course of 2006, the committee continued to analyse and assess the issues raised by those submissions. So it has not been left to languish, even though no published paper appeared in that time. As I say, the committee is very close to a discussion paper now.

Senator WONG—What is the complement on CAMAC now?

Mr Jewell—We have three legal staff, an office manager, the executive director John Kluver, myself and a legal researcher, Anne Durie, who works for us part time, three days a week. And we did have another legal researcher last year who was full time.

Senator WONG—And how many people are there on the committee currently?

Mr Jewell—About 10, off the top of my head. I am sorry, I cannot tell you exactly.

Senator WONG—Mr Kluver was not able to come today?

Mr Jewell—No, he is on leave at the moment.

Senator WONG—Has the government actually acted on any of these reports: the personal liability, the liability below board level or CSR? Have there actually been any responses yet?

Mr Jewell—No formal response at this stage.

Senator WONG—My recollection is that there was a CAMAC report in relation to corporate groups, which is obviously related to the insolvency issue.

Mr Jewell—Yes, that is correct.

Senator WONG—Did the government ever respond to that?

Mr Jewell—Yes, in the insolvency bill, which was introduced into parliament yesterday, as I understand it—

Senator WONG—I was going to ask you about that.

Mr Jewell—there are recommendations for pooling. I am only relying on media reports. I saw the draft bill and the draft bill picked up CAMAC's recommendations on pooling among corporate groups and pooling in other respects. I understand from the media report that that pooling is going ahead.

Senator WONG—I have to be honest, I have not looked at the bill. Actually, I saw the media reports about it today. I do not think the opposition has been advised—certainly I have not—but they may have gone through some other process. To your knowledge, does the bill deal with the issue of assets being held in other companies? I presume the pooling provisions must deal with the corporate structures where, for example, either the subcontract or the employment relationship is with one corporate entity and many of the assets are held with another.

Mr Jewell—I would not like to comment on the detail of that because, whilst I have seen the draft bill, I do not know how the final bill reflects what was in the draft. I know that there were submissions to Treasury on this. I have not seen the final draft.

Senator WONG—I have forgotten the section, but there was a provision that was inserted in, I think, 2000 post the Patrick's matter, which said you could go behind the corporate veil and look at assets held by another company if you could establish that the intention of the restructure was to avoid liability. My recollection is there has not been any litigation under that section, or certainly no successful litigation because of the difficulty in establishing intention. Is that your understanding?

Mr Jewell—That is as far as I am aware, yes.

Senator WONG—We put it in but it did not ever get used.

Mr Jewell—Yes, it may act in terrorem, as they say, to prevent the undesirable behaviour.

Senator WONG—Or it has happened but no-one could prove it—that would be the other explanation.

Mr Jewell—There are various possible explanations for these things.

Senator WONG—Intention is a difficult thing to prove.

Mr Jewell—Yes.

Senator WONG—The bill that has been introduced does not deal with the long-tail liabilities issue?

Mr Jewell—No. Well, again, not as far as I know, but I doubt that it would given it has been referred to us.

Senator WONG—What is the progress on the Sons of Gwalia referral?

Mr Jewell—That is also well advanced. Of course, the decision was only handed down on 31 January this year, and shortly thereafter the government gave us the reference on the topic. We have actually done quite a bit of research and there have been some meetings about it where the issues have been discussed. Again, the committee is working towards a discussion paper on that.

Senator WONG—You will issue a discussion paper about the implications first?

Mr Jewell—Yes.

Senator WONG—When is that likely to occur?

Mr Jewell—It is difficult to say. The committee is in control of the timing of that.

Senator WONG—CAMAC has done a lot of reports and, to be honest, I am not clear about the extent to which any of them have actually been taken up or responded to by the government.

Mr Jewell—We have had quite a good response rate. For example, in 1994 we put out a report on takeover anomalies and that was adopted in the CLERP reforms—

Senator WONG—1994?

Mr Jewell—Yes. In 1998, there was the voluntary administration report; the 2000 corporate groups report; the 2004 large enterprises report—

Senator WONG—The 2000 corporate groups report has not been acted on until now.

Mr Jewell—That is right, but that is part of the insolvency bill—

Senator WONG—Yes, but it is 2007.

Mr Jewell—Yes. But the other aspect of insolvency was a report in 2004 on large enterprises, and that forms an insolvency package. I suppose by the time the government got the full range of insolvency matters that it wanted to deal with in one go, it was able to deal with them all at once. Some of the reports, of course, have aged a bit but others were more recent. They formed a package and now it is going through.

Senator WONG—What is happening on the insider trading report?

Mr Jewell—Yes. There was a position and consultation paper put out by Treasury in, I think, March or April this year, and the government listed the recommendations of CAMAC that it agreed with, which was the vast majority of the recommendations. There were some recommendations about which it wants to consult further and it set out those issues in the paper. And the submissions for that government paper, consulting on insider trading, close this Saturday, 2 June.

Senator WONG—Yes. I saw that they were seeking further comments on a report that was already four years old, but that is a matter for the government. Has there been any further work on the CSR report from CAMAC?

Mr Jewell—No. The report is the final word on that for the moment unless we are requested to do any more.

Senator WONG—You have been given quite a lot to look at by government, but I am wondering if any work is being done from CAMAC's own motion in relation to private equity?

Mr Jewell—No. The committee has noted the Senate inquiry into this matter, but it is keeping a close track of that.

Senator WONG—Are there any other matters that you are looking at on your own initiative?

Mr Jewell—No, not at the moment.

Senator WONG—You have got your plate full with all the others?

Mr Jewell—Yes.

Senator WONG—I have a brief question about the implementation of the Uhrig recommendations to CAMAC. Have we passed those?

Mr Jewell—I think they have been enacted.

Senator WONG—We have had so many Uhrig bills through, I cannot recall where we up to.

Mr Jewell—That is right. I was advised just the other day that they have gone through. They are still awaiting royal assent, as I understand, but that may have been given already.

Senator WONG—What changes has CAMAC made to prepare for the different governance arrangements which will be imposed as a result of that legislation?

Mr Jewell—There are a number of things that have to be done and CAMAC is working on all of those. We have been in negotiations with the bank as to the banking arrangements and that is virtually complete. We have to do other things like fix the delegations and have chief executive instructions, and work is well advanced on all of that. We are certainly on track to be ready by 1 July, which is when we will become an FMA agency.

Senator WONG—What about the arrangements for the new responsibility of CAMAC convenor, or what will become the chief executive?

Mr Jewell—In what sense? We are getting that ready. The chief executive, who is the convenor, will be giving the delegations which, as I say, are virtually complete. He will be issuing the instructions and doing other things. He is ready with that. He is fully aware of what needs to be done and is being briefed by us on it.

Senator WONG—The requirement to report on a financial year basis under the FMA Act will not come into place until 2007-08—is that right?

Mr Jewell—That is correct. Our next report will be our final report as a CAC body and then after that we will be an FMA agency.

Senator WONG—Going back to the long-tail liabilities report, do you anticipate a discussion paper or a full report being released with it soon?

Mr Jewell—It will be a discussion paper because there are further issues that did not come out of the terms of reference and that have been raised in the submissions and in the course of the discussions. There are certainly things we would like to test so that the government gets a more complete report.

Senator WONG—Thank you. That is all I have.

Mr Jewell—Thank you.

[11.20 am]

Australian Acounting Standards Board

CHAIR—We will move to the Australian Accounting Standards Board. Professor Boymal, do you wish to make an opening statement?

Prof. Boymal—No, but I introduce Angus Thomson, the Technical Director of AASB, who may answer some of the questions.

Senator WONG—Professor Boymal, how are you?

Prof. Boymal—I am fine, thank you.

Senator WONG—I want to ask some questions about your 2006-07 business plan. Firstly, what items remain outstanding for the financial year as against that business plan for 2006-07? Do you have a copy?

Prof. Boymal—I do have a copy. Many of the items in the business plan are ongoing. Basically, one of our functions is to take the international accounting standards of the IASB, convert them into Australian law and amend them slightly if need be for the not-for-profit sector and the public sector. That is ongoing. You might well say that that has no beginning and no end these days. The principal measure of our activity there is whether we can do that on a timely basis. But the IASB's program is ongoing, so we continue to do that.

Senator WONG—Presumably either through your annual report or on notice you could go through your work program and just give me an indication of where you are at with those?

Prof. Boymal—Yes. Let me say that at our last board meeting, which was only last week, we got to a point of completion on quite a number of issues. We put out two new accounting standards and three exposure drafts. The two accounting standards related to the capitalisation of interest and inventory for the public sector. And the three exposure drafts were gap GFS for the whole of government—

Senator WONG—Yes, I want to come back to that. From page 7 onwards you have your work program in a table.

Prof. Boymal—Yes.

Senator WONG—I do not want a long explanation. I do not want to impose too much on you, but if you could perhaps print that off with a final table that just gave a little indication of where the status was, that would be much appreciated.

Prof. Boymal—Sure.

Senator WONG—Thank you. One of the things that is commented on in the business plan is that for most of the year 2005-06 the board was I think at least one staff member below the FRC approved complement. Has that been addressed for the 2006-07 year?

Prof. Boymal—No, it has not. We are still one staff member below the IASB complement and it is a matter of finding an appropriate person. But, to add to that, we put in an application in our budget to the Financial Reporting Council that they should agree to an additional person. That means as of today we are two—

Senator WONG—Two down.

Prof. Boymal—below the complement. Mind you, that additional one is for the next financial year, but I acknowledge that the next financial year is coming upon us fairly quickly.

Senator WONG—What is the difficulty in finding an appropriate staff member? It has been quite some time now.

Prof. Boymal—Yes, you are right.

Senator WONG—It is in the context where you are being asked to do quite a large amount of work.

Prof. Boymal—That is true. The difficulty is in finding the appropriately skilled people. It is not so easy. Where do we sit? We would like to get people from the technical departments of the big accounting firms, but unfortunately, they offer more money, so it is difficult to get them from there. But they would be ideal in terms of their technical background. As to people from academia, we do offer better salaries than academia, so that is another source for our people. But I think it is fair to say that our pace is a bit faster than what people in academia are accustomed to, so they generally do not prove to be all that satisfactory. We sort of sit in the middle. What I am saying is that it is always possible to get head counts but it is quite difficult to get appropriately skilled people. We just keep looking. We head hunt and get them that way.

Senator WONG—After that comment, you may not win the popularity prize with Australian vice-chancellors.

Prof. Boymal—I may not.

Senator WONG—After the departure of two senior project members in August or September, one of the positions was filled internally. Is the other position filled or is that the one down?

Mr Thomson—We filled that position in a number of ways—ramping up the hours from some part-time people—so that position was effectively filled.

Senator WONG—It was filled by a number of people?

Mr Thomson—Yes.

Senator WONG—How many staff members are currently seconded to other agencies?

Mr Thomson—At the moment, one.

Senator WONG—To IASB, or somewhere else?

Mr Thomson—No, actually. We have one staff member seconded to the South Australian Auditor-General's Department.

Senator WONG—Is there anywhere else?

Mr Thomson—Not presently, no.

Senator WONG—No-one to the IASB?

Prof. Boymal—Not at the moment. We have a couple of our staff who have indicated an interest, but not just at the moment. The reason is children's schooling and the like. I think that one of these people has got a youngster in year 12, so it is really a matter of fitting it into their personal situation.

Senator WONG—Can you give me an update on the progress on the convergence of New Zealand and Australian accounting standards?

Prof. Boymal—New Zealand and Australian accounting standards are very similar. There is a group called TASAG, the Trans-Tasman Accounting Standards Advisory Group, and I tell that group often at this stage that the remaining differences in the accounting standards between the two countries are the consequence of the differences in the Corporations Law rather than deliberate differences in the standards themselves. But with different filing obligations in two countries, and the like, it is impossible to have them absolutely identical. But we have achieved a lot in that for the corporate sector, apart from the small ones where, as I say, the filing requirements are very different. The publicly listed companies, for example, are in effect identical. For the public sector there are some small differences primarily because in New Zealand they tend to provide a lot more guidance for the public sector than we do. But the standards themselves are really very similar.

Senator WONG—There will be no further work in terms of convergence of the standards as a result?

Prof. Boymal—There is ongoing work. An example of that is that we both have a standard which applies primarily in the public sector in relation to government grants. At the moment our standards there are different and we are working together to try to create a common standard between the two countries. It is progressing, but there is not a large amount left to do in that regard. We both use international financial reporting standards as the starting point, so that explains why there is not much more to do.

Senator WONG—I want to turn to the differential reporting/SME issue. There was a memo in March 2007 regarding this issue. Do I understand that the AASB has decided to apply the two-tiered rather than a three-tiered approach to SMEs?

Prof. Boymal—That position at the moment—

Senator WONG—Can you just explain to me what the options were between the two-tiered and three-tiered approaches and then we will perhaps go on to explain why you did that.

Prof. Boymal—What we mean by ‘tiers’ are a different set of accounting standards for external financial reporting, to outsiders. There is what you might think of as a third tier because small proprietary companies are totally exempt from producing external reports or holding annual meetings for their shareholders. So there is an exempt third tier. We do not write standards for them if they are exempt, so we do not regard that as a tier of accounting standards. But that is quite an important factor. Other countries, including New Zealand, do not have that exemption for the vast majority of their small proprietary companies. Therefore they have to have accounting standards for that group. Our two tiers, or what we envisage as the two tiers for companies—and this stems from the IASB’s proposal—is that publicly listed companies and deposit takers should be a group of companies at the top tier that apply the full suite of international financial reporting standards.

Senator WONG—When you say ‘deposit takers’ is that APRA-regulated institutions only?

Prof. Boymal—Not only but you would say primarily, but there could be credit unions and a few other deposit takers that APRA is not interested in.

Senator WONG—So they would be top tier applying the full IFRS and accounting standards?

Prof. Boymal—Yes. Our accounting standards are based upon IFRS. The proposal coming out of the IASB is that there then be a second tier which can apply the proposed IFRS for SMEs. IFRS for SMEs coming out of the IASB—and it is only in exposure draft form—is accounting standards light, you might say. To give you an idea, the book of accounting standards runs to about 2,500 pages but the proposed light book runs to more like 250 pages. It contains less stringent measurement and recognition rules and considerably less disclosures, but it is a complete suite of accounting standards nonetheless. When we looked at that proposal, we said, ‘That sounds fine for publicly listed and deposit takers but are there not other very large companies where the community would expect them to be applying the full raft of accounting standards?’

Senator WONG—This is as opposed to SMEs?

Prof. Boymal—As opposed to SMEs, yes. The IASB, while they call them ‘small and medium enterprises’, their cut-off was deposit takers and listeds, which is not really a size test. We concluded that there would be some other large enterprises in Australia that were not listed and were not deposit takers which we believe the community—and the FRC confirmed to us—out of a matter of public interest would expect a full suite of accounting standards to be applied. In our discussions we kept talking about a privatised Qantas, so we are talking about huge companies. If they are no longer listed and not deposit takers, what level of accounting standards should apply to them? We concluded that there was this other very large corporate group who may not be listed or deposit takers who should also follow the full set of IFRS.

Senator WONG—The argument about publicly listed companies would be they are essentially hanging up their shingle and saying, ‘Invest in us.’ I think there is an argument, certainly a prudential argument, in relation to deposit takers.

Prof. Boymal—Yes.

Senator WONG—What is the argument in relation to the large enterprises? First there is community sentiment, but perhaps just to get behind that a bit, is it that they are very substantial economic players and their impact on our economy is significant?

Prof. Boymal—That is exactly right.

Senator WONG—So therefore we would want higher standards of accounting in terms of their reporting.

Prof. Boymal—That is precisely so, yes.

Senator WONG—So what are you going to make them do?

Prof. Boymal—I know this is getting a bit longwinded but, therefore, for that top tier who should apply full IFRS, we added a requirement for very large companies. We are proposing a size test basically because any other test is too judgemental. We are putting out on exposure a test for a company that has reached either $500 million of revenue or $250 million of assets.

Senator WONG—Is that cumulative or an alternative test?

Prof. Boymal—It is either one of.

Senator WONG—So $500 million annual revenue, net or?

Prof. Boymal—No, that is gross revenue.

Senator WONG—And $250 million worth of assets?

Prof. Boymal—$250 million of assets. So we have added a group to what the IASB has proposed for tier 1. Tier 2 will be the rest and there will be no third tier. The question of the third tier is: how do you identify a third tier?

Senator WONG—Would the third tier have been SMEs? When you had a three-tier model—

Prof. Boymal—Remember—

Senator WONG—I am sorry, I am not an accountant—as you are probably painfully aware. But in the original proposal for three tiers, what were the three tiers?

Prof. Boymal—We never proposed the three tiers.

Senator WONG—Okay. You did consider staff papers.

Prof. Boymal—We simply discussed whether there should be a third tier.

Senator WONG—I am not advocating, I am just trying to get a sense of what the options were. So what was the three-tier proposal, or the option of the staff paper?

Prof. Boymal—It is a third tier or, if you like, a third group of accounting standards at the lower end. Presumably that third group of accounting standards would need to be more simplistic, less detailed and have less disclosure than the IASB's SME document, because we are applying that to the second—

Senator WONG—Sorry, I need the ABC before we get further. I am trying to clarify when there was a three-tier option on the table and who would be in which tier. Obviously AASB has considered that option and said, 'Look, that is not the way to deal with it.'

Prof. Boymal—The entities in a potential third tier would be smaller companies.

Senator WONG—Not publicly listed—private?

Prof. Boymal—Certainly they would have to be privately owned but they could also be very small charities or community organisations. A local tennis club can be a company limited by guarantee.

Senator WONG—Profit and not for profit. Both?

Prof. Boymal—It could be either.

Senator WONG—So you said no to that.

Prof. Boymal—We said no to that because, No. 1, small proprietary companies are totally exempt, so our reporting regime does not impose any burden on them. We do not have accounting standards for them. So for those who do report, how many different groups should you have? The ones who do not report, in very broad numbers, is 1.5 million companies so there is an enormous group who have no reporting obligation. And the ones who have reporting obligations are in the tens of thousands. Our second rationale for not contemplating introducing a third tier, or a third group, of accounting standards is how do you distinguish them from the second group, and that becomes quite difficult.

Senator WONG—And the second group were?

Prof. Boymal—The second group are those that are not listed, not deposit takers and fall below $500 million revenue or $250 million of assets. The proposal is that that group, down to where they are totally exempt and have no reporting obligations whatsoever, apply the IFRS for SMEs. If we created a third tier our problems would be, as well as the fact that most of these small companies are exempt anyway, how would we create another dividing line and what would those standards contain? If they were to contain anything then we would have to write a complete new suite of accounting standards.

Senator WONG—Because the IFRS only has the two tiers, essentially, the International Accounting Standards Board has the top tier and then—what did you call it—IFRS light?

Prof. Boymal—Yes.

Senator WONG—Do other jurisdictions have that third tier?

Prof. Boymal—No, I do not believe so. You have to remember that the ISB's SME project is only in exposure draft form. Most countries, as we are, are looking forward rather than at what they currently have. I do not know of any jurisdiction that currently has three tiers being three existing sets of accounting standards.

Senator WONG—So the architecture of what you are outlining will be top tier, deposit takers, publicly listed companies and large entities defined on the $500 million revenue and $250 million assets test?

Prof. Boymal—Yes.

Senator WONG—The second tier are those who do not fall within that, who would have the IFRS Lite—that is, the SME standards?

Prof. Boymal—Yes.

Senator WONG—Amongst the justifications for not having a third tier is that, under our reporting, we exempt regime small proprietary companies?

Prof. Boymal—Yes.

Senator WONG—That summarises it?

Prof. Boymal—That summarises it.

Senator WONG—Can you give us some sense of impact? Who would have fallen into the third tier? Are there significant numbers of small companies that are not exempt because they are not small proprietary companies that would now have to apply the SME standards? Do we have some sense of the numbers involved here?

Prof. Boymal—We do. Unfortunately, I do not have the numbers with me. It is quite difficult to answer. The reason is that, under these new proposals, there are some companies who currently would be regarded as reporting entities and, therefore, would have to follow the full suite of standards and who would fall down into the SME standard. So they would be getting relief. There are other companies who would claim not to be reporting entities,who are still lodging their numbers and who are producing bits and pieces in terms of accounts where following the SME standard would be a greater burden. Some companies will have a greater burden and some will have a lesser burden coming out of these new proposals, but the difference will be that every company who has to lodge its numbers with ASIC will have a set of accounting standards to follow. Whereas the current regime has a situation where there are a group of companies who claim not to be reporting entities who lodge their numbers with ASIC and who do not have an accounting standard regime to follow.

Senator WONG—This will resolve that?

Prof. Boymal—This will resolve that.

Senator WONG—I would like to go back to the issue I raised. I realise it might be difficult to ascertain, but from a public policy perspective it would be useful for us to get some sense of what the impact of the decision is.

Prof. Boymal—We do have some information on that.

Senator WONG—From my perspective, I would like to know broadly what sorts of numbers we are talking about in each of the tiers. More importantly, I would like to know the number of companies that will be impacted by a decision not to establish a third tier and which sectors are they in? In other words, whether or not they not-for-profits? I do not need a detailed analysis. I am not clear in my own head whether those outside of the small proprietary company exemption will now be picked up in the SME tier and whether that is a shift. That is the practical impact of this decision that I would like to get a handle on.

Prof. Boymal—It is somewhat difficult to quantify. We toyed with the question of a third tier but we did not pursue it. We never actually defined the companies that could potentially fall into a third tier. The cut-off, if it was to be a size cut-off, was never struck. Obviously, the number of companies that would fall into that tier would depend upon what size cut-off we would create. There is a bit of guesswork, because we never actually got to the point of saying what the size cut-off would potentially be.

Senator WONG—I am happy to get any answer on notice, with the caveats that you have outlined. I am interested in descriptors. Are we talking thousands or are we talking very small numbers? It is only those that fall outside of the exemption that we are looking at. Is that right?

Prof. Boymal—Yes, that is right.

Senator WONG—How many are there?

Prof. Boymal—The grand total of companies that have to lodge their accounts with ASIC, tier one, tier two and potentially tier three is only about 80,000. The exempt group, with no requirements whatsoever, is around one and a half million. The exempt group is huge compared with the others.

Senator WONG—Absolutely, but there would be some in the 80,000?

Prof. Boymal—Yes.

Senator WONG—Would the two-tier model extend to those outside of the 80,000? Yes, they would?

Prof. Boymal—Yes, they would. The reason is that our standards also apply to public sector entities. The majority of those fall outside the Corporations Law. The answer is, yes, and we are proposing that there be some size cut-offs in relation to the public sector, too, so that some smaller public sector entities can use the lighter set of standards. That is a different issue.

Senator WONG—Could you take this question on notice? I would like to get some sense of the number of companies that will now have to apply IFRS Lite, or the SME standards. Senator Murray raises a good point: can we have some indication of which sectors they occupy?

Prof. Boymal—Yes. But, in terms of what industries they are in, we would not have any information.

Senator WONG—You would have the not-for-profit sector—

Prof. Boymal—Yes, we do have not-for-profit information.

Senator WONG—What we are trying to get a sense of is whether this two-tier system will bring more of those smaller companies into the SME reporting regime. I am trying to get a sense of the impact of the reform.

Prof. Boymal—Yes, I understand.

Senator WONG—It is a fairly general question but, if you can understand the sentiments, I would appreciate that.

Prof. Boymal—Yes.

Senator MURRAY—My apologies for not arriving earlier; I had another engagement. I followed as much as I could of Senator Wong's questioning, and that broadly picks up the area of interest. My own belief is that, once you have settled down these new systems, it is then time to review what you might describe as the third tier—in perhaps five or 10 years time—to see whether you need to further adjust or tinker with it. I have no quarrels with a more gradual approach. I very much look to the benefit side more than the cost side of what you are doing, so I tend to be a supporter of what you are on about.

Prof. Boymal—I would like to make an observation, which applies to Senator Wong's question, too. If there are entities which say that following the standard for SMEs is still too burdensome for them, then in my mind one would say, 'Why shouldn't they be exempt?' In other words, the exemption cut-off is part and parcel of this same issue. In terms of writing accounting standards, it would be a lot of work to write standards for a third tier when the simple answer is that the exemption level is set at the wrong spot. The issue of the third tier has to be looked at in conjunction with the exemption cut-off and no reporting obligations at all.

A bill has just been submitted which increases that exemption level by two and a half times. A lot of the smaller companies that currently have a reporting obligation will find that, by the raising of that exemption level, they no longer have any reporting obligation. They will not care about what the accounting standards say since they then fall outside of the requirements. It would seem to me, just to pick up your point, that we should let all of that bed down—I agree entirely with you—before we do anything more drastic. The simple answer in the years to come might be just to revisit that exemption level again.

Senator MURRAY—My impression of the higher cut-off is that thousands will be affected rather than hundreds of thousands. I do not think it is that material an impact. The question I wanted to ask you is tangential. I am a fan of quality data and timely data for the better understanding and management of the economy, and I am of the view that the work you are engaged in is likely to qualitatively improve the data available on the operations of the corporations affected by more consistent accounting standards and also pick up those companies that do not presently report. My tangential question is: has the ABS shown any interest in the work that you are doing with respect to what impact that will have on their data collection and their understanding of the Australian business and not-for-profit sector?

Prof. Boymal—No, it has not. I know that the ABS asks all businesses to provide some data, but whether that data is reliable or not would depend upon whether it is drawn out of financial reports that are prepared in accordance with accounting standards or whether it is at the really the bottom end where a proprietor of a small business just fills in a form and nobody checks the accuracy of it. The ABS has not been in contact with us in relation to these changing cut-offs.

Senator MURRAY—My other question may replicate one that Senator Wong has asked. When do you expect this process to be completed?

Prof. Boymal—The exposure draft is intended to be put out today. By coincidence, it happens to be today. At its meeting last week, our board concluded the issue and we have just been tidying up some wording over the last few days. At the moment it is only in the form of an exposure draft seeking comments.

Senator MURRAY—With a cut-off time?

Prof. Boymal—It is about a three-month cut-off for comments, and we will then review the position.

Senator MURRAY—Are you suggesting that it could apply from the financial year 1 July 2008?

Prof. Boymal—No.

Senator MURRAY—When is your start date?

Prof. Boymal—It would more probably be 1 July 2009.

Senator MURRAY—That is what I wanted to understand. Professor, I want to ask you a separate and different question. You are aware of the continuous disclosure regime that applies for corporations listed on the Australian Stock Exchange. I am interested in large corporations which are not on the Australian Stock Exchange and the concept which I have been toying with of a continuous disclosure regime applying for certain material factors to key investors. This is of particular interest to me with respect to what is known as the private equity phenomenon. My view is that, if very large numbers of Australian investors are indirectly connected to private equity companies via investment funds and super funds, those investment and super funds need a higher level of reporting in terms of risk, which is essentially what continuous disclosure is about, than they get at present. Do your accounting standards deal at all in concept or in actuality with this, or is there any thinking about ways in which regular high-level reporting can occur to major investors over and above that which occurs to the directors in the normal course of their monthly or quarterly meetings?

Prof. Boymal—I had indicated to Senator Wong—and it may have been before you came in—that part of our proposal is that full international financial reporting standards be applied to large entities even though they may not be listed or deposit takers. I did indicate that in our discussions about the issue we kept referring to ‘Well, what about a privatised Qantas? Isn’t there a sufficient public interest that it should follow the full raft of accounting standards?’ But to take that one further to the ASX disclosures, we do not write standards for what the continuous ASX disclosure requirements are. Their requirements are based upon the requirement for listed companies to make a continuous disclosure to the stock exchange on matters that the directors believe would have an effect upon the market price of the shares. If the shares do not have a market price, that system cannot work for other entities.

Senator MURRAY—I am using a similar phrase for a different purpose. Let us backtrack. Normally an investor who does not have a direct board connection will only receive information from a private company annually or on inquiry—from the annual reports and the financial statements. The concept I am asking you about is whether in the construction of the standards of keeping financial statements and reporting on them, which is of course an internal as well as an external matter—it is not just designed for the regulators, it is designed for investors and participants—any thought has been given as to how well that facilitates disclosure to major investors, who in turn represent a substantial public market, which is typically what an investment fund or super fund does? Do you understand where I am going?

Prof. Boymal—I understand the point. That area is outside our terms of reference, but I would say that that would also represent an enormous policy shift. The making public of continuous disclosure information—

Senator MURRAY—Again, it is not making it public in the public sense. It is making this available to major investors who do not have a direct board connection and who would otherwise rely on only receiving their information annually.

Prof. Boymal—I would say that that differentiation would cause a problem in itself, because you have investors and you have potential investors. Potential investors are the public at large. The whole idea of a fair market is that the level of knowledge between all participants in the market should be the same. It would end up such that the public differentiating between existing investors and potential investors would create an unfair playing field. I think what you are suggesting is an enormous policy change that deals with areas far beyond what the AASB has to deal with.

CHAIR—Professor Boymal has indicated that he does not want to get into some of those policy issues.

Senator MURRAY—You cannot anticipate my question, Chair. Professor, you have worked on harmonising and internationalising of standards for the sake of not just efficiency but also a better management of risk. By the proper disclosure of consistent data, markets are better able to assess risk. What I am discussing here is the issue of how you better disclose and manage risk in private operations where at present they are likely to be apprised of that risk only on an annual basis. That is a principal issue that normally would come into your orbit. You have confirmed for me that the AASB has neither had that as a term of reference nor considered the issue of how you deal with that matter.

Prof. Boymal—We wrote to the Senate inquiry. We were asked to make observations on the current proposals and I wrote a one-page letter that singularly and only pointed out that the current laws apply to corporations. If a private equity arrangement, no matter how large, is set up outside of the corporate area, there is no law requiring it to report publicly; it is only required to report to the tax office. Our whole system is based upon an expectation that is probably now becoming outdated—that is, if you are big and you operate these things, you are a corporation and the Corporations Law therefore embraces you. I think there are some very important new things to be dealt with, but they are areas outside of the charter of the AASB.

Senator WONG—Just on that point, have you made a submission to the Senate private equity inquiry?

Prof. Boymal—Yes, but it was purely on that observation.

Senator WONG—I hope that you will actually be called. It seems to me that it would be useful to hear from you on two issues. One is what you have raised, which is the presumption essentially within our reporting regime of the structure of the operating entity. I do not know whether your letter addresses this second issue, but I would be interested to know what effect, if any, you think your—what did you call it—publicly accountable entity?

Prof. Boymal—Yes, that is the term used for what I have called listed or deposit takers.

Senator WONG—Yes, but there is the size test of $500 million or of large enterprises that you have added into the first tier.

Prof. Boymal—We have added them in, but we have chosen not to put them into the definition of 'publicly accountable'. It is a plus.

Senator WONG—What do you call them?

Prof. Boymal—The larges ones are 'publicly accountable-plus', but that is playing with definitions.

Senator WONG—We have IFRS Lite and now publicly accountable-plus. I would be interested in knowing what you say the impact of the publicly accountable-plus category would be on private equity activity. To what extent would it and would it not bring in some of the examples we have seen in recent times, which is one of the issues you raised with Senator Murray. We do not need to traverse that here; I am flagging that with you because it is a current policy area for parliament. Your shift in the accounting standards that you have described today has some relevance to our inquiry. I do not know whether you will be coming along to give evidence or whether you can put in a supplementary submission on that point—essentially, the impact of the evidence that you have given today about the two-tier model and the inclusion of the plus category.

Prof. Boymal—At this stage I have not been invited to attend. That might be the easy way of dealing with it, but I do not know.

Senator WONG—Is it this committee?

Prof. Boymal—Yes.

Senator WONG—Mr Secretary, if you could take that onboard, I would appreciate it.

Prof. Boymal—It would be just another trip to Canberra.

Senator WONG—I am happy to do that over the phone. You will be pleased to know that we will not have another estimates before the election and inquiries are trending downwards, as you can probably imagine. You will probably have a bit of free time after that inquiry. I will go now to the GFS and GAAP. I asked questions about this at the last estimates and for progress on updating 1049. Can you tell me where that is at?

Prof. Boymal—The same thing occurred there at our board meeting. Yesterday we put out an exposure draft dealing with the harmonisation of GAAP and government finance statistics for the whole of government. Accounting standard 1049 harmonises GAAP and government finance statistics for the general government sector. The general government sector is a lesser entity than the whole of government.

Senator WONG—Am I correct in saying that the exposure draft relates to the general government sector and not to the whole of government?

Prof. Boymal—No, the whole of government.

Senator WONG—It relates to the whole of government?

Prof. Boymal—The general government sector is already an accounting standard.

Senator WONG—This is 1049?

Prof. Boymal—Yes.

Senator WONG—Is the exposure draft out today?

Prof. Boymal—Yes, it should be.

Senator WONG—You have had a flurry of activity.

Prof. Boymal—Yes, we had a great week last week. There has been some urgency in connection with that whole-of-government harmonisation. In 1049, in order to protect the integrity of whole-of-government reporting, we said in 1049 that a general government sector report should be issued only when a whole-of-government report is available. Then the various Treasuries said that we had better do a standard for the whole of government quickly; otherwise, the information will be prepared on two different bases, which of itself will create confusion. We have moved very quickly to produce an exposure draft harmonising GAAP and government finance statistics for the whole of government. That was put out yesterday.

Senator WONG—This question will probably have a very long answer. I am really not clear about what 1049 will do to government reporting. What will it mean for an agency?

Prof. Boymal—I have the minister sitting next to me, so I had better be careful.

Senator Minchin—You go for it. I am listening intently

Senator MURRAY—Just remember that you have privilege.

Prof. Boymal—I am only joking.

Senator WONG—He is not actually your minister.

Prof. Boymal—I know, but he produces the government's accounts. The proposition was put to us that there is a set of standards that emanates from the International Monetary Fund, and the Australian Bureau of Statistics looks after that in Australia. It produces accounts in a certain format. Then there are GAAP—generally accepted accounting principles—which also, according to our standards, apply to government, and they produce accounts in a different format. That can create confusion in the eyes of the readers because there is more than one set of accounts for each government in Australia.

Senator WONG—It is more than confusion. There has been criticism from some of the accounting firms.

Prof. Boymal—Governments can refer to one or the other at will in order to present a rosier story. The idea of having one set of accounts rather than these two alternatives is in the public interest. We were directed by the Financial Reporting Council, to whom we are responsible, to get this problem solved. Our first focus was to get it solved for the general government sector, because accounts for the budgetary sector are those that are most commonly presented. So accounting standard 1049 was produced. The initial implementation date is still to arrive but the standard is in place, which will mean that governments will not be able to refer to the ABS form of accounts only when it suits them.

Senator WONG—Pick and choose which accounting standards they will use.

Prof. Boymal—Cherry-pick, yes. That is the objective of the harmonisation process. As soon as we start to put two different systems into one, there are serious questions as to which one should predominate. Our solution to that was that, for the measurement—principles of accounting—GAAP should be used; but, in terms of the presentation and format of the accounts, we went for government finance statistics.

Senator WONG—When you say ‘format’, that is where things are entered, like what is classified as—

Prof. Boymal—Where they are classified and what is the bottom line. The bottom line in a GAAP set of accounts is a net profit, but the bottom line in government finance statistics is net borrowing and lending. The way in which it is arrived at comes out of the same ledger, if you like to think of it that way, but the format of presentation is different. We went for GAAP measurement but GFS format. It really will mean that, instead of the large variety of government accounts that exist at the moment—different states have gone about this in different ways—we will have standardised the whole process. However, there is still the issue of the general government sector or the budgetary sector compared with the whole of government, which is why we had to put out this second exposure draft.

Senator WONG—What is the implementation timetable with respect, firstly, to the Commonwealth?

Prof. Boymal—We have a short period for consultation, primarily because most of the problems have been solved in the general government sector standard. We are asking for comments by the end of August. We hope to have a standard out for the whole of government by, let us say, October. That deadline date is in order to enable governments to present their 2008-09 budgets in that format. Again, governments are different from the private sector. The private sector reports only at the end of the period; governments report before the period has arrived in terms of presenting their budgets.

Senator WONG—So it will be October for the May budget?

Prof. Boymal—It will be October for the May budget.

Senator WONG—That is fast. Thank you; that has been very helpful.

Senator JOYCE—Have you been involved lately in the update of auditing standards such that the valuation of public assets has to be on a fair market value and not a written-down value?

Prof. Boymal—The accounting is our responsibility but the auditing is not. We have nothing to do with the auditing standards—there is an auditing standards board—but the requirement of how to measure these assets is our responsibility. It is a bit of a ‘yes’ answer. However, we do not mandate that the assets of government be valued. Our accounting standard has an alternative of cost or valuation, and it is the governments themselves that have chosen to take the valuation option. We did not impose it on them.

Senator JOYCE—Being somewhat involved in this area, we have the situation now where audits have gone from a detailed but definitive process to something quite extensive. I am thinking of Aboriginal housing societies and things like that. Houses are not going to walk away, once you have identified that they exist. Now they have to go through the process of valuing all of these houses. Basically, this means that the bills we are sending to Aboriginal housing societies will not be paid; so we are not going to do it and so it is not going to happen.

CHAIR—Professor Boymal, you are not required to give an opinion on that statement.

Senator JOYCE—I will rephrase it. Are you aware of any increase in compliance costs associated with an increased standard of auditing? Do you feel that this standard of auditing is required in all instances? I am referring to the requirement for this higher standard of auditing on such things as fair market valuation of fixed assets.

Prof. Boymal—I cannot answer that because the area of audit is outside of the AASB's charter. However, to be of assistance to you, I am aware of some concern at the extent of market valuing of assets. One area of assets that has come to our attention, for example, is heritage assets. It is not quite the same as Aboriginal housing, but I imagine there are similar difficulties. All I can say is that we provide in our standard the option between cost and market value; therefore, it is not us who impose that burden.

Senator JOYCE—That is the point I wanted you to make. Thank you very much for that.

CHAIR—Professor Boymal and Mr Thomson, thank you most sincerely for your attendance.

[12.18 pm]

Department of the Treasury

CHAIR—I welcome officers from the Fiscal Group. Mr Tune, do you wish to make an opening statement?

Mr Tune—No, but perhaps I could seek your indulgence. We anticipate questions around the *Intergenerational report* released back in March. That was an effort within Treasury that involved a number of different groups, including our Revenue Group and our Macroeconomic Group. We have in attendance a couple of people who worked on the IGR. It would very useful for us if we could have any questions around the IGR first. That would mean that those who are not part of the Fiscal Group could return to the department.

Senator SHERRY—I am happy with that, although I have two appointments at lunchtime and cannot give a commitment that we will finish it by 12.30 pm.

Mr Tune—That is fine.

Senator SHERRY—I am happy to kick off and then come back straight after lunch. I know well the individuals concerned.

CHAIR—We are happy to accommodate those officers being returned to the department, but it will certainly be after lunch before we are finished. We will break at 12.30 pm and be back at 1.30, so they will be required after lunch.

Mr Tune—Thank you very much.

Senator SHERRY—We will go to the *Intergenerational report*. Can Treasury confirm that the productivity growth forecast in the IGR has been revised down this decade to just 1.5 per cent?

Dr Gruen—The assumption that we used for the 40-year projection in the *Intergenerational report* was 1.75 per cent, which is the same assumption as that in the first *Intergenerational report* published five years ago. There is a table in the *Intergenerational report* from which that number comes, which is the productivity growth over the decade of the 2000s, which encompasses some history. It encompasses forecast years and then, once the projection starts, the productivity assumption is 1.75 per cent. When you add all those years together across the decade of the 2000s, the outcome turns out to be 1.5 per cent.

Senator SHERRY—I have to say that that is a pretty convoluted old explanation. I am looking at table 2.3 on page 29 and I am looking at a figure on labour productivity of 1.5 per cent.

Dr Gruen—That is right.

Senator SHERRY—Then I am looking at later figures of 1.75 per cent through from the 2010s, 20s, 30s and 40s.

Dr Gruen—Yes.

Senator SHERRY—I am looking at a figure of 1.5 per cent.

Dr Gruen—Yes.

Senator SHERRY—Wasn't the figure 1.7 per cent in the last *IGR*?

Dr Gruen—I will try again. I did not do a very good job that time; I will see if I can improve that.

Senator SHERRY—Can you just confirm that the figure in the last *IGR* was 1.7?

Dr Gruen—It was 1.75 per cent. The figure for the projection period in this *IGR* is also 1.75 per cent. However, we do not override the forecasts in the budget. In the years in which we provide a forecast in the budget, we use whatever labour productivity growth is forecast for the forecast years. That was also true for the previous *IGR*. In other words, for the previous *IGR* the forecast was for the 40 years, and the first two years came from the budget. They were the budget forecast years.

Senator SHERRY—Which were?

Dr Gruen—It was 2000—

Senator SHERRY—No, the figure for the first two budget years.

Dr Gruen—I can take that on notice, but we do not actually publish the labour productivity growth numbers in the budget.

Senator SHERRY—I had noticed that. You can calculate it indirectly, as Senator Minchin knows.

Senator Minchin—In a very rough and rudimentary fashion.

Senator SHERRY—If you do not publish the figures, we have to make the best calculation we can on what is provided to us, as you know, Senator Minchin.

Senator Minchin—I recall that exchange.

Senator SHERRY—You do not publish it, but I am still seeking an explanation of the 1.5 per cent.

Dr Gruen—The decade of the 2000s includes some history. It includes forecast years from the MYEFO. The *Intergenerational report 2007* takes as its base the MYEFO of late last year. It uses the forecast numbers for labour productivity in the relevant years and then, once the projection starts, it uses 1¾ per cent as the labour productivity growth assumption. When you put all of that together over the whole of that decade the outcome is 1.5 per cent to—

Senator SHERRY—In this decade—we are in 2007—we have got some history.

Dr Gruen—Yes. That history is shown in chart 2.17, on the previous page.

Senator SHERRY—What does the history tell us about the figure for the 2005-06 year history period on productivity growth?

Dr Gruen—I think the answer is 1½ per cent. I can certainly take it on notice and give you the answer for the productivity growth over that period, but I think the answer is 1½ . Do you still want that number?

Senator SHERRY—Yes, if you have got it.

Dr Gruen—I do. You can read it off the graph, and it is approximately 1½ per cent, but I am happy to give you the exact number.

Senator SHERRY—It would be preferable to have the exact number reading off the graph. I have some questions on trying to identify some figures off a graph.

Dr Gruen—I have all the numbers here. For the 2000s—that is, 1999-2000 to 2005-06—whole economy labour productivity is 1.5 per cent.

Senator SHERRY—So we have established the historical figure is 1.5 per cent.

Dr Gruen—Yes.

Senator SHERRY—Can you please go to the explanation for the remainder of the 2000 years—the next three or four years.

Dr Gruen—The projection years, which for MYEFO were 2008-09 and 2009-10, would be 1.75 per cent.

Senator SHERRY—For those two years, for the remainder of the 2000s, the projection is 1.75 per cent?

Dr Gruen—Yes.

Senator SHERRY—Are we missing a year here—2007-08?

Dr Gruen—There are two years.

Senator Minchin—They are forecast years.

Dr Gruen—Which are forecast years.

Senator Minchin—As opposed to a projection.

Dr Gruen—Indeed, which are 2006-07 and 2007-08.

Senator SHERRY—What is the forecast?

Dr Gruen—As I have said, that is not published, and I will take that on notice if you want me to.

Senator SHERRY—The point I am getting at is this: we have 1.5 per cent historical?

Dr Gruen—Yes.

Senator SHERRY—For the forecast you have a question mark because you do not publish it.

Dr Gruen—Yes.

Senator SHERRY—And you have projected 1.75 per cent and 1.75 per cent. How does that, in the aggregate, get to either 1.75 per cent or 1.5 per cent?

Dr Gruen—You have significantly more years at 1.5 per cent than you do at 1.75 per cent, and then those two years taken together, presumably when you add them in, give you an outcome of 1.5 per cent.

Senator SHERRY—So it is not a matter of rounding to the nearest 0.5 per cent?

Dr Gruen—It is a matter of rounding to the nearest 0.1 per cent.

Senator SHERRY—Okay. Shall we stop there, Chair?

CHAIR—Thank you. These hearings are suspended until 1.30 pm.

Proceedings suspended from 12.29 pm to 1.33 pm

CHAIR—We will now resume these hearings.

Senator SHERRY—I think we left it just before lunch with those two years of productivity figures. Can you enlighten us?

Dr Gruen—Sorry?

Senator SHERRY—The estimated figures?

Dr Gruen—We do not publish those figures.

Senator SHERRY—I knew that. I want you to get them for me.

Dr Gruen—I am happy to take the question on notice.

Senator SHERRY—You are very secretive. We can get the projected figures but we cannot get the estimated figures. Let us just work this through. We have got 1.5.

Dr Gruen—Right.

Senator SHERRY—Sorry. For two years we have got 1.75?

Dr Gruen—What I have done is make sure I have got my dates right.

Senator SHERRY—So they were not—

Dr Gruen—They were one year out. The years for the history are 2000-01 to 2005-06, and the two forecast years are 2006-07 and 2007-08, and then 2008-09 is a projection year and 2009-10 is a projection year.

Senator SHERRY—In fact, we have got 1.5 historically running through to 2005-06; we have got question mark, question mark, refused to publish for the two other years, 2006-07 and 2007-08; and then 2008-09 and 2009-10, the projected figure of 1.75. I am not going to do the maths now. We can actually work it out, can’t we, based on the average?

Dr Gruen—You certainly could. There are two minor complications. One is that the data that we were basing it on was the September quarter national accounts. The data I quoted you before lunch was the latest available data, so it may differ slightly from the data as of the September quarter of last year. That is a small issue, but apart from that it would be straightforward.

Senator SHERRY—It gives us a very good ballpark figure?

Dr Gruen—It is a geometric average, not an arithmetic one.

Senator SHERRY—You are essentially telling me how to work it out. I am just surprised that you cannot give me the figures for those two years.

Dr Gruen—I have not done the calculation myself.

Senator SHERRY—I am sure someone down there in the bowels of Treasury has.

Dr Gruen—That is possible.

Senator SHERRY—I am not sure it is a possibility; I am sure it is a certainty. Coming back to the general issues of the *IGR*, is it the case that with an ageing population all of the future improvements in living standards, real GDP per capita, will be driven by the productivity gains that we are able to achieve?

Dr Gruen—Do you have a copy of the *Intergenerational report* in front of you?

Senator SHERRY—No, I do not have the entire document. I have some tables in front of me. Sorry, have the staff got a copy there? We will go on as best we can with it.

Dr Gruen—Yes, certainly. Rounded to one decimal, over the past 40 years real GDP per person grew at 2.1 and productivity was 1.8 of that. So participation and population contributed 0.3 per annum. Over the next 40 years those two contributions will subtract 0.2. So it is the case that the rate of growth of real GDP per person will be slightly slower than the rate of growth for productivity. The reason for that is that it turns out that there continues to be a slight rise in the proportion of people in the 15-plus population. That makes a small positive contribution, but, of course, of those people who are 15-plus, an increasing share of them are above 55 and an increasing share of them are above 65, and the participation rates of those people are significantly lower than for people of traditional working age.

Senator SHERRY—I think the average retirement age at the moment is 59. I have seen a figure recently. A slight increase I think.

Dr Gruen—It is possible. We are not sure about that.

Mr Tune—Overall on participation you get our contribution of minus 0.3 over the next 40 years.

Senator SHERRY—That is the other factor?

Mr Tune—Yes. You have positive 0.1 on population, negative 0.3 on participation, and productivity 1.8; net all that out and you get 1.6. That is on page 30 of the report.

Senator SHERRY—If we look at chart 2.24 on page 38 of the *IGR*, it shows that forecasts for real GDP per person fell by two per cent compared to *IGR* 2 after you take into account the data revisions.

Dr Gruen—Compared to *IGR* 1.

Senator SHERRY—Yes, compared to *IGR* 1. What is the main reason for this fall relative to *IGR* 1?

Dr Gruen—The outcomes have been weaker for real GDP per person. The outcomes since 2000-01 have been weaker than was projected at the time of the first *IGR*, and the main contributor to that has been weaker productivity growth than forecast.

Senator SHERRY—Is it the case that this chart shows that, if it were not for data revisions—and I think that was by the ABS, was it not—

Dr Gruen—Yes.

Senator SHERRY—the projections of real GDP per person or average living standards would actually have been lower than forecasting in *IGR* 1?

Dr Gruen—That is true, as in over the period out from—

Senator SHERRY—Yes.

Dr Gruen—Yes, over the projection, that is true.

Senator SHERRY—That relates to the issue of productivity?

Dr Gruen—That is not the only thing that is different.

Senator SHERRY—I am sorry; that is a factor. We can go to the other issues that are different.

Dr Gruen—That is a factor.

Senator SHERRY—Is it also the case that this chart shows nominal GDP per person is eight per cent higher currently and five per cent higher by 2040-41 because of a higher GDP deflator?

Dr Gruen—Yes.

Senator SHERRY—Is it right to conclude that this is the benefit the economy has received from our higher terms of trade, predominantly?

Dr Gruen—It turns out that a majority of it is the stronger terms of trade. Early in the period some proportion of it was the housing boom, which also contributes to various components of the GDP deflator. We estimate that about five per cent is a consequence of the terms of trade.

Senator SHERRY—Just going back to that productivity issue again, what would be the likely impact on long-term economic and fiscal projections if productivity does not improve in line with the forecasts—if it is in fact lower?

Dr Gruen—If productivity growth was slower than we have projected then living standards would rise less fast, and we actually have alternative scenarios on page 99 of the document.

Senator SHERRY—That is table B2?

Dr Gruen—It is.

Senator SHERRY—Yes, I was going to come to that. If we look at table B2 on page 99 it shows that in fact, if it were to average 1.2, which was the average in the 1980s, the productivity, the GDP, in 40 years would in fact be 20 per cent lower. It is a big difference based on a small average. It just shows the impact of compounding over time, I assume.

Dr Gruen—Yes.

Senator SHERRY—Sorry, 20 per cent lower than if it grew at 1.75 per cent.

Dr Gruen—Yes.

Senator SHERRY—It is a big final change just off a relatively small difference in productivity.

Dr Gruen—Half a per cent compounded over 40 years, yes. You can do just the simple arithmetic, which would give you 20 per cent, and that is roughly the answer.

Senator SHERRY—It is a bit like long-term compounding rates of return.

Dr Gruen—Yes, indeed it is.

Senator SHERRY—Why does the sensitivity analysis not show the impact of changes in assumptions like productivity on the fiscal pressure?

Mr Tune—I think it does, doesn't it?

Senator SHERRY—Could you indicate where that is illustrated?

Mr Tune—It shows it by component, so you have got lower productivity, and you go down on change in spending per cent of GPD. In some cases it is zero for lower productivity; in other cases we think it is 0.3 for other payments to individuals, for example.

Dr Gruen—That link is quite complicated—there is a footnote which makes that point—because lower productivity growth would be expected to be associated with lower growth in real wages and therefore payments that are tied to wages would be lower. It is not a simple exercise to undertake.

Mr Tune—'Other payments to individuals' there is largely things like age pensions, which is tied to MTAWE, so that you have got that being built in.

Senator SHERRY—I just had a specific question on this. My assumption is that *IGR* 2 does incorporate the recent legislative changes to the assets test of the age pension.

Mr Tune—On the spending side it does, yes. The impact of the change in the assets test for age service pensions, yes.

Senator SHERRY—I see Mr Gallagher poised. I actually have a specific question about this issue which he may be able to assist us with. From 1 July for the financial year going forward, what is the estimated number of individuals who will go onto, firstly, a part pension and, secondly, a full pension as a consequence of the assets test change?

Mr Gallagher—In chart C6 of the report we show the impact of the change in both superannuation assets and age pension coverage in these projections. One of the first things you see in those projections is the rise in the number of part-rate pensioners which comes from the assets test change.

Senator SHERRY—We see it there.

Mr Gallagher—On top of other continuing trends.

Senator SHERRY—Yes, I see that, but I cannot identify the actual number of that measure, can I?

Mr Gallagher—I do not have the actual number with me, and I do not think it is in the report.

Senator SHERRY—No, it is not in the report. That is why I am asking.

Mr Gallagher—I will take the question on notice.

Senator SHERRY—Do you have any idea of the approximate number? Are we dealing with in the next financial year, what, 10,000, 20,000 or 100,000 people in terms of part age pension increase or full age pension increase?

Mr Gallagher—What is shown here is the percentage change on a population which is close to two million.

Senator SHERRY—You are not suggesting that two million people have an increase in—

Mr Gallagher—No, I am not suggesting the two million, but I am saying that one per cent of two million people is not an insignificant number.

Senator SHERRY—No. One per cent of two million, which is just 20,000 then? That is the ballpark figure you are indicating to me? You are not being very specific. You are giving me some hints.

Mr Gallagher—No, I will take the specific question on notice.

Senator SHERRY—The *IGR* makes the point that both higher GDP and lower spending growth have reduced fiscal pressure and that a large proportion of the reduction in spending growth seems to be from changes—I think it is from changes—to methodology, not spending restraint or policy change by government. If we look at chart 3.20 on page 79, it shows that real per person spending is actually higher over the period to the end of this decade than was projected in *IGR* 1.

Mr Tune—That is correct.

Senator SHERRY—Is it correct to conclude from that that there is not going to be a reduction in real spending per person over that period?

Mr Tune—That is what we are projecting, yes.

Senator SHERRY—The factor I just touched on with Mr Gallagher would be included, presumably—the additional expenditures on part and full pensions would be part of that?

Mr Tune—Indeed.

Mr Gallagher—And other factors such as the aged-care package. There was an aged-care package of one and a half billion announced in about March.

Senator SHERRY—Would the aged-care package and the changes to assets tests be the two principal components? Are there any others that are of significance?

Mr Gallagher—There have been a significant number of policy changes that would affect the *Intergenerational report*.

Senator SHERRY—I understand that, but, in terms of the impact, they would be the two big ones, would they not?

Mr Gallagher—They are the two big ones affecting the aged population.

Mr Tune—Obviously the number of people is driving it strongly as well.

Senator SHERRY—I accept that, but that was an underlying issue in the *IGR* 1.

Mr Tune—Sure.

Senator SHERRY—What I am getting to is that we have just discussed two measures—and Mr Gallagher is right: there are others—that have had a significant impact on increased expenditure that otherwise have occurred.

Mr Tune—There are things pulling it back the other way. If you look at health, for example, the impact of the changes to the PBS that have been made pull the impact the other way. You have got pluses and minuses going all the time.

Senator SHERRY—Yes, you have got pluses and minuses, but the outcome is a plus.

Mr Tune—Yes, that is what we are saying.

Senator SHERRY—The outcome is a plus in real expenditure per capita?

Mr Tune—Our overall conclusion is that whilst the fiscal gap has come down there remain significant pressures.

Senator SHERRY—On the one hand, there is an improvement by certain policy measures; on the other hand, there is an increase by other policy measures, and the outcome is an increase.

Mr Tune—Yes, and then there are demographic factors that drive a lot of it.

Senator SHERRY—I accept that, but that is in *IGR* 1. The demographics do drive it; I accept all of that.

Mr Gallagher—One of the big changes in demography between the two reports is that in actual fact far fewer Australians have died than we had expected. Life expectancy has gone up further, and the consequence is that there are far more older Australians than we expected in the first report, and that is projected forward. That gives a change in the base compared to *IGR* 1. There have been changes in the demography as well changes in the spending.

Senator SHERRY—What is the main reason for the slower rate of growth in spending over the projection period? Is it policy or methodology or both?

Mr Tune—It is mainly health and, it is true, you will see in one of the appendices that we describe the change in the methodology that we used in relation to health where we refined it between *IGR* 1 and *IGR* 2, and does that have an impact. If you go to page 77 you can see the components there. Sorry, that is not showing the change between *IGR* 1 and 2; it is just showing the change from 2006-07 to 2046-07. That is the overall one.

Mr Gallagher—Page 51, chart 3.3.

Mr Tune—Taking 2041-42 as an example, you can see there we have the dark bar below the lighter bar.

Senator SHERRY—What would be the projections for real per person spending, or what would they look like if this *IGR* 2 was modelled on the same basis as *IGR* 1?

Mr Tune—We have not done that analysis.

Senator SHERRY—In the area of health and disease prevention, in the preparation of the report was there at any point a section or plans for a section that dealt with the impact of chronic or preventable illness?

Mr Heferen—Page 101 highlights the process by which we did the health modelling. Essentially, what we do is look at the trends in the historical data and then project that forward. So to the extent that you have a growing burden of disease in the historical data, we assume that it occurs at the same rate going forward. In a sense, it is implicit in the modelling.

Senator SHERRY—You say it is implicit in the modelling.

Mr Heferen—That is right.

Senator SHERRY—Is there any direction consideration of it into the modelling?

Mr Heferen—Sorry, in what sense?

Senator SHERRY—Changing the circumstances around preventable and chronic illness.

Mr Tune—Only to the extent that there has been a trend in the history that is incorporated into the overall numbers can you sort that out; otherwise, it is impossible to disentangle.

Mr Heferen—If you look at, say, the prevalence of lung cancer and the reduction in smoking that has occurred over the past 20 years or so, the reduction in the rate of cardiovascular disease—or at least stopping the rate of increase of cardiovascular disease—through a range of lifestyle modifications and, in particular, medication has occurred over the last 10 or so years. To an extent those things are there, so it is assumed that the rate of behaviour change and the rate of policy change that has occurred over the period in which we have looked at the data will go forward. We do not try to guess what might be a major health factor in 10 years, 20 years or 30 years time. We never try to get down to that level of speculation. We rely on the past as being the best projection tool for the future.

Mr Tune—Take a negative example: we cannot incorporate into what we are doing a future pandemic outbreak.

Senator SHERRY—I accept that.

Mr Tune—But going the other way: if there is a major breakthrough that prevents cardiovascular disease or stops the incidence of diabetes type 2 or something like that, and that has a major impact on the use of Medicare or the use of public hospitals, then we cannot pick that up, either; but if we can see it occurring in the next few years we would take it into account in the next *IGR*. You cannot actually discern the exact change; it is implicit in the numbers in terms of usage of the various components.

Senator SHERRY—Likewise, you might have a factor that goes the other way.

Mr Tune—Exactly, yes.

Senator SHERRY—In obesity, and being overweight, which seems to be the modern disease, there is an improvement in a number of areas—for example, chronic cancer treatment—but in other areas things are in fact worse.

Mr Tune—Absolutely, yes.

Senator SHERRY—There was not at any point a section dealing with the effect of poor health or chronic or preventable illness on workplace participation and productivity?

Mr Tune—I certainly cannot recall it. We had various drafts of the report done. I was chairing the steering committee that was looking after this, and I cannot recall a section in there at any point.

Mr Heferen—From the modelling point of view, that was never part of the process.

Senator SHERRY—Just on that pension-superannuation intersection we discussed earlier: why do you not disaggregate those figures—specifically, the impact of the increase in superannuation and the increased costs of the age pension—as identified figures in the tables in the report?

Mr Gallagher—The report is projections of estimates. The report does not concern long-term costings, and as such we do not separate out particular measures in expense or in revenue which we look at over the longer term. It is about the projected estimates.

Senator SHERRY—I just want to double check on the *IGR* so that I can finish in that area. Mr Gallagher, have you provided input into the modelling work on climate change?

Mr Gallagher—No, I have not provided any input into modelling of climate change.

Senator SHERRY—Perhaps I should ask: why not? You are providing input into—

Mr Gallagher—I think it is a different sort of modelling.

Mr Tune—We have the people here to explain that.

Senator SHERRY—No, I was just interested in whether Mr Gallagher's footprint was—

CHAIR—Do not worry, Mr Tune, they have been going like this all week!

Senator SHERRY—Mr Gallagher is my favourite modeller. What more can I say?

CHAIR—I gathered that.

Senator SHERRY—He is a fountain of information—when we can get to it. I have a couple of other questions on the *IGR*. If we go to charts 3.13 and 3.18, where is the underlying data information for 3.13 and 3.18?

Mr Tune—This is Defence that we are looking at?

Senator SHERRY—Yes, let us look at Defence—3.13. Where are the underlying figures?

Mr Tune—As chart 3.13 says, it is based on ABS data and the Department of Defence annual reports from various years. We have built up the historical series from those.

Senator SHERRY—In the ABS data and the Department of Defence annual reports, is the data actually given in number terms?

Mr Tune—Dollar terms?

Senator SHERRY—Yes.

Mr Tune—Yes, they have been given in dollar terms, and then we have had to put that as a proportion of GDP to derive the chart.

Senator SHERRY—Yes, I know what you have done, but if I go to ABS data and the Department of Defence annual reports, will I actually get that dollar figure that you have graphed?

Mr Tune—Have we manipulated the data or done something to it—is that what you are saying?

Senator SHERRY—No, I did not say that or imply that in any sense.

Mr Tune—We would do something to the data to be able to derive it. We might need to take that one on notice to give you the detail of that.

Senator SHERRY—It is actually the raw numbers for the graph figure. The dollar figures are not available in a chart. As I understand it, if you go to ABS or the Department of Defence, it is not there. This is clearly data prepared by Treasury based on those documents.

Mr Tune—Absolutely.

Senator SHERRY—I accept that, but the actual dollar numbers are not published in either of those two sources. You have calculated it yourself on the historical data?

Mr Tune—Yes.

Senator SHERRY—You have produced a graph, but the actual table of the numbers is what I would like to see.

Mr Tune—We will have to take that on notice.

Senator SHERRY—Have there been any requests for release of that dollar data?

Mr Tune—On Defence?

Senator SHERRY—Yes.

Mr Tune—Not that I am aware of.

Senator SHERRY—Is anyone else aware of any requests?

Mr Tune—No.

Ms Furnell—No.

Mr Tune—Ms Furnell looks after the requests, and we have had none.

Senator SHERRY—Do you actually have the precise level of Defence spending, as a proportion of GDP, from 2002-03 through to 2005-06? Frankly, it has been very difficult to get the precise figures from chart 3.13.

Mr Tune—No, as I said, we will have to take all that on notice.

Senator SHERRY—I do not know whether it is because of my eyes or not but, if we look at bar chart 3.18, Defence spending, as a proportion of GDP, in 2046-47 looks absolutely infinitesimally lower than in 2006-07. Would that be a correct read by everyone?

Mr Tune—That is correct, because we are basically assuming a constant proportion. The Defence spending shown in the *IGR* is an assumption. Defence is not modelled, per se. We just make an assumption.

Dr Gruen—The 2006-07 number is the current year, and the 2046-47 number is the assumption beyond the forward estimates. They do not have to be identical proportions of GDP, but they are extremely close.

Senator SHERRY—I was just wondering whether you are seeing it in the same way I am; there is an absolutely fractional difference—

Dr Gruen—Yes, it looks like it is slightly smaller.

Senator SHERRY—Can I also have the actual raw figure for Defence spending, as a proportion of GDP, in 2006-07?

Mr Tune—We will take that on notice.

Mr Francis—The number is actually in the text. For 2006-07, it is 1.7 per cent of GDP.

Senator SHERRY—The last peak in that graph, on the right-hand side, looks like it is around 2003-04. Is that slight peak 2003-04?

Mr Tune—I do not know. It looks like it is around that point but, once again, I think we had better take that on notice to pinpoint it for you.

Senator SHERRY—I do not think my eyes are kidding me, but for whatever the period is, three or four years, it is a slight trend downwards as a percentage of GDP. That is correct, isn't it?

Mr Tune—Sorry, could you repeat that?

Senator SHERRY—There is a slight trend downwards, as a percentage of GDP, over that last couple of years—whether it be two years or three.

Mr Tune—The years 2005-06?

Senator SHERRY—You do not segment the bar graph by years; it is just segmented by decades. So it is just a bit hard to tell when that little peak occurred. Interestingly, I suppose that downward decline has occurred at a time of major commitment in Iraq, which has not put it up.

Mr Tune—These numbers would incorporate commitments in Iraq, Afghanistan and those sorts of places, as well as capital spending on Defence equipment and so forth.

Senator SHERRY—So the whole lot is aggregated in there?

Mr Tune—Yes. The other thing in here is GDP, of course. If nominal GDP, which is the denominator in all these calculations, has been moving very quickly, that could have an impact. As we were talking about earlier, in aggregate you have got real increases in spending going on in some of these components, but when you put them as a proportion of GDP they actually stabilise, or slightly fall perhaps, because GDP is going up so fast.

Senator SHERRY—I think we are just about done on those. Let me just have one final check. Yes, I am all done on the *IGR*.

CHAIR—Thank you to the *IGR* team. We appreciate your time and we are happy to accommodate those requests from Mr Tune this morning. Thanks, too, to anyone else I have not mentioned.

[2.10 pm]

CHAIR—We will now move to output 2.1, Fiscal group

Senator SHERRY—I want to deal with an area on page 10-22 of Budget Paper No. 1. It shows an estimate of $49.043 billion for departmental expenses in 2007-08; a downward revision of $4.5 billion, which is contained on page 10-23 of the 2006-07 budget papers; and estimated departmental expenses of $54.569 billion for 2007-08 in those 2006-07 budget papers. I am just seeking an explanation as to that downward revision. It is a significant downward revision.

Mr Martine—Comparing 2006-07 Budget Paper No. 1, are you referring to the figure of $54.369 billion in 2007-08?

Senator SHERRY—Yes.

Mr Martine—The simple answer to the question is that the movement between the two is simply the sum of the differences embedded in the table for each of the departmental expenses attributed to each agency. In terms of the reasons behind each of those movements, I do not think we are in a position to fully explain the movements in the departmental expenses for all of them. Essentially, the major movements would be explained just by looking at the two tables, side by side, to compare which departments have moved the most.

Senator SHERRY—On page 10-22 of Budget Paper No. 1, if you look at the list of whole-of-government intergenerational amounts which are 'netted departmental expenses', that shows the figure of $9.822 billion in 2007-08 and an upward revision of $9.871 billion from the 2006-07 budget papers, which estimated the whole-of-government and intergenerational amounts for departmental expenses at $49 billion.

Mr Martine—Effectively, the interagency transactions are eliminated at the whole-of-government level so that the expenses for each agency listed in the table would include transactions with other entities within the general government sector, but in terms of the aggregate expenses—when they are aggregated at the whole-of-government level—those amounts are eliminated. The reasons why those amounts are different to those in the equivalent table in the 2006-07 budget papers, I am not entirely sure. I would have to take that on notice and consult with the department of finance.

Senator SHERRY—I just wanted to deal with some issues relating to debt under the Commonwealth-State Housing Agreement. The 2004-05 annual report for the Housing

Assistance Act of 1996 states on page 9 that total long-term debt is just over $6 billion, down from about $43 billion; approximately $4 billion is owed to the Australian government as funds borrowed under previous CSHAs, the main method of funding under the CSHA until the 1980s when grants were phased in; and interest rates for loans ranged from three per cent to six per cent, with the majority of loans at interest rates between three per cent and 4.5 per cent. What is the current level of debt owed by each state and territory under that Commonwealth-State Housing Agreement?

Mr Martine—We do not know.

Senator SHERRY—You have got a published figure for debt, but you say you do not know—

Mr Tune—It came out of an annual report, if I heard you correctly. I guess you would have to go to the most recent annual report for that—

Senator SHERRY—No, the state-by-state breakdown; is that there?

Mr Tune—In the annual report?

Senator SHERRY—Yes.

Mr Tune—Sorry, it is not in the budget papers as far as I am aware, and—

Senator SHERRY—No. That is why I am asking.

Mr Tune—I suspect the best place to go is the Department of Family and Community Services and Indigenous Affairs. They look after housing issues.

Senator SHERRY—Do you know what interest is charged to each of the states and territories?

Mr Tune—My recollection—and this is going on the history—is that most of those agreements stem from the late 1940s, that they were five-year agreements and that the interest rate would vary by each agreement. But it is true, as you read out, that they were basically very concessional loans. Most of them are very long-term loans too. My recollection on that is that the loans were generally made for 53 years.

Senator SHERRY—I have a few other questions about the details of these arrangements. Do you want that to go to—which department?

Mr Tune—To Family and Community Services or, alternatively, to the Department of Finance and Administration.

Senator SHERRY—I go to page 93 of Budget Paper No. 3, table D6—Estimated specific purpose payments direct to local government authorities, 2007-08. There are two splits for all states on that page. Direct payments current is $52.2 million for all states and direct payments capital is $556.6 million. What is the difference between current and capital payments?

Mr Tune—I think it is the normal definition there—to capitalise is to build something.

Senator SHERRY—Sorry?

Mr Tune—The capital is to build something. So you see things like the South Australian State Aquatic Centre there, $1 million to South Australia. That is to build an aquatic centre. So it is a capital expense.

Senator SHERRY—What about ‘current’?

Mr Tune—’Current’ would be recurrent funding. So you have got—

Senator SHERRY—Such as?

Mr Tune—One of the items there is disability services, or children’s services. That would be to run operations of children’s services, childcare centres or something like that. These are payments to local government authorities, so it would be a local government operating some of those services. It is the recurrent spending involved in operating those things, wages and so forth.

Senator SHERRY—There is a clear definitional difference between ‘current’ and ‘capital’ in this category?

Mr Tune—In all categories, in fact.

Senator SHERRY—I accept it is in all categories. I am only asking about this paper. I am interested in two issues relating to the current payments. There is a Regulation Reduction Incentive Fund. Why has Queensland received such a large proportion of the funding from that fund over the last two years? I will get to an even better state in a moment.

Mr Tune—We are not aware of the reason for that. You are getting into levels of detail that we certainly do not have. It is probably best to approach the relevant agency on those sorts of issues.

Senator SHERRY—But is this the fund that contains things like the Blackburn Lake Sanctuary.

Mr Tune—I can see that is one of the items listed under ‘capital’ there—$1.8 million to Victoria for the Blackburn Lake Sanctuary. I do not know what it is, quite frankly.

Senator SHERRY—That is why I am asking—not so much about what it is but the process undertaken to approve that project.

Mr Tune—That would be done by the department which looks after local government funding, which is DOTARS.

Senator SHERRY—Does Treasury know whether the money has been spent?

Mr Tune—No, we do not.

Senator SHERRY—What is the process if a project is announced and the money is not spent?

Mr Tune—There is a variety of processes. In some cases it might be rolled over. If there is a good reason why the money was not spent in the financial year it has been appropriated for, there is then a process whereby it might be rolled over. There might be a delay in letting a contract, or something like that, or just a delay in getting something started. Alternatively, the money comes back to consolidated revenue.

Senator SHERRY—Is it to the minister for finance or the Treasurer, or both?

Mr Tune—It is generally to the minister for finance, I think.

Mr Martine—Yes, that is correct.

Senator SHERRY—Okay. I want to turn to some issues relating to climate change. Before I get to specific issues, as you know, we have had a discussion on previous occasions about the section in which this work has been done and the staffing levels there. Has there been any change since last estimates in that regard?

Mr Tune—Yes, there has been some change. There are probably a few more people working on these issues than there were back in February, I think it was.

Senator SHERRY—Can you just be a bit more specific today about the few more staff changes?

Mr Tune—Okay. We have an Industry, Environment and Defence Division, of which Ms Mrakovcic is the general manager, and next to her is Geoff Francis, who is the principal adviser in that division. That has four units, one of which is called the environment and agriculture unit. That unit looks after a range of issues around environmental issues and also primary industry issues. And then we have a greenhouse unit which we started up in about February as well. On top of that we have a group at the moment looking at some modelling issues around climate change which is outside that divisional structure.

Senator SHERRY—Okay. We have got the greenhouse unit which was established in February. Who is responsible for that?

Ms Mrakovcic—That is situated in my division.

Senator SHERRY—How many staff are in that unit approximately?

Ms Mrakovcic—Approximately four to five.

Senator SHERRY—In terms of the total number of staff in your area that you are responsible for, has that declined as a consequence, or have those four or five, because of the greenhouse unit, added to the staff in the area?

Ms Mrakovcic—We used to, of course, always look after energy and greenhouse issues, and in fact that unit is called energy and greenhouse policy, so we did have an ongoing responsibility in those areas. I think what has changed is that previously those were covered by the environment and agriculture unit and industry policy unit; that was shared among those. What we have done is essentially and largely extract resources from those two units and put them into a new and energy and greenhouse unit. There is one additional EL2 that we did not have in the previous structure.

Senator JOYCE—What is the key idea about the greenhouse unit? What is it trying to do?

Mr Tune—Provide advice to the government on climate change issues.

Senator SHERRY—I think you said there is another group on climate change?

Mr Tune—Yes. More recently we have been asked by the government to start thinking about modelling the impact of climate change policy changes on the economy. We have started to think about those issues.

Senator SHERRY—Has a group been established yet?

Mr Tune—There is a small group within Treasury, yes.

Senator SHERRY—And that is to focus on climate change and greenhouse?

Mr Tune—On modelling per se, yes.

Senator SHERRY—This is the modelling area?

Mr Tune—Yes.

Senator SHERRY—How many staff are in there?

Ms Mrakovcic—About 11.

Senator SHERRY—Is this your area of responsibility too, Ms Mrakovcic?

Ms Mrakovcic—That is correct.

Mr Tune—Ms Mrakovcic is offline from her normal general manager position to do this at the moment.

Senator JOYCE—Climate change and greenhouse are part of the same area, are they?

Ms Mrakovcic—That is correct.

Senator SHERRY—So it is a modelling unit with 11 persons. When was that established?

Ms Mrakovcic—About six to seven weeks ago.

Mr Tune—Yes.

Senator SHERRY—In terms of the overall staff in these units, has there been a net increase or has it simply been a case of transfer from one area to another?

Ms Mrakovcic—They have all been transferred from other areas.

Mr Tune—In terms of the people working on climate change issues, there would be a net increase within the Treasury. Some of the people that transferred into this modelling unit, whilst they have come from Treasury, have come from parts of Treasury that were doing other things.

Senator JOYCE—On what are you basing your information on climate change and greenhouse issues? What do they do during the day? What are they researching?

CHAIR—I think we might let Senator Sherry continue with his questions; that is probably a whole new area. We will come back to that.

Senator SHERRY—I might get to those sorts of areas.

Senator JOYCE—I am just curious.

Senator SHERRY—I am curious too; don’t worry. What is the approximate number of net additional staff working in these areas now?

Mr Tune—Seven, eight, nine—somewhere around there.

Senator SHERRY—Approximately seven to nine. We have the modelling unit with 11, and we have a new greenhouse unit, both since February, with four to five staff. Just coming back a step, Treasury Secretary Henry recently stated:

Water has got away from us a bit in recent times, but it will come back for some quality Treasury input at some stage—it will have to—and we are, at last, right at the centre of policy development in the climate-change area.

Can you outline to me—although I think it is a reasonable assumption, given the areas we have just been talking about—what role Treasury is playing in the development of climate change and water policy?

CHAIR—Mr Tune, before you do that, it is probably opportune for Senator Joyce's question to be taken in conjunction with that as well, I think. Probably both questions work in with each other.

Mr Tune—That is fine. We will try to cover them both. I might make some initial comments and then, for the detail that Senator Joyce was after, I will hand over to Ms Mrakovcic. Maybe I should start with water and then we can go into more detail on the other one. With water we are involved, as you know, in the National Plan for Water Security. The government is negotiating with the states on the implementation of that plan. There is a water coordination group across the Public Service of which Treasury is a member. We are involved in ongoing issues around water as part of all of that. That is along with a range of other departments, obviously.

On climate change, there are probably two key aspects. First is that the secretariat doing the work in the task group on climate change—which is reporting to the Prime Minister today, we understand—has been led by an executive director from Treasury on secondment, so there has been a central involvement in that. As well as that person, there has been someone seconded from Treasury to work on those issues as well over in the Prime Minister's department. The second major aspect, as well as the ongoing policy issue surrounding climate and greenhouse which we deal with on a day-to-day basis, is this work that we have been asked to do on thinking about modelling the impacts of climate change or of climate change policy on the economy. I might ask Ms Mrakovcic to give you a bit of detail about where we are up to that, which may help with Senator Joyce's question as well.

Ms Mrakovcic—Do you want me to focus on the modelling task team that has been established?

Senator SHERRY—Yes, certainly initially.

Ms Mrakovcic—It is basically at the stage where it would be fair to say that we are trying to improve our capacity in this area. We are in the process of essentially being on the steep part of a learning curve in terms of understanding exactly the sorts of different approaches to the modelling of climate change mitigation policy. As we have noted, we have only been involved in this for a relatively short period.

CHAIR—Do you mind just—

Senator SHERRY—I am really relaxed about splitting the questioning.

CHAIR—Do you want to repeat your question, Senator Joyce?

Senator JOYCE—Yes, I will repeat my question. With respect to the greenhouse and climate change section, what sort of expertise do the people working there—and this is not targeting them; I am just generally curious—have in that area? What are you actually looking for when you put a person in that department?

Ms Mrakovcic—Are we talking about the energy and greenhouse team now or the modelling team?

Senator JOYCE—Let us talk about the energy and greenhouse team.

Ms Mrakovcic—Essentially that would be comprised largely of economists and some public policy analysts or experts.

Senator JOYCE—The modelling section would have scientists?

Ms Mrakovcic—The modelling section would have economic modellers.

Senator JOYCE—Economic modellers?

Ms Mrakovcic—That is correct.

Mr Tune—We do not have scientists per se. They do have science degrees but they are not employed as technical scientists per se in Treasury. We are relying on the science coming from other parts of the—

Senator JOYCE—That is what I want to know. Where is the premise, basis, front-end loading information for this modelling department coming from? When they turn up to work what data are they grabbing and from what samples?

Ms Mrakovcic—It is from a wide variety of sources. Obviously we try to keep up with what the Department of the Environment and Water Resources is doing, we try to keep up with CSIRO developments and, more broadly, the different studies undertaken by various organisations and released into the public arena.

Senator JOYCE—Just so that the Australian people can understand the structure of how this thing works: do they come to you and say, 'We think the temperature is going to go up 0.8 of a degree,' or do they come to you and say, 'We think the temperature is going to go up by 0.8 of a degree and these will be the consequences'? When does their role stop and your role start?

Ms Mrakovcic—To be clear on this, what we are advising on are the policy responses to climate change. In that sense, for the information on the impacts of climate change we draw on other departments and organisation. So we are informed by a whole range of science out there that is telling us what they believe is the probable range of temperature impacts and what kinds of implications that might have for different sectors of the economy, for example. Implications in terms of rising sea levels or changes in precipitation—all of that is information that we draw on that comes from outside the department.

CHAIR—Do you model on a variety of scenarios?

Ms Mrakovcic—We have not undertaken any modelling as yet. I was trying to indicate a few minutes ago that really we are just at the front end in terms of trying to establish a capacity to understand the modelling that has been undertaken out there.

Senator JOYCE—If they turn up and say, 'Okay, the temperature is going to go up one or two degrees, the sea level is going to rise 20 feet and the people on Koorong Road, Vaucluse, are going to be in a world of bother because they are now going to be underwater', do you walk away with that data, or does the information also flow on from the Department of Meteorology, oceanographers and so on? When the data arrives with you, what exactly do you have? Do they say, 'The temperature is rising, the El Nino will happen and, therefore, our grain production will fall to this level'? I did an economics degree, but if somebody says, 'The temperature will rise by 0.8 of a degree', I would say, 'That's marvellous. So what?' Unless I have more data to front-end load with any modelling or theories—and it has to be pretty precise—I really cannot generate anything for you. I cannot give you something to work with.

Mr Tune—The work we are doing is not so much about trying to look through the impact of climate change on the economy. As has been said, we are at a very early stage of trying to think it through. The work we are trying to do is on what the impact of policy change would be on the economy. If you were looking at some kind of change of policy put in place by the government, we would be working on what the impact of that would be on the economy. They are slightly different questions.

Senator JOYCE—That makes a lot more sense. If we say that we want to reduce carbon emissions by 60 per cent, for example, you would say, 'The price of fuel is going to go up by $1.20 a litre. Let's see what that does to the shopping budget when that happens'?

Mr Tune— That is the sort of thing we are trying to work through. It is very difficult to do and we are at the very early stages of looking at the various models that are around.

Senator JOYCE—I would say that a lot of parents doing their shopping today will tell you what will happen to them if you put up the price of fuel by about $1.20. I know what they will do to us.

Mr Tune—We are trying to work out what will happen to the price of fuel, if you do certain things on climate change, and therefore what will be the impacts across the economy. They are the sorts of things that we are trying to answer.

Senator BERNARDI—In your modelling of economic impact, what sorts of limits of or extremes in the range of impacts do you put on it?

Mr Tune—We are not picking up those impacts at all really. I think that is right. As I said, we are trying to—not 'measure', because that is an overstatement—estimate the impact of a policy change on the economy per se. As I said to Senator Joyce, what we are trying to do is slightly different from the question you are asking. What I think you are alluding to is more like the sort of thing that Stern was trying to do, which we are not trying to do.

Senator BERNARDI—Yes, I guess it is, but it is related in that you are provided with information or a set of information that is driving policy and there have to be some parameters within which that information has been provided to you.

Mr Tune—Yes.

Senator BERNARDI—For example, if you receive something from the environment department about a policy initiative and you want to know the cost, they might say, 'If we do this, we could do it at this level or at this level.' How different are those levels?

Ms Mrakovcic—Perhaps I should explain. As we indicated the last time round, Treasury does not have its own CGE capability, a computable general equilibrium model, that in fact you need to—

Senator JOYCE—By 'CGE', do you mean greenhouse?

Mr Tune—It is a type of model. It is where you try to model the impacts on the economy of a certain policy change. You can use it for greenhouse, for a change in industry policy or for anything else.

Ms Mrakovcic—In a sense, we have tried to improve our understanding of the main models out there that have been used in various studies that have been done by various people in the private sector and who have released reports on the implications of different climate change mitigation policies. Essentially, we are trying to establish an understanding of what is driving the model results in each of the key models that have been used for the purposes of modelling climate change mitigation.

Senator BERNARDI—I suppose there are a number of reports in that particular area, going right from a minimal impact to an extreme. In the case of a sea level rise, some say it will rise six centimetres and others say it will rise 100 metres. I suspect that both of them are wrong.

Ms Mrakovcic—They are perhaps models that deal with climate impacts.

Senator BERNARDI—The physical impacts, yes.

Ms Mrakovcic—That would be an attempt to model climate change impacts. That is not an area that we are getting involved in. We are trying to understand the economic implications of climate change mitigation policies—policies that actually seek to address climate change.

Senator BERNARDI—I understand and appreciate that. Thank you very much.

Senator SHERRY—You are not putting together a model as such?

Ms Mrakovcic—No.

Senator SHERRY—Have you got on to any external modellers for advice or a contracted service?

Mr Tune—We have commenced discussions, but we have not gone into any contracts.

Senator SHERRY—Which areas are you discussing modelling for?

Mr Tune—Sorry, I do not quite follow the question.

Senator SHERRY—You have gone to some external providers. Are you able to name who you have gone to?

Mr Tune—There are various modellers around in academia who are attempting to do these sorts of things. Perhaps I can give you an example of something similar. A couple of years ago we were provided with some money to try to develop a model around the impact of changes in tax and social security arrangements, on participation in the economy in particular, and to try to pick up some of the dynamic flows or behavioural impacts. The Melbourne Institute of Applied Economic and Social Research has such a model, which is called MITS. They have been generating data from that. The government asked us to have a look at it and see what could be done. We have spent the last two years examining that MITS model to see whether we think it is up to scratch before using it. We are doing a similar exercise with this stuff. We are going to the existing models—which are different and will generate different results, because the assumptions implicit in them are slightly different and the structures of those models are even built slightly differently—and picking their eyes out, in looking at where we think we should be going. It is not a quick exercise; this is a slow exercise.

Senator SHERRY—I accept that it is not a quick exercise. I just want to understand the stage you are at. There has not been any modelling per se commissioned by Treasury in this area as yet?

Ms Mrakovcic—That is correct.

Senator SHERRY—That is where you are at?

Ms Mrakovcic—I think it is fair to say that we are in the process of discovery. We are trying to get a feel for the major models out there that have been used for climate change mitigation policy and, essentially, look at what the key features of each of them are and understand how they are generating the kinds of results they are generating.

Senator JOYCE—Tell me if this is not an appropriate question to ask now. With respect to your modelling that you are giving advice on, are you modelling carbon trading and its economic effects?

Ms Mrakovcic—Again, we have not done any modelling as yet. We are in the process of discovery.

Senator JOYCE—Are you collecting information about prospective modelling on carbon trading?

Ms Mrakovcic—We are collecting information and analysing the key relationships in each of the models.

Senator JOYCE—Will you be collecting information on what sort of people will hold the carbon, buy the carbon and trade the carbon—that sort of information?

Mr Tune—If you are going to model the impact of such a scheme, you would need a fair amount of detail about that scheme before you could model its impact.

Senator BERNARDI—We are sort of exploring a policy area here.

Senator JOYCE—I am just curious. I just want to know whether farmers will get a chance to make some money out of carbon trading. That is basically where I am coming from.

Senator SHERRY—The government will announce that, if it announces—

Senator BERNARDI—I think we are exploring a policy area.

CHAIR—I think Senator Bernardi is right—that we are heading into these areas.

Senator SHERRY—Senator Joyce is. The National Party is finally getting a bit motivated.

Senator JOYCE— I have become very environmentally conscious in the last five minutes. I think it is going to warm up and we had better make some money out of it.

CHAIR—I think questions about modelling are quite reasonable, as long as we are not heading off into some of those other areas.

Senator SHERRY—The point of discovery at the moment is what is out there in terms of models available, but no modelling has been commissioned in any area. Have you examined in detail any issues around climate change or emissions trading? There is no modelling, but are you looking at the issues there?

Ms Mrakovcic—Certainly, over a long period, we have been looking at the issues around climate change and the various instruments that one can use for climate change mitigation policy. That is what I would call a day-to-day responsibility of ours.

Senator SHERRY—So there are policy options—I am not going to ask you what your conclusions are—that have been passed on to the ministers and the Prime Minister. Work is being done in the climate change and emissions area and the consequences of that were referred to earlier by Mr Tune. Is that being done?

Mr Tune—We are at the very early stages. We have not been asked yet to model the impacts of a particular policy change.

Senator SHERRY—In what way has Treasury contributed to the work of the Prime Minister's emission trading task group, if at all?

Mr Tune—As I said, the person running the secretariat for that group is an executive director of Treasury. There has been another Treasury officer seconded. The secretary of the Treasury has been a member of the task group itself, and we have had some discussions with the people on the task group, which you would expect to happen there.

Senator SHERRY—Effectively Treasury's input has been to provide these two staff but not to provide any modelling at this point in time?

Mr Tune—No, absolutely not.

Senator SHERRY—Because you are still in the discovery stage?

Mr Tune—That is correct, yes.

Senator SHERRY—In terms of options on emission trading schemes or carbon taxes, it is clear, is it not, that would impose cost to individuals and households through higher energy bills?

Ms Mrakovcic—Any measure that you take to address an externality in that way would result in a cost being incurred by some sector of the economy, and ultimately that would be reflected, presumably in the form of what households would face.

Senator SHERRY—There is a cost, but how it is paid for is effectively a policy decision at some point in time?

Ms Mrakovcic—That is correct, except that when one also thinks about where the cost is borne in the first instance, it obviously raises secondary issues of, for example, if the costs were to be borne by the government, how would that be funded? What about if it were borne by the households? It obviously has implications.

Senator SHERRY—There are a variety of scenarios, outcomes and options for ultimately that being funded?

Ms Mrakovcic—Sorry, I missed the last part of that.

Senator SHERRY—There are a variety of scenarios, outcomes, costings and options for funding the additional cost where that occurs?

Ms Mrakovcic—That is correct.

Senator SHERRY—At some point in time you will deal with that?

Mr Tune—Yes.

Senator JOYCE—The carbon trading market has collapsed somewhere, has it not? Was it in Europe that it has fallen over?

Mr Tune—In Europe there have been some problems, yes. That is correct.

Ms Mrakovcic—There have been some establishment issues, but I guess no more than you would expect in—

Senator JOYCE—Who buys and sells the carbon there? Who owns the carbon?

Ms Mrakovcic—The governments take responsibility for the issuance of permits, and then they have a choice as to whether or not those are auctioned or in fact given away.

Senator JOYCE—Who gets paid for it? That is basically what I want to know.

Ms Mrakovcic—Again, it depends on whether we are talking about situations where the permits are auctioned or where they have in fact been given away or what they call grandfathered. In that case, basically existing emitters are given permits equivalent to the historical—

Senator JOYCE—This question might be self-interest for the farmers, but this is what they will be wanting me to ask: do farmers and people who own property get the chance to make money out of the carbon that is on their land?

Ms Mrakovcic—It is impossible to answer that question. It would very much depend on—

Senator JOYCE—Or is it that they are trading carbon on their land but the people who actually own the land do not make any money out of it, in which case—

Mr Tune—It depends crucially on the design of your scheme. You cannot answer a priori. You would have to look at the detail of what the scheme was before you could—

Senator JOYCE—Are there any countries that do anything similar to that?

CHAIR—It is a very hypothetical scenario.

Senator JOYCE—Can we take that one on notice, then?

Senator SHERRY—I think if Mr Tune or any of the officers had knowledge of the schemes operating in any other countries that operate in the way that Senator Joyce is interested in—

CHAIR—Do you want to take that on notice?

Senator JOYCE—Yes, take it on notice.

Mr Tune—We are happy to take it on notice.

CHAIR—You say you are in the absolute infancy of putting together a modelling system, for want of a better word, in relation to climate change. Is there anyone else within Australia doing that or has systems that—

Ms Mrakovcic—ABARE, within the Australian government, undertakes some modelling of climate change, and it has GTEM, which is their CGE model.

Mr Tune—And there are two academic models that we are aware of. They are the sorts of people we are talking to. One is at Monash University and the other one is at the ANU.

Senator MURRAY—That is—

Mr Tune—Yes, the CoPS model. The work is being done but the models differ. If we are going to look at this stuff, we want to look at all of those models and we want to make sure that we are happy with the structure of them before we go forward. This process of discovery and investigation is the crucial one for us.

CHAIR—Are those models finalised?

Mr Tune—Yes, people use those models. People publish results from them.

Ms Mrakovcic—Except that models generally tend to be in a state of flux in any case because modellers are constantly making improvements to them or changing them. But they are well-established models that have been used in previous exercises.

CHAIR—Are they imprecise models at this stage?

Mr Francis—The model is a mathematical representation of the economy and, as the economy changes, you change the model to update it.

Senator BERNARDI—How do the two external modellers you mentioned, Monash University and the other one, which I did not pick up—

Mr Tune—ANU.

Senator BERNARDI—What are the principal differences in their modelling environments?

Ms Mrakovcic—They have different approaches to the way that they treat, if you like, the external sector. For example, GTEM by ABARE is a global model that incorporates information from a very large number of countries. Whereas, for example, the CoPS, the Centre of Policy Studies model, down in Melbourne, is basically a closed economy model. But where their comparative advantage lies is in the detailed sectoral representation. They have a lot of information on a large number of sectors within Australia, which the GTEM model does not, and then you have other models, such as the G-cubed model.

Mr Tune—G-cubed; that is the ANU one?

Ms Mrakovcic—That is Warwick McKibbon’s model. That tries to incorporate a great deal more of the macroeconomic type of effects coming through, and I think it has around seven or eight countries. It does not have as many other economies as the GTEM model. But the sectoral representation is not as rich as the Centre of Policy Studies model. They each have different strengths that they bring. One of the things that you go through is having to decide just how much you want to weigh different features in terms of the global interactions vis-à-vis the sectoral detail that you are able to get.

Senator BERNARDI—It would be nigh impossible for a layperson to rely on any of them as a definitive answer, because you would take aspects of all of them in your consideration?

Senator MURRAY—And because the assumptions vary.

Senator BERNARDI—They do. That is precisely the point. It is very hard—

Senator SHERRY—You have not selected a model yet?

Ms Mrakovcic—That is correct. It is because we are taking that path of discovery in understanding exactly what assumptions have been used in each of the models in how they model the relationships in the economy and in the kinds of parameter assumptions that have made. We want to understand, if you like, the path to the sorts of results that they are getting and what kind of assumptions have been made and come to a stage where we can hopefully make some judgements ourselves as to the relative validity of some of the assumptions.

Senator BERNARDI—A very prudent approach, I would have thought.

Mr Tune—We are not saying they are bad models or anything like that. We think they are very good pieces of work. We want to demonstrate this to ourselves and think it through in a prudent way.

CHAIR—Just so I am clear, are you going to formulate a model that will bring bits of these models in?

Mr Tune—Not necessarily. We have not come to that conclusion by any stretch yet.

Senator SHERRY—It is discovering the models that exist? You may or may not go with an existing model, a blend of models or add to a model?

Mr Tune—All of which are options, yes. We need to keep our mind open to these things.

Senator MURRAY—Just one last question: are you restricted in terms of the number of sectors you can examine by the models? My memory is that the largest is about 300-and-something sectors.

Ms Mrakovcic—As far as we are aware, there is the CoPS model, which has somewhere around the 50 mark in terms of sectors, and then at the other extreme you have the G-cubed model, which is, from memory, around 12 sectors.

Senator MURRAY—Maybe I am confusing it with Econtech’s model. I thought they could break down a domestic economy into about 300 or something.

Mr Tune—You might be thinking of PRISMOD, which is the model that we looked at for the distributional consequences of the GST. That is a different sort of model.

Senator MURRAY—Is that about 300?

Mr Tune—I do not think it is quite that many.

Mr Francis—It is not actually sectors in so much as commodities.

Mr Tune—I do not think it is quite that many, but it is much larger than that.

Senator MURRAY—I asked you the question deliberately because obviously for people assessing the merits of any government proposal they will be particularly keen to assess their sector. You need to have sufficient fields, as it were, to satisfy that view. Ten or 12 people would be far too restricted, in my view. It would need to be much more substantial than that, given the complexity of the Australian economy. Would you agree with that?

Mr Tune—As a general proposition, I would agree with that. Of course, the difficulty is that once you start increasing the number of sectors, you start increasing the complexities and the linkages and that makes your task harder. You have always got trade-offs in this area.

Ms Mrakovcic—The sectoral representation is one of the key issues that we are looking at. You would also want to make sure that the model you were using was robust in overarching terms. A model has to be robust at a very broad level in order for the results to be robust at that sectoral level.

Senator MURRAY—I understand that.

Senator SHERRY—In the discovery process is there any usefulness in looking at overseas models at all, and are you doing that?

Ms Mrakovcic—We are certainly trying to understand what models have been used overseas and the sorts of assumptions that they have incorporated in the models, but at this stage the focus has to be by default on essentially the models that are available in the Australian context.

Senator SHERRY—By choosing, selecting, modifying or developing a model there may be some useful experience overseas from another jurisdiction that has already gone through the process.

Ms Mrakovcic—We would be very interested in understanding—and we are trying to understand—some of the key models that have been used in modelling climate change mitigation policy overseas as well.

Senator SHERRY—Has any work been done on the distributional impact of carbon pricing?

Ms Mrakovcic—No. That goes back to our earlier answer; we have not actually undertaken—

Senator SHERRY—I just wanted to be clear, though. Presumably no work has been done on compensation mechanisms for households or individuals affected by higher energy prices?

Mr Tune—No.

Senator SHERRY—Has Treasury done any analysis of the macroeconomic implications of various responses to address climate change?

Mr Tune—No. That is the work we are starting the journey of discovery on.

Senator SHERRY—It is part of the journey of discovery?

Mr Tune—Yes.

Ms Mrakovcic—It depends on what your interpretation of the word ‘analysis’ is. We certainly did try to have a preliminary discussion around that point, for example, in the IGR, where we essentially talked about the different policy instruments and how policy instrument choice and issues such as sectoral coverage, et cetera, can impact on the physical and economic cost. That is an area that we have been trying to analyse in qualitative terms and analyse drawing on the modelling that has been done elsewhere. Again, it comes down to the fact that internally there has been no modelling or analysis of that modelling within Treasury.

Senator SHERRY—What about the macroeconomic consequences in principle of emission trading systems?

Ms Mrakovcic—I would give the same answer to that in terms of the efforts that we did in the IGR.

Senator SHERRY—So it is limited to that. Have you looked at the macroeconomic implications of specific carbon tax or emission permit prices at all?

Mr Francis—We have looked at work that is out there that has been published by other people.

Senator SHERRY—You have examined work from outside?

Mr Francis—We have examined work from outside, but we have not undertaken any specific work ourselves.

Senator SHERRY—Have you given any consideration to incorporating emissions trading or carbon pricing in forecasts for growth, inflation and employment revenue and, if you have not, when would you?

Mr Francis—We have not at this stage. We made a reference in the budget papers this year that we think any impacts on the economy are going to be a fair way out. They do not come into the budget period at this stage.

Ms Mrakovcic—Are you talking about essentially some sort of revenue or expenditure that is associated with—

Senator SHERRY—The impact on growth, inflation and employment and revenue, if any?

Ms Mrakovcic—Of an emissions training scheme, carbon tax or a climate change policy mitigation tool?

Senator SHERRY—Yes.

Mr Tune—No.

Senator SHERRY—Nothing at all?

Mr Tune—No.

Senator SHERRY—I would like to go to a couple of reports. Are you or any of your officers familiar with the ABARE report from 2006 called the *Economic impact of climate change policy: the role of technology and economic instruments*?

Ms Mrakovcic—We are aware of it.

Senator SHERRY—I want to go briefly to some of its findings. It compares a range of greenhouse gas abatement scenarios with a reference case, which includes no implementation of any significant greenhouse gas emission reduction policies, and then there are some projections on average annual growth from 2002-05. Have you had a look at those projections?

Mr Francis—Yes.

Senator SHERRY—Does Treasury agree with that analysis?

Ms Mrakovcic—That goes back to the point we were making earlier; part of what we are trying to do is essentially to take a very good look at these sorts of modelling results. We have not had the opportunity to delve into those results or any of those models as deeply as we would have liked to at this stage.

Mr Francis—To add to that, the model produces results subject to the assumptions, and what weight you place on the results depends on what weight you place on the assumptions. That boils down to a value judgment, which I do not think we are well placed to answer. It is something that is useful for policy analysis, but you cannot really make a definitive statement about what you believe of the various scenarios.

Senator SHERRY—At this point in time you have not included any of the scenarios or analysis for that model, for example, in any economic forecasting from a Treasury perspective?

Mr Francis—No.

Mr Tune—No.

Senator SHERRY—And you cannot comment on the veracity or otherwise of that report and its conclusions?

Mr Tune—No. The model used to derive that report is one of the models that we are looking at.

Senator SHERRY—I understood that from your earlier response.

Senator MURRAY—Your answer is that you do not discard it just because you are not involved in it?

Mr Tune—No, but we are not endorsing it, either.

Senator SHERRY—Are you familiar with the Allen Consulting report prepared for the business roundtable on climate change called *Deep cuts in greenhouse gas emissions: economic, social and environmental impacts*?

Ms Mrakovcic—We are aware of that.

Senator SHERRY—They use the MMRF-Green model from Monash. That is the one we discussed earlier.

Ms Mrakovcic—That is correct.

Senator SHERRY—Again, examining that is part of your current analysis?

Ms Mrakovcic—The MMRF-Green?

Senator SHERRY—Yes.

Ms Mrakovcic—Yes.

Senator SHERRY—Are you aware of the MMA research for the Climate Institute? Is that actually the ANU?

Mr Francis—If I am understanding you correctly, you are referring to the McLennan Magasanik analysis.

Senator SHERRY—I do not have that expression used. It is called *Making the switch: Australian clean energy policies*.

Senator MURRAY—It has the same initials on it.

Senator SHERRY—Yes.

Ms Mrakovcic—Yes.

Senator SHERRY—Is that all part of this analysis?

Ms Mrakovcic—That is correct.

Senator SHERRY—I have a couple of other areas. Agencies are appropriated on an accruals basis. Has Treasury had any involvement or discussions or done any work on the appropriations framework?

Mr Martine—Not in a lot of detail. As you would expect, we do have ongoing discussions with the Department of Finance about general budget framework issues. In that context we have had some limited discussions about those issues.

Senator SHERRY—It is the case that agencies have appropriate funds for the depreciation of assets?

Mr Martine—That is correct.

Senator SHERRY—Is Treasury aware of any instances where agencies have been using this funding and then sought additional funding for capital or asset replacement?

Mr Tune—That is probably more for the Department of Finance than for us. They are the people that monitor these things.

Senator SHERRY—As a general principle, do you have any involvement in examining a request for additional capital asset replacement beyond what has been expected to have been set aside under the depreciation regime?

Mr Tune—Only if it really came up in the context of a new policy proposal. If it was just an estimate of a variation or something like that, that would be negotiated directly between the agency and Finance. We would only see it if it was—

Senator SHERRY—But unless it is a direct Treasury request, for example?

Mr Tune—If it was us involved, yes?

Senator SHERRY—Yes, if it was you.

Mr Tune—Yes, if it was us involved.

Mr Martine—To the extent that a proposal came through the expenditure review committee process we would be involved in that sense in looking at it and advising the Treasurer in that context.

Senator SHERRY—Yes, I understand that. As to a request that comes from, say, ATO or APRA, which are Treasury agencies, have you been involved in any evaluations? There are a couple of significant capital allocations. Presumably you were involved in that directly?

Mr Tune—I was just checking with our corporate services and financial management people. If it was going to come through the Treasury and it was coming from ATO, they would be dealing with it rather than Fiscal Group per se. Mr Burton has confirmed with me that none has come through that he is aware of.

Senator SHERRY—I did ask the ATO some questions about this, but I just was not sure whether it was direct or through Treasury.

Mr Burton—Where their bids come through they are included in our PBS, but the ATO negotiates directly with Finance.

Senator SHERRY—Thank you for clarifying that. Would that be true of, say, APRA and ASIC and other like agencies?

Mr Burton—Yes. We have some involvement, but their negotiations in terms of the finances and their new policy bids are negotiated directly with Finance.

Senator SHERRY—So any work done on the overall or whole-of-government funding of depreciation is a matter for Finance?

Mr Tune—That is correct.

Senator SHERRY—Is there any working group that Treasury is involved with in examining the existing appropriations framework around depreciation?

Mr Martine—I am not aware of any specific working group that Finance may have set up. As I said earlier, we are continually talking about a whole range of budget and framework issues and we do have established working groups and committees on general sorts of issues. I suspect this issue will come up in those sorts of fora.

Senator SHERRY—To date this issue of depreciation has not come up?

Mr Martine—We have had discussions with Finance about the issue of appropriating for depreciation.

Senator SHERRY—What is the nature of the concern or issue?

Mrs McDonald—There is one particular area of concern relating to heritage and cultural assets. In the accounting standards overall there is some concern about whether depreciation is being applied properly in that area. That is possibly one area we have been looking at.

Mr Martine—The assets held by the National Gallery are a good example. Take the depreciation on *Blue Poles*, for example. The accounting standards do not necessarily account too well for that. Those are the sorts of issues where Finance, as I understand it, is talking to agencies at the moment to try to nut through.

Senator SHERRY—In some areas at least there is an appreciation of assets?

Mr Martine—That is right, particularly in the cultural and heritage-type agencies. The National Gallery is a good example, as is the War Memorial.

Senator SHERRY—Land appreciates even with a building on it. There are some cases where that would appreciate, are there not?

Mrs McDonald—The issue is particular to heritage and cultural assets and it is actually not just Australia, it is an international problem. International accounting standards are still grappling with the idea of how to provide depreciation for, say, the crown jewels.

Senator MURRAY—I am not sure you should.

Mrs McDonald—Yes, that is one view.

Senator SHERRY—I am not sure what you could do with them. The paintings appreciate or depreciate. In one sense, what can you do with that value? I suppose that, if you wanted to swap one painting for two others, you would need to know the value or something like that.

Mrs McDonald—The higher the value presumably the more costly the maintenance as well. But the question is: should that be picked up through your maintenance costs or through your depreciation provisions.

Senator SHERRY—I did have a fair exploration of that National Gallery project. The entire gallery was shifted. It is interesting reading and slightly amusing I have to say. The power of High Court judges extends to shifting buildings. But to go back to the matters at hand, it is the cultural heritage area. You are not aware of any other areas of concern around depreciation of assets?

Mr Martine—Not from memory. That is probably the main area that I understand Finance is looking at, at the moment.

Mrs McDonald—There are some particular issues. For example, agencies have only been appropriating that money since 1999-2000. If it is a pre-1999-2000 asset, they have never actually had resources appropriated. So there are issues around the changeover to accrual budgeting, which are minor relative to the heritage and cultural asset issue.

Senator SHERRY—Are they relevant to any other depreciation issues outside cultural heritage? If we go back to 1999-2000, there would not be too much depreciated prior to that, would there?

Mrs McDonald—This is an area of detail; Finance has much more information than we do.

Mr Tune—It is a generic issue, though, and it occurs because that was the point at which we moved to accrual accounting and that was the point at which we started to make provision for depreciation. So it was what was happening in the past that was not provided for. There is a switch that has happened. It is across-the-board, but it is not a huge issue in itself.

Senator SHERRY—I want to turn to some aspects of the Future Fund.

Mr Tune—I wonder if I could seek some indulgence. I have an officer here on Commonwealth-state financial relations who has lost part of his tooth and has a dental appointment at 4 o'clock, which he would really like to achieve if he could. Otherwise, he has to wait for three weeks before he can get in. If there are any questions on that—

Senator SHERRY—I do not think there is. I have great sympathy. A friend of mine had four wisdom teeth removed and had big problems as a consequence.

CHAIR—Senator Murray, do you have any questions on a particular area?

Senator MURRAY—The question is whether we should delay him in the hope that he will influence the Commonwealth government to adopt a better policy on dental care.

CHAIR—Senator Chapman, do you have anything in that particular area?

Senator CHAPMAN—No, I do not.

CHAIR—You are excused, Mr Willcock.

Senator MURRAY—I think you gather you have the committee's sympathies.

Mr Willcock—Thank you very much.

Senator SHERRY—I wanted to come to some issues relating to the Future Fund. In Budget Paper No. 1, statement 7, pages 7 to 9, it is estimated that the liability is $148 billion. Budget Paper No. 1 estimates assets as at 30 June 2007 at $52 billion. What is the default position for government surpluses at the present time? Do they go to the Future Fund, the government Education Fund or to deposits at the Reserve Bank?

Mr Tune—There is no default position per se. The government has announced that in relation to the Future Fund it will make decisions on an ex post basis once the FBO for that particular year has been finalised. It will then make a decision about what it puts into the Future Fund.

Senator SHERRY—So the surplus at the present time would literally be sitting at the Reserve Bank until otherwise determined?

Mr Tune—That is correct.

Senator SHERRY—In terms of hypothecating asset pools for particular purposes, does it of itself generate additional revenue capability?

Mr Tune—Sorry, I am not quite sure what you are getting at there.

Senator SHERRY—You set aside an asset pool, with whatever value, for a particular purpose. It might be building roads, dental treatment or whatever comes to mind. Does that generate additional revenue capability itself?

Mr Martine—It really depends on what the funds are then invested in. Surpluses, once they are realised, have traditionally been on deposit at the Reserve Bank. To the extent that those financial assets might be invested in equities—and the Future Fund is an example there—your returns are higher than they otherwise would be. In that sense a fund can generate additional revenue, but it comes down to the investment strategy of the fund.

Senator SHERRY—And the operational costs after that?

Mr Martine—That is correct. It is the net return after costs.

Senator SHERRY—If you wanted to fund a program or project ongoing, you can draw it down from current or future year surpluses, can you not? You do not have to set up a fund from surpluses and then draw the revenue from the fund that is set up for the hypothecated purpose?

Mr Martine—You can fund your current spending through the budget.

Senator SHERRY—That is what happens at the moment in the vast majority of cases, is it not?

Mr Martine—Yes, certainly for a lot of cases.

Senator SHERRY—Could you have one asset pool with various segments and fund all spending from consolidated revenue?

Mr Martine—I am trying to think of the easiest way to explain this. Given that we are in a surplus position at the moment, in a sense the majority of your spending in the current year is funded through the revenues that you are deriving in that current year. If your revenues are higher than your spending, that is why at the end of the year you end up in a surplus position.

Senator SHERRY—The diversion of the $5 billion to the higher education fund section of the Future Fund, which I understand to be in that investment pool—

Mr Tune—I am sorry, it is not necessarily within that investment pool. It is managed by the Future Fund but not necessary treated in the same way.

Senator SHERRY—There might be some common asset backing?

Mr Tune—There may be.

Senator SHERRY—I accept that.

Mr Tune—It is not a common pool. That is all I want to say.

Senator SHERRY—I accept that. Has the $5 billion for the higher education fund effectively reduced the allocation for the Future Fund for the public sector?

Mr Tune—Not really. As I said at the outset of this discussion, the government has a position that it decides ex post when it looks at the FBO how much, if any, it is going to put into the Future Fund. There is not quite a one-to-one relationship there.

Senator SHERRY—If there had not been a higher education fund, presumably it would have gone into the Future Fund, based on what was said?

Mr Tune—That is a separate decision to be made by the government, which will not be made until we know the FBO.

Senator SHERRY—We know what has happened with the higher education amount of $5 billion?

Mr Tune—Yes, that has been announced.

Senator SHERRY—Yes, that has been announced.

Mr Tune—I am saying that there is a second set of decisions to be made, which is about what to put into the Future Fund.

Senator SHERRY—As I say, we could have a dental health fund. We could have any number of different funds for different purposes.

Mr Tune—Yes, you could.

Senator SHERRY—We could have a broadband fund. Has Treasury done any work on examining where the Future Fund, without the higher education fund, is placed in terms of its ability to meet the latest actuarial calculated funding super liabilities; and if it can meet them by 2020?

Mr Martine—We have done some modelling on that.

Senator SHERRY—What is your conclusion?

Mr Martine—When I say ‘modelling’, without downplaying the expertise of my staff, it is a very simple sort of modelling in terms of taking the assets as you described earlier in the budget papers. It is the asset balance at 30 June 2007, which is expected to be $52 billion, and just simply projecting that out, taking the earnings rate, the mid-point of the investment mandate less costs, and projecting that out from now until 2020 and beyond.

Senator MURRAY—So it is an arithmetical spreadsheet rather than a modelling in the conventional sense?

Mr Martine—That is right.

Mr Tune—That is fair enough.

Mr Martine—The government’s investment mandate is for the fund to achieve a 4.5 per cent to 5.5 per cent real return. We pick the mid-point of the 5.5 per cent, so it is roughly 7.5 per cent nominal, subtract costs, apply that compounding to $52 billion.

Senator SHERRY—It is really no different than going to the ASIC website and looking at the superannuation projection model and putting in, if you could, $52 billion and then the accrued earnings rate of 5.5 per cent?

Mr Martine—It is just looking at the compounding effect of the earnings rate less costs.

Senator SHERRY—Did you say 5.5 per cent is the mid-point?

Mr Martine—The mid-point is five per cent real.

Senator SHERRY—Five per cent real after all costs?

Mr Martine—That is prior to costs?

Senator SHERRY—Prior to costs?

Mr Martine—Yes. So 7.5 per cent nominal less costs. Then we take costs off that and just compound the $52 billion.

Senator SHERRY—What did you get at 2020?

Mr Martine—Just as a purely arithmetic exercise of running a spreadsheet that anyone can do, for 2019-20, if you take the $52 billion and compound it with those factors you will get about $124 billion.

Senator SHERRY—Did you do other projections with different compounding rates of return?

Mr Martine—In a sense it has an infinite number of scenarios. As an ex post fund we are not making any assumptions about future contributions, so to the extent the government makes a determination in the context of the final budget outcome it will transfer some of this year’s surplus to the Future Fund, and obviously you plug that into the spreadsheet to get these numbers.

Senator SHERRY—Let us do this on what we know at the moment.

Mr Martine—We have pretty much taken the mid-point of the investment mandate, which is a long-term benchmark. What the government has said to the Future Fund Board of Guardians is that over the longer term we are looking for a real return of 4.5 per cent to 5.5

per cent, which helps the Future Fund Board of Guardians to get a sense of that risk-return trade-off. In some years they will obviously achieve higher than that benchmark return and in other years they will achieve less.

Senator SHERRY—For some years it might be negative?

Mr Martine—It could be if there is a downturn in the equities market, and so on. But in the long term the expectation is five per cent real.

Senator SHERRY—I understand the latest actuarial valuation for 2020 was $148 billion?

Mr Martine—Yes.

Senator SHERRY—It was revised up.

Mr Tune—Yes, it has been revised up.

Mr Martine—Yes, it is $148 billion by 2020.

Senator SHERRY—Given the $52 billion and given for 2007 you said you took the mid-point, do you know what the actual rate of return would need to be to get to $148 billion by 2020?

Mr Martine—No, I do not. We have not worked backwards that way, but it would be an easy thing for anyone to do.

Senator SHERRY—You might take that on notice. We could use a superannuation calculator to do it.

Senator MURRAY—It does not sound like a lot more to lift from $124 billion to $148 billion over 12 or 13 years.

Mr Martine—You are looking at another $20 billion to $25 billion.

Senator SHERRY—The extra real rate of earnings would be a fraction of one per cent. That would be compounded to get to $148 billion. It certainly would be less than half a per cent, I suspect.

CHAIR—I think you are probably going to ask the same question I was going to.

Senator BERNARDI—Have you done any modelling on the rate of return of $4.7 billion until 2020? What would the value of that be in 20 years if you had an amount of $4.7 billion invested at your rate of return—the five per cent or 5.5 per cent?

Mr Martine—No, we have not. That would not be difficult to do.

Senator BERNARDI—Would you be able to do that for us?

Mr Martine—We could take that on notice.

Mr Tune—Is it $4.7 billion or $2.7 billion that you want us to look at?

Senator BERNARDI—Perhaps you could look at both. That would be very valuable.

Mr Tune—At what rate?

Senator BERNARDI—At the modelling rate.

Senator SHERRY—What was the figure?

Senator BERNARDI—We have asked for two figures—$4.7 billion and $2.7 billion.

Senator SHERRY—I thought there was a bit of personal financial planning going on there.

Senator BERNARDI—There is, actually.

CHAIR—In a strange way there is some involved in that particular question.

Mr Tune—Given what the money is being used for eventually.

Senator MURRAY—I go back to the question Senator Sherry was putting to you. It is not beyond a reasonable assessment of market prospects to envisage that it is possible to reach the $148 billion with slightly better rates of return. It is not such a high increase in the rate of return that would make it unrealistic. Is that true on existing market parameters?

Mr Martine—I am not sure of the mass. By definition, if the fund was earning higher than 7.5 per cent less costs, then by definition it would get—

Senator MURRAY—My point is that, if you said to the fund that they have to earn 20 per cent, then that is ridiculous. It is a very marginal increase in return, and we will lift it; that is the point, isn't it?

Mr Tune—We think the mandate is reasonably testing. It is not a given that we can achieve that. We have put a bit of a stretch in there, so to stretch it a bit further is asking a bit more of the board of guardians to do it. You need to be realistic about what you can actually do, particularly when you think that you have got to do this year in and year out on average.

Senator MURRAY—But for a politician budgeting for the future, if the choice was to put in a lot more now because you thought you would not reach the target otherwise, you could probably afford to wait a couple of years to see how it is progressing before you made that decision.

Mr Tune—We should do the maths before we come to that conclusion.

Mr Martine—I am just thinking about this issue. There is also thinking about the other side, which is the liability number. As one has seen from one budget to the next, that is not necessarily a stable number, either. That can jump around as well. So the judgement on what is required to get to exactly $148 billion is very sensitive to a whole range of factors, both on the assets side and the liabilities side as well.

Mr Tune—That is an important point. Once you hit the $148 billion your liability is not staying steady so you have to ensure that you have sufficient there to finance the payments beyond that $148 billion, because it is going to change.

Senator MURRAY—If you are going to keep policy makers and legislators current, are you likely to include these updated calculations in your periodic reports—for instance, the budget reports, MYEFO and those sorts of reports?

Mr Martine—The liability number is normally updated at budget-time. In the current budget last year we included the liability chart that went out roughly about 40 years in statement No. 7.

Senator SHERRY—Not that each fund making up the liability is updated each year; one or more of them may be updated.

Mr Martine—That is right. Sometimes the actuaries may only be updated, say, every three years. We source this information from the departments of finance and defence and the Australian Government Actuary. We try to ensure that it is at the latest number. The information in this chart is based on the most recent long-term cost report.

Mr Tune—It is.

Mr Martine—I think it is the 2005 long-term cost report.

Senator MURRAY—Are you actively considering upgrading and making more frequent these sorts of reports or are you going to leave them in the time series that they presently are?

Mr Martine—We would certainly look to update a chart like this for each budget in statement No. 7 as best we could.

Senator MURRAY—Not half-yearly?

Mr Tune—We do not normally publish the amount of detail that we put into a budget at MYEFO, as you are aware.

Senator SHERRY—You can print the chart, but it may not be updated in the sense that it changes necessarily from one budget unless you have an accrued liability increase.

Mr Tune—You have two things happening. You have the liability, which changes in itself, as we have just been talking about, and then you have the asset position on the other side.

Senator SHERRY—Yes, that is right. Could the liability be changed significantly if the defined benefit funds that are open were closed down?

Mr Tune—Yes, very much so.

Senator SHERRY—That is not necessarily a constant.

Mr Tune—Under current policy you have the big one, being the defence scheme, still open as a defined benefit scheme. That is why the liability keeps on going up, even though you have a number of schemes that are closed. It is moving against you.

Senator SHERRY—The judges' is still open.

Mr Tune—That is a small component.

Senator SHERRY—Yes, I know that. It is a relatively generous scheme.

Mr Tune—It is the defence scheme that drives it.

Senator SHERRY—I think the Governor-General scheme as well is included in the pool.

Mr Tune—That is correct. It is.

Senator SHERRY—In terms of benefit, but that is still open.

Senator JOYCE—That is saving you a bit of money.

Senator BERNARDI—I have a question in relation to the investment in the Future Fund. You mentioned that it was going to be invested for long-term superannuation liability. Accordingly, the returns would be predisposed over that period and there is a possibility of negative returns in a long-term investment strategy. How difficult is it to plan for a long-term strategy if you cannot guarantee the funds will always be invested—that is, if someone continued to require that the fund redeem investments? Have you done any modelling about the difficulty associated with that or the expected change in returns?

Mr Tune—We have not done any modelling per se, but I think you are right in the sense that you are wanting the fund to be investing in long-term assets and hence getting good returns—as I said to Senator Murray, we are looking at a reasonable testing target for the Future Fund Board of Guardians—and the more stability you have the better off you are going to be. It is useful to try to keep the amount in there stable, if not growing; that will make your job easier.

Senator BERNARDI—And to know that there is not going to be any external requirement for the redemption of investments before that time?

Mr Tune—That is correct.

Senator BERNARDI—That is what I would have thought too.

Senator SHERRY—It makes you wonder why $5 billion was diverted to a higher education fund.

Senator BERNARDI—For the record, I do not think it was diverted for a higher education fund. It is a completely separate proposal.

CHAIR—From Mr Tune's evidence, I think that it was converted. Is that correct?

Mr Tune—Yes, that is correct.

Senator BERNARDI—It is separate to the Future Fund.

Mr Tune—That is a totally different question and a different decision.

Senator MURRAY—You should know your Latin, Senator Bernardi; 'ex post', after the fact.

Senator SHERRY—Despite the diversion of the $5 billion to the higher education fund, what we have at the moment on the figures that you have just given us is that the fund with the assumptions-calculations made, and the new actuarial valuation and the liabilities, requires additional capital contributions to reach the equilibrium point of the target, does it not?

Mr Martine—If the fund achieves the mid-point of the benchmark return less costs—as I said—running a simple spreadsheet compounding the $52 billion, it would be less than the $148 billion.

Senator SHERRY—You said $124 billion.

Mr Martine—Yes, about $124 billion.

Senator SHERRY—By my very rough calculation, if you assume another $5 billion, or a little less than the 10 per cent of what is in there at the moment, if it was in this year and had not gone to higher education, that would give you an outcome of roughly another 10 per cent at the end, so you would be looking at about $135 billion to $136 billion. I would suggest that is fairly rough. It needs a figure of about $7 billion or $8 billion at the base in the next year to get you to $148 billion approximately.

Mr Tune—Everything would have to go right.

Senator SHERRY—Yes.

CHAIR—I may be incorrect, but I think the question is premised on the inclusion of this $5 billion?

Senator SHERRY—No, it was not—based on $52 billion.

Senator MURRAY—It was premised on the good times carrying on.

CHAIR—Yes. So the $5 billion I thought was—

Senator SHERRY—No, it was not premised.

Senator BERNARDI—Going back to long-term investment returns, you have assumed a rate of return of five per cent. The bulk of the Future Fund is scheduled to be invested in equities. Notwithstanding the variability of the rate of returns over a long-term period of 20 to 30 years, do you have a figure that equities have returned, say, in this country in your returns?

Mr Tune—The information I have to hand is that the rate of return is quite significantly higher than what you based it on and the real rate of return is around eight per cent.

Mr Martine—The issue of the extent to which the fund invests in equities was one of the factors taken into account in establishing the benchmark. In a sense, what the government is saying to the Future Fund is not to go out and invest everything in equities and achieve as high a rate of return as you can. What the government is saying is that, given the government's risk-return preference, the government is seeking a return of five per cent real. It is then up to the Future Fund to look at equity returns over a period and to say to itself that to achieve five per cent real in the long term means that we need to invest in X per cent of equities. They are working backwards to that extent. Their objective is to get the five per cent real. It is not to get seven per cent real, for example. In some years they will certainly get seven per cent real and in other years they might get two per cent real, but they will pick the level of equities required in the long term to get five per cent real.

Senator BERNARDI—In essence, the government has instructed the Future Fund to pursue a very conservative mandate, given the risk-return ratio?

Mr Martine—I would not say that it is conservative.

Mr Tune—I do not think it is conservative. As I said before, it is probably a bit testing if anything. I am not being soft of them.

Mr Martine—We think we are being fair. I think the government thinks it is being fair in terms of the mandate that it has set, but it is not as if they can just put the money somewhere fairly benignly. They have got to manage it to get that, so it is a difficult task for them.

Senator BERNARDI—Which is why we have the expertise employed.

Mr Martine—Absolutely.

Senator SHERRY—What is the current Australian long-term bond rate?

Mr Tune—Are we talking real and not nominal?

Senator SHERRY—Yes.

Mr Martine—It is probably about 5.9 per cent.

Senator SHERRY—That is real?

Mr Martine—We are doing some instantaneous research for you. It is probably in that ballpark.

Senator SHERRY—I will do that after dinner tonight.

CHAIR—As long as there is no paid advertising in this.

Mr Martine—No.

Senator SHERRY—I think any journo from the *Financial Review*—and there may be one, and probably the only one—would be very impressed by your providing that information at estimates.

CHAIR—Just on that question, to get to that $124 billion spreadsheet in 2020, if you take money out of that $52 billion or whatever your accumulated capital amount is, the only way that you can get to your $124 billion spreadsheet within the 2020 time frame must be to pursue higher and riskier returns?

Mr Tune—That is one option. If you are assuming no other injections by that?

CHAIR—Yes.

Mr Tune—The other way is to put more in.

CHAIR—That is right. Or extend the date?

Mr Tune—The 2020; yes, that is correct.

CHAIR—Are they the only three options?

Mr Tune—That is basically it.

Mr Martine—With the latter the liability continues to grow after 2020.

Mr Tune—You are trying to chase your tail a bit then.

Senator BERNARDI—That goes back to the question I asked you about the modelling of $2.7 billion. Perhaps to keep it at its most simple you could provide us with the impact for every billion dollars removed from the fund in terms of what the opportunity cost is at the other end?

Mr Tune—We can do that.

Senator BERNARDI—That would be a simple way in which we could—

Mr Martine—We will confirm what we will do. We will just assume that we stick with the 2020 being the point at which we are trying to work out the gap?

Senator BERNARDI—Yes.

Senator SHERRY—Or the government, if it was re-elected, could be totally cynical and decide to shut down the military defence fund after the election to reduce the liabilities long term; they are examining the Defence Force DB fund at present.

CHAIR—That is a question of relevance.

Senator BERNARDI—Are you letting out Labor policy there?

Senator SHERRY—It could shut down the Defence Force fund after the election when it has completed the review of its liabilities.

Senator BERNARDI—There is a scoop for the *Financial Review* for that journalist listening.

Senator SHERRY—It is an interesting question.

Senator BERNARDI—They can print the Labor Party's policy.

Senator SHERRY—That is your approach and not ours.

CHAIR—I suspect the point might have been made.

Proceedings suspended from 3.43 pm to 4.17 pm

CHAIR—We will resume the hearing.

Senator SHERRY—I want to go to statement 13 of the budget which provides historical spending and taxation data. There is a change in the structure of the data associated with a shift to the new tax system. Statement 5, table C4, shows that total tax receipts in 1996-97 were $125,815 million and table C5 shows that this is equivalent to 23.1 per cent of GDP.

Mr Martine—I can see the $125,815 million.

Senator SHERRY—And table C5 shows this is equivalent to 23.1 per cent of GDP. If you look at statement 13, table 2, total tax receipts in 1996-97 were $124,559 million or 22.28 per cent of GDP. What is the reason for the difference?

Mrs McDonald—The basic difference between some of the historic series in statement 5 and the historic Australian government data in statement 13 is that statement 5 is actually published outcomes generally without back casting which, according to the government financial statistics you are supposed to do, and that is why in the historic series we actually do back cast for things like accounting changes and other things that are required. If you want to think about why we actually do it, there is some information relevant for users in terms of what has actually been published as the outcome. But then in the historic series, that data from time to time needs to be revised. For example, your tax-to-GDP ratios change as the ABS revalues historic GDP, finds new sectors of the economy or makes changes to it, or accounting classification changes which may mean that things that were considered tax revenue in the past may not be considered now.

Mr Martine—I do not have a copy of the 1996-97 FBO in front of me but I am sure it would show a figure of $125,815 million. In other words, as Mr McDonald has indicated, they are the numbers as published in the particular outcome document and any differences would largely be the result of particularly back-casting accounting type changes. If there is a change this year in terms of the treatment of a particular item to come up with a consistent historical series in statement 13, those changes are generally then back cast.

Senator SHERRY—Is that the basis for making adjustments of this type?

Mrs McDonald—That is right. Under the government financial statistics, when there is information that you did not know in the past but you do know now, you are supposed to effectively change the outcomes so that there is a consistent comparison available with the new information. That is potentially why you might get larger and larger differences with outcomes that were published further and further back, because there were more and more accounting changes going forward.

Senator SHERRY—Do you understand that a reader might look at some information five years ago as a statement of historical fact and then look at a later document that refers to the same period as a statement of historical fact, and it is a different figure?

Mrs McDonald—That is right and that is why current understanding needs to be back cast so that people can actually compare properly the data. If there were errors in the past I presume it is better to actually fix them. When I say 'errors', I mean information that you know now that you did not know in the past. Things like whether something should be included inside the general government sector or not, accounting changes on which the Australian Bureau of Statistics may rule later, you therefore have to back cast some of the data. In fact, all the time that we make a change that is material, we actually put a little footnote in the historic series to say the numbers in the past have been changed because of factor X, Y or whatever.

Senator SHERRY—Yes. I note the tables contain a footnote warning of a break in the series for the introduction of accrual accounting. How substantive is that break?

Mrs McDonald—I guess if we knew the exact quantum of the break there would be ways of actually removing it, but it is substantial enough that it gets a mention as something that the reader needs to be made aware of when they are comparing data across the time series.

Senator SHERRY—Are you able to give any consideration to the break being as significant as the structural break for the introduction of the new tax system?

Mrs McDonald—In terms of what criteria?

Senator SHERRY—Just the significance of the break: the outcome, the figure adjustment required.

Mrs McDonald—Do you mean in terms of the accuracy?

Senator SHERRY—Yes.

Mrs McDonald—Conceptually the data that is there at the moment is the best available that we have. When we come up with new information, we generally take all of our changes back to 1999-2000 because before that the data becomes a bit harder to find. The data up to 1999-2000 is very good. Before that it is a bit harder to actually adjust that data with new information that comes to hand because agencies may have lost the relevant data series that we are trying to amend.

Senator SHERRY—Loss of data could occur even as relatively recently as up to 2000?

Mrs McDonald—No, I think there might be data going back before that. If you started to make adjustments back to, say, 1972, some to 1980 and some to 1994—

Senator SHERRY—I understand that.

Mrs McDonald—then all the data becomes non-comparable.

Senator SHERRY—Yes.

Mrs McDonald—If you try and take all your data, a series of structural breaks, back to 1999-2000, that is a way of making sure that at least the data from 1999-2000 onwards and the data before 1999-2000 is relatively comparable.

Mr Tune—You do not have accruals data prior to 1999-2000, of course, so you have to be very careful. That is why you draw the line there and say, 'Look, these are two different types of data, so be careful.'

Mrs McDonald—The break with the introduction of the GST is of a slightly different nature. It is not informational data; it is a policy break.

Senator SHERRY—So where there is a break, whatever the reason, there would be a warning or a caution, if I could put it that way.

Mr Martine—We do have a bit of a health warning on, for example, table 2, page 13-6:

Due to associated methodological and data source changes, time series data that encompass measures derived under both cash and accrual accounting should be used with caution.

Mrs McDonald—This is very similar to most Australian Bureau of Statistics releases where any qualifications regarding the data are put upfront. On page 13-3 and over to page 13-4 there is a list of the different types of problems that the reader or user who is trying to use the data for comparison purposes needs to know. It runs through classification differences in the data relating to the period prior to 1976, which means that earlier data may not be entirely consistent with data for 1976-77 and onwards. There are adjustments in the coverage of agencies, including the accounts of the different sectors. Anyway, there is a long list of cautions that people may need to take when looking at the data.

Senator SHERRY—Or caution otherwise. Is data still comparable, despite the structural break from the new tax system?

Mrs McDonald—I think it is, otherwise it would not be published. This is the best available data that the community needs for public policy purposes.

Senator SHERRY—If you were to adjust the series of GST collections and payments to the states, what would that add to the tax to GDP and spending to GDP figures in tables 1 and 2 of statement 13?

Mr Tune—We do not do that because we classify the GST as a state tax.

Senator SHERRY—We are still classifying it as a state tax?

Mr Tune—We do.

Senator SHERRY—I had not read that in the budget papers.

Mr Tune—That has been the standard practice since it was introduced.

Senator SHERRY—I thought it may have been varied but it is still categorised in that way.

Mrs McDonald—On page 13-3, in one of the cautions I mentioned before, there is a little note that says that specific factors that affect the comparability are transfers of taxing powers between the Australian government and the states.

Senator SHERRY—Is Treasury aware of an article published by Mr Des Moore, who, I understand, was a former Treasury deputy secretary? It is entitled ‘When will the leviathan fade away?’ In this article Mr Moore argued that the historical data in the budget provides a seriously misleading picture of government finances. I have a number of extracts here. He says he has actually attempted to persuade Treasury to publish an appendix in Budget Paper No. 1 showing the correct figures already available on the Australian Bureau of Statistics website. Have Treasury officials met or discussed with Mr Moore these issues and has there been any progress in developing a more consistent historical series?

Mr Tune—I am not aware of any discussions.

Mrs McDonald—We are aware of the paper, but I do not see any reason why we would need to meet him to discuss those issues.

Senator SHERRY—So you are not aware of anyone meeting or discussing, because it may not be a discussion at a meeting, with Mr Moore about these issues?

Mr Tune—No, I am not aware of anything.

Mr Martine—I cannot remember the timing of that article, whether he sent something through via the Treasurer as a ministerial, I am not aware. He may have done that. I am not too sure.

Senator SHERRY—It is policy volume 22, No. 3, Spring 2006. It does not give us the exact date, of course.

Mr Martine—I certainly remember the article.

Senator SHERRY—He is quite scathing. There was an exchange of letters in the business section of the *Age*, which did publish his letter to Senator Minchin. Are you aware of that exchange?

Mrs McDonald—Yes.

Senator SHERRY—Are you aware of work done by a Macquarie Bank economist, Mr Rory Robertson, on trends in government taxation and Commonwealth-state relations?

Mr Tune—Yes, we are.

Senator SHERRY—Do you consider the methodology used by Mr Robertson as reasonable?

Mr Tune—We have some problems with it.

Senator SHERRY—Could you outline those problems?

Mr Tune—There are a few issues about classification, particularly with the issue about back casting. One issue there is about higher education payments, which at one stage were classified as a payment through the states and were included as part of SPPs but then became

Commonwealth owned purpose outlays, so you need to make corrections for that. There are a few other things along those lines as well. In broad terms, we do have some issues with it.

Senator SHERRY—The analysis showed that the government effective funding of the states is as low as it has been in three decades, at the same time as the government's tax GDP ratio stands at record highs. Has Treasury conducted any of its own analysis on these trends?

Mr Tune—Yes, we have done a bit of analysis. We think it has stayed pretty much constant over the last 30 years.

Senator SHERRY—Why do you think there is a difference between his analysis and Treasury's?

Mr Tune—I think it is the treatment that Mr Robertson applies to the state taxes that have been abolished under the IGA, the Inter-Governmental Agreement, and also the revenue replacement grants which applied as a result of the High Court decision on various state taxes in late 1999, I think, where the Commonwealth, in effect, took over some of the taxing of those by increasing excises and they were incorporated into the new tax system in 2000. So there are issues about how you apply those and how you include them in the analysis. That is probably the basic difference between us and Mr Robertson.

Senator SHERRY—So you reckon that is the basic difference. Was that not as a result of a High Court decision which removed the—

Mr Tune—It was. Yes, indeed. The High Court ruled those taxes invalid and the Commonwealth took over the raising of those taxes as excise and then passed the money over to the states. So you have a classification issue there that you need to be aware of.

Senator SHERRY—Table 1 on page 13-5 of statement 13 is a reference to growth in spending. Can I confirm how you calculate the real growth in spending.

Mr Tune—The real growth?

Senator SHERRY—Do you use the non-farm GDP deflater?

Mr Martine—Yes, that is correct.

Senator SHERRY—Is it correct that over the four-year forward estimates, spending in each year from 2007-08 is growing faster than the economy?

Mrs McDonald—If payments are growing as a proportion of GDP then they must be growing faster than the economy.

Senator SHERRY—Can you indicate the last time when we had a period where real spending was growing above three per cent for four consecutive years?

Mr Tune—We would have to take that on notice.

Senator SHERRY—You cannot recall any period when that happened?

Mr Tune—I cannot myself, but I will take it on notice and we can check that.

Senator SHERRY—Has Treasury considered the prudence of such growth, given the operating capacity of the economy is full?

Mr Tune—I will go back to the previous question. I am just looking at the table itself. You can see periods leading up to 1995-96 where, in fact, it was doing something greater than that. In 1990-91 it was 4.2 per cent; in 1991-92, it was 5.3 per cent—then 5.2 per cent, 4.3 per cent, 3.9 per cent and 4.1 per cent. So that is a period of about six years where it was growing faster.

Senator SHERRY—Has Treasury done any further analysis of recent trends in spending growth?

Mr Tune—Historical trends?

Senator SHERRY—Yes.

Mr Tune—Not really.

Senator SHERRY—Going back to that other question, does Treasury consider that such growth is prudent given that the current economy is operating at close to full capacity?

Mr Tune—I suppose the view we have taken, and it is consistent with the view we have taken in the *IGR* as well, is that it is important to try and increase the supply capacity of the economy to do things that will improve participation and productivity in particular. Quite a bit of the additional spending in this year's budget we think will actually achieve that. The education package is probably the key example of that on the spending side. The childcare changes are probably going to contribute, in particular, to improved participation for women with kids over time, so, in that sense, we see those things as helping to improve the supply potential. The tax cuts on the revenue side should also do the same in terms of improving incentives to work. There are quite a number of big things in the budget that are actually improving the supply potential of the economy.

Senator SHERRY—Table 3 in statement 13 shows net debt and net interest payments. How much of the reduction in net debt is due to asset sales?

Mr J McDonald—That is a difficult question to answer because when you sell an asset you get a lot of cash and that money then gets invested in the Future Fund or goes towards reducing net debt, so that is a different question. You do not actually generally mark an asset for sale and say, 'This cash then goes to pay off bonds,' or, 'This cash goes for a different purpose or goes to students in loans under HELP.'

Senator MURRAY—The superannuation liability was off balance sheet. It was never recorded in the debt figures, was it?

Mr J McDonald—No, it is on balance sheet but it is not included in the net debt calculation.

Mr Martine—It is not part of the definition of 'net debt'. So the unfunded super liability sits on the Australian government balance sheet and it is around $100 billion.

Senator MURRAY—Now it does. It did not used to though, did it?

Mr Martine—That has always been there. But it is not part of the definition of 'net debt'.

Senator MURRAY—And therefore surely Senator Sherry's question cannot be answered with reference to the unfunded super liability, or have I confused your answer?

Mr J McDonald—No, it is illustrative of the point that net debt can be affected by financial asset allocations. For example, if you issue lots of bonds and put it all into the Future Fund your net debt will rise. That has nothing to do with an asset sale. So it is a compositional effect which outweighs some of the sale proceeds.

Mr Martine—For example, equity is not part of net debt, so the extent to which a government sells its equity holding in an entity—if those proceeds are then invested in some other entity, you may have a situation where net debt is not affected at all. If those proceeds are put in cash deposits in the Reserve Bank, which contributes to net debt, then you may see an improvement in net debt as a result of the sale of that asset. So it really depends on what happens to the proceeds of those asset sales in terms of how it actually feeds through to net debt.

Senator BERNARDI—I suppose the question is how much of the net debt is due to the current government and how much is due to previous governments.

Mr J McDonald—The question that can be answered is, 'What are the proceeds from asset sales?' and I think that is on the department of finance website.

Mr Tune—It is fair to say that a fair proportion of the proceeds of the sale of government assets that has occurred in the last 10 years or so has been used to redeem debt.

Senator BERNARDI—To redeem debt, and the debt specifically was the $96 billion deficit.

Mr Tune—Yes.

Senator BERNARDI—It was on the record so since then—

Mr Martine—That is the net debt.

Senator BERNARDI—So any asset sales have been—

Mr Tune—I could not answer categorically and say 100 per cent, but I can say that it is a fair proposition—

Senator BERNARDI—A fair proportion.

Mr Tune—that a fair proportion of the proceeds have been used to redeem debt and reduce that net debt.

Senator BERNARDI—To reduce the $96 billion debt that was inherited by this government?

Mr Tune—Yes.

Senator SHERRY—I indicated that the sale of assets has been used to pay down net debt, and that is accepted. But is there not at the same time a loss of income from the sale of some of those assets?

Mr J McDonald—For assets that are incoming producing it would be.

Senator SHERRY—Yes.

Mr Tune—But once again it would—

Senator BERNARDI—But you need to take into account the interest payments on the debt.

Mr Tune—That is correct.

Mr Martine—Or alternatively what those proceeds might be invested in. If you do not redeem debt but you invest in other financial assets, you replace one stream of income with another stream of income.

Mr Tune—You are quite right; you have to look at both sides of the equation.

Senator BERNARDI—You cannot look at it in isolation.

Senator SHERRY—When we talk about interest payments of $9 billion saved from payment of $96 billion debt, the equation should also include the loss of revenue that occurs from some of those assets. There is a loss to budget of the revenue as well as a gain in terms of lesser interest payments.

Mr J McDonald—I think it is reasonable to link net debt with net interest payments. You can see that is why in this table they are actually presented side by side, so you have a reduction in net debt, and you have a reduction of net interest because the net interest flows from the net debt. It is a bit harder to link particular asset sales and their flows to the reduction.

Senator SHERRY—It might be a bit harder but the fact is that, when you sell the asset, you do lose, in many cases, an income, do you not? Telstra is the obvious one.

Mr J McDonald—Another way of thinking about it is that you bring forward all the future streams of incomes. So, when you sell the asset, you get a stock of money which is just the present value of all the interest forgone.

Senator SHERRY—Does Treasury know how much in revenue in dividends and the like has been forgone as a result of asset sales?

Mr Martine—I think we would need to take that on notice. I think Mr McDonald mentioned a little while ago that on the department of finance website they list the proceeds from assets sales. I am not too sure whether as part of that information they also include the dividends.

Mr Tune—It is a bit hard to tell also as we do not know what the dividend policy would have been if we had retained the asset.

Senator SHERRY—We can only go on the information that is available.

Mr Tune—The only way you could do it would be, hypothetically, by saying that, if the asset continued to provide the dividend at the last dividend distribution point before the sale, you could incorporate that sort of assumption. It may or may not be true.

CHAIR—I think it is a very important point.

Senator SHERRY—Has Treasury done any calculation of the net saving to budget after taking into account the saved interest payments and the forgone dividends of asset sales?

Mr Tune—No, we have not. It follows on from the answer to the previous question.

Senator BERNARDI—Would it be fair to say, Mr Tune, that the balance of probabilities would be that significantly more money has been saved than has been forgone?

Senator Colbeck—It is a bit hypothetical, I think, and I do not think the officers really want to get into hypotheticals.

Senator MURRAY—If I can add to that question, I would assume it is a very difficult one to answer because if you go away from, for instance, the highly charged issue of the sale of Telstra to the less high visibility sale of an office building, at the time you sold the office building you thought you were getting market value and the cash realisation was laid off against a future lease and therefore you have a higher standing cost, but of course you have the cash realisation to lay that off against. Suddenly the market takes off and in fact you discover you sold the property too cheaply. But there was no way you could have forecast that, absolutely no way. So the problem with your question is that as the market moves, if you look back in hindsight, you may or may not have made a good decision. That is correct, is it not?

Mr Tune—Absolutely.

Senator Colbeck—There can be a market crash or rise.

Senator BERNARDI—My point was about really the income stream versus the expenditure on debt, rather than the increase or otherwise in the asset value. But I understand the minister has said it is a hypothetical and I accept that.

Senator MURRAY—Yes, but the point I am making on income streams is you take asset sales may be no income stream because you are just occupying it but the opportunity benefit is that you forego a lease payment and if you reverse that you sell the building and the opportunity has as a totality of below the line as well as above the line. For instance if you own a building there passed. You have now got a lease payment but you have made the cash. The problem is that you are thinking asset sales in terms of the most highly visible ones, but we have sold massive numbers of buildings, a huge value of buildings, and that is a market shift.

Senator BERNARDI—We did not sell Centenary House.

CHAIR—The effective proceeds of that abolition of interest rate payments which is then invested back into the economy—whether it is invested back into the tax cuts that include disposable income, which will enable investment, or whether it is reinvested back into hospitals, roads or schools—I presume it is almost impossible to model that, but it would be acknowledged that there is a return on investment that might be a bit hard to put an actual figure on, but it is still an investment.

Mr Tune—I think that is right. It is just an extension of that point we were making before about what you do with the proceeds that you need to take account of as well. Whether you invest them for a higher rate of return as a financial investment or whether you put them into some physical asset. All of those things are going to produce some benefit. If you are doing this, and I am struggling to think how I could do this in a rigorous sort of way, you would want to take into account those sorts of factors.

[4.50 pm]

CHAIR—I thank the Fiscal Group officers most sincerely for attending. We now move on to outcome 4, Well functioning markets. We welcome the markets division and Mr Murphy. Do you wish to make an opening statement?

Mr Murphy—No, thank you.

Senator SHERRY—I would like to go to the issue of equity buy-out. We have seen a great deal of activity in the last year or two in this area. Is there any work underway in the area to examine aspects of consequences of these equity buy-outs?

Mr Murphy—Worldwide various financial regulators and forums of financial regulators are looking at equity buy-outs. It is largely not a new phenomenon but it has gained some notoriety or publicity in recent times. We can go into more detail but what you would say is that regulators, in particular, are keeping a weather eye on the developments in equity buy-outs. There have been various issues about whether there are appropriate disclosures, whether it introduces more risks into various corporations, whether there have been issues about conflicts of interest and whether there have been issues of various entities joining together to limit the amount of information that is going to the marketplace.

There is a range of issues. Worldwide, people are looking at it but also in the context of Australia you have seen comment by the Reserve Bank, the Council of Financial Regulators—which Treasury is a part of, with the Reserve Bank—APRA and ASIC. We have all been looking at it. At this point in time there has not been any concrete action other than regulators being aware of what is happening and keeping a close watch on it.

Senator SHERRY—In your area there has been nothing new initiated with respect to research and examination?

Mr Murphy—We would not initiate things. What we would be doing is ensuring, through the various forums, that we are fully apprised of what people think—in particular what regulators think—about these developments. We see it as the role of a policy department to be apprised of what is going on and then be able to look at the regulatory framework we have in place at the present time. When you see what the developments are, you look at your regulatory framework and ask whether there is a need for any action. The view at the moment worldwide is that people see this development, and there could be tensions on each of the regulatory frameworks, but do we have in place the principles or the regulation which would meet any possible mischief or poor performance by players in this area? Most people think that the regulators have the array of tools to be able to deal with these issues. I do not want to be seen as being dismissive of it and saying it is not a recent phenomenon, but it is matter which everyone is keeping a close watch on.

Senator SHERRY—In keeping a close watch on it, one of the aspects that has drawn considerable comment and criticism is the issue of potential conflict of interest.

Mr Murphy—Yes.

Senator SHERRY—That is of board members and senior executives who may be involved in the entity being purchased, or bid for. What we have seen in a number of cases is a potential conflict of interest. Have you carried out any examination of that aspect of equity buying? It is obviously not a feature confined to equity buy-outs, but it has received considerable comment in the context of a couple of the recent cases.

Mr Murphy—Particular cases are Alinta and Qantas. We would say that possibly the response in Alinta was that the market corrected the potential conflict. With Qantas, I do not know whether you would say there was a true conflict of interest. There were allegations and people saying that there was a conflict of interest. I do not think you would classify that as a conflict of interest. Under the law, with the conflict of interest it is mainly an issue of people either excusing themselves from decision-making or disclosing their particular conflict.

As well as law, some of these things rely on corporate morality and also ethical conduct. The reason that there are corporate morality and ethical conduct is that the law may not be as crystal clear as some people would like it to be. We have looked at the conflicts of interest. We would think that at the present time the regulatory framework deals with those issues. We examine, we look and then we make that assessment. That is not to say if something else was thrown up, where people thought that the law was inadequate or people were circumventing it, we would talk to the regulators but at the same time we would also give advice to the ministers.

Senator MURRAY—I react favourably to your analysis. I thought the market reaction to Alinta did indeed fire a moral shot across the bows of those elements of corporate Australia that think that sort of behaviour is justified, and the situation did correct itself. But there is a deeper problem, which people like me who think about these issues, as one of a number of parliamentarians who specialise in this area, are grappling with and not coming to a conclusion about. I will explain briefly before I ask my question. I support the idea that directors should have a stake in the company. I do not believe they should be cut off from anything else but the salary for what they do, but if that stake and those options become great then plainly the temptation to be an active barracker for a deal is there. Nobody is a saint. I have never met a saint. We are all capable of being tempted in one way or another in those circumstances. It was not an issue of failure to disclose in the Qantas circumstance. You knew exactly what benefits the directors were to get. But the fact is that the problem remains that shareholders may be encouraged to support a deal because the temptation to support that is too great for some or all of the directors at hand. I am not making an allegation about particular directors in Qantas and I am not convinced we have the market or governance mechanisms yet worked out to deal with that. So after the long lead-up, my question is: do you have policy thinkers in your team actively worrying about that issue? It is not going to go away. It is going to come back in different forms for different companies and the market is seriously concerned about it. That is why they keep talking about Qantas and Alinta.

Mr Murphy—Yes. We see as policy advisers on corporate regulation and business regulation the responsibility to ensure that the regulatory framework is acting in the best interests of the community. That involves not only the players and the participants, but also the general community. Yes, we have thought about it and I appreciate your views. The rules are there that directors must really act in the interests of the shareholders. There is a view around saying that directors should be able to be stakeholders in the company. In some people’s view that is seen as leading to better performance from directors because they have actually got some skin in the game in terms of the company. That should be disclosed. Now when someone comes forward with an equity buy-out with a proposal to the board in these major public companies the board seeks the advice of independent people to advise on how they should act on behalf of the shareholders. To be candid, those people are paid very good money—these investment banks and the lawyers—to provide objective advice to the board. Usually public companies and boards are a group of people that again to my way of thinking flush out the self-interested person because he is only one of a group of people. The requirement usually to obtain that independent third party objective advice on what you do is another check and balance on the self-interested director. The requirement for the directors to actually disclose their holdings is again what the law does as another check and balance. So I think governance of major public companies is an ongoing issue and a very important issue. We have all seen people underestimate the importance of appropriate corporate governance, say, 10 years ago, whereas not only regulators but also the community at large now place much more onus and responsibility on directors. The other side of the coin to this is that directors feel that their duties and responsibilities are onerous and are too heavy. Largely the law has not changed; in my view, it is that the community expectation on directors is much greater.

Senator MURRAY—And rightly so, given what is at stake.

Mr Murphy—That is one view. I would say, if we had a bevy of directors here, a lot of directors in public companies in Australia would say that their duties are too onerous and too much is expected of them. On these issues of conflicts we have a regulatory framework there that does flush that out and in the major takeovers the requirement is to have an independent third party. There have always been allegations that people buy the advice they want, but that is by and by. I think there are safeguards there at the moment. As you well know, there will always in this area be some nefarious conduct which points to how people can work their way around the regulatory regime. I do not think we have seen that nefarious conduct in Australia in these issues yet; by and large I think the issues are being addressed.

CHAIR—Regulatory changes are also a flawed matter, aren’t they? They are capable of responding to those changing circumstances.

Mr Murphy—Corporate regulation is far too principles based. You have got to have something, so you have principles based and to some extent it does reflect that community standards change. It does weave its way into what those principles mean and it can also come through where the regulator starts to interpret the law in a fashion—and there are dangers in this—which may be a bit more expansive than what it was originally thought it was portrayed as.

CHAIR—If you look at the Qantas situation—I do not know what the share price is doing today—there is some irony in the allegations of conflict of interest when the share prices actually went up, but putting that to one side you are satisfied that the principles of corporate governance are able to satisfy the requirements of shareholders, government and the wider community in relation to this escalating private equity dynamic?

Mr Murphy—At this point in time in Australia we have virtually covered the field on what we think should be the particular principles or prescriptions as to covering equity buy-outs.

CHAIR—We do have the sons and daughters of Uhrig which are still being implemented. There is another piece of legislation in relation to the Public Service, which we were talking about that during the week. So I presume the sons and daughters of Uhrig are still flowing through the system.

Mr Murphy—We have to make sure that we get a balanced view on this. Equity buyers are not bad per se. They will lead to efficiency. They will lead to a better market. They will lead to improvements in corporate performance. Yes, they have some notoriety, but that does not mean that in terms of economic performance for shareholders and for the economy at large they are a bad thing. In my view it is a more recent phenomenon because of the amount of capital that is actually circulating in the world looking for a home.

Senator MURRAY—It is a question of scale and impact. I am actively engaged and interested in the private equity phenomenon but the last thing that I would do is condemn it as bad. It is a very legitimate part of market capital raising and dynamic mergers and acquisitions. I regard it as a good thing but I am wary of scale and impact. That is where I want to see what the ups and downs are. To come back to the conflict of interest question, these two instances are good instances to examine. The difficulty of Qantas and Alinta is that it still leaves the market without certainty that in certain instances people with a conflict of interest will be ruled out. In the case of Alinta, in my view, the board failed in its responsibility and was forced to a conclusion by the market, and that is a problem for me. Why did the board fail? What were the processes which allowed people to be on that board—we would expect people singly to have a problem—who in the majority failed to exercise proper judgement?

In the Qantas case the view is that the attraction of the deal was so great for some directors that they failed to realise that the advantages that the private equity people saw in the company could in fact be realised by the company staying as it was and growing in that direction anyway, which is why the shares have gone up. So there is still concern that the deal was tainted. As I say to you, I have not got a set mind on this but I think this problem is going to get worse. So if we go back to my question, do you have a formal appraisal of this conflict of interest issue continuing within your group or are you merely watching the market and appraising as it goes on?

Mr Murphy—I would say both. We watch the market. As I have said, the regulatory regime that we have is on the money and up to date. It cannot be circumvented. At the same time we look at these major transactions. In this instance, we talk to ASIC about how they view the world and how they view the circumstances of Alinta and the circumstances of Qantas and we look worldwide as to these other developments. I would say that it is our responsibility to ensure that we are apprised of these developments.

With that said, we have got to go back and look at what the current regulation is, and if we think that meets the circumstances then there is not a case for change. In both those instances, the law clearly states that, as well as being independent, directors have to act in the interests of the shareholders. People cannot avoid that. I personally thought in the Alinta case that if the company had not acted to redress the matter there could have been some legal action about that. I take people on face value. In the Qantas circumstances I really feel that the directors felt at that point in time that they were acting in the best interests of the shareholders. These are judgements and people are appointed to boards to make judgements on the best information they have. People can make the wrong judgement but you can only provide professional people with the best information available and they then exercise their judgement.

Senator MURRAY—I have stressed that I have agreed with your analysis and I have stressed that I have not got a set mind to it. But where I am going to with all of this is: is there an authoritative body that is ready, able and equipped to fire a warning shot if they see that there is a potential problem? I will give you an example. The Treasurer sees particular remuneration going on in particular companies and he comments. He says that this is beyond what is acceptable. He is firing a shot in a policy sense across the bows of corporate Australia, telling them to restrain themselves, and the hidden threat behind that is ‘or else I will restrain you’. I do not mean that in the ugly sense; I mean that in the policy sense. I do not recall ASIC, for instance, doing that in the Alinta case, which was far more clear-cut. You do not need to change law to do that. You need to get the regulator to think in that way and to act in that way. Do you follow what I am saying to you?

Mr Murphy—Yes.

Senator MURRAY—What I am asking you is whether you think the regulatory and legal devices that we have are being used effectively to their fullest extent by those with the authority to act and remark on these matters.

Mr Murphy—Some of this information that comes into government is on websites. For instance, the Financial Stability Forum, which is a collection of central bankers and securities regulators, meets a couple of times a year to discuss pertinent issues. Leverage buyouts and equity are on that agenda. They note, they comment and that feeds down to us. In Australia the Council of Financial Regulators, on a couple of occasions, has discussed the implications of the leveraged buyout price and equity buyouts to assess where they are going, what is the impact on the economy and what is the impact on regulation. It is very difficult for me to comment.

I am not sure whether the chairman of ASIC or ASIC themselves made any comments publicly about Alinta in that instance. They may well have raised issues with the board. They may well have discussed issues with the principals involved in that. I know APRA goes in a quiet fashion directly to boards and speaks to CEOs and chairmen of boards about matters. So I am not sure if ASIC has made public comments. They may have made private comments to directors. ASIC can talk in general terms in speeches and so forth, but before they can make really particular comments in relation to a company they need to have a reasonable suspicion that there is some misconduct there. That is in their legislation, so that to some extent may—

Senator MURRAY—In the Alinta case I contend there was.

Mr Murphy—One has to be cautious before saying that.

Senator MURRAY—I contend not that illegal activity was underway but improper activity.

Mr Murphy—Improper, yes.

Senator MURRAY—That is a different matter.

Mr Murphy—That is why I go back to what community expectations are in corporate governance. In some of these corporate governance issues now the action may not be illegal but it is not what people consider appropriate conduct. It is an ethical community expectations overlay.

Senator SHERRY—I wanted to move to a new area. You have obviously heard of the Westpoint case.

Mr Murphy—Yes.

Senator SHERRY—And then the Fincorp case?

Mr Murphy—Yes.

Senator SHERRY—And then the ACR case?

Mr Murphy—Yes.

Senator SHERRY—They are all in property investment structures of the varying types. We have now had three of them in the last two years impacting on a great many people with significant asset loss. The final asset loss we do not know yet, but it is significant. Have your staff carried out any examination of any of the issues around these types of collapses and the difficulties that are now present in this sector of the property trust type market?

Mr Murphy—The three instances that you refer to with these property companies are of considerable concern to Treasury, within our responsibilities. We have worked with ASIC on various issues on these three. I will just talk in general terms before I go back to these issues. In general terms the concern is the lack of understanding within the community as to the risk return on some of these investments. I will not go over the ground which Chairman D'Aloisio spoke about, but we are concerned.

CHAIR—I will just interrupt. You were aware of the comments he made and the evidence he gave?

Mr Murphy—Yes. I have got his papers that he has provided. I think he is right and we have already raised with him, or with ASIC, this issue of financial literacy and understanding in the community and whether there needs to be more work done especially for people to get a better understanding of things. That is in general terms. Notwithstanding the comments by ASIC about risks in certain investments and notwithstanding the actions that you see over the last few years that ASIC has taken against these three companies on various aspects of the prospectuses and whatever, people still put money into these companies. They are regulated as a debt under debenture rules under the law.

Senator SHERRY—Promissory notes in the case of Westpoint.

Mr Murphy—Yes. We have been looking at that as to whether there are any fundamental flaws in the law. We have reached a tentative conclusion that there are not. We have had further advice from ASIC and they have raised issues with us that we are looking at again.

Senator SHERRY—That is the promissory notes issue?

Mr Murphy—Yes, the promissory notes issue.

Senator SHERRY—I have raised that issue myself.

Mr Murphy—Yes. We felt that it was regulated and people could not use the promissory notes exception of $50,000 to raise money from the public to avoid proper disclosures in this area. We are looking at whether there is a flaw in the law or not in light of the more recent advice from ASIC, because we went to them with our views and told them how we see it.

Senator SHERRY—Just on this issue, and there are some other issues, I am aware and you are obviously aware the chair has put in his statement to us that a letter has gone from ASIC to Treasury, presumably to your area—

Mr Murphy—Yes.

Senator SHERRY—on the $50,000 promissory note matter. But the previous chair, Mr Lucy—I have not been able to identify the date—publicly called for this last year. As I said, I cannot recall the exact dates, but approximately six months afterwards, a further letter goes out. I am told that there were exchanges between ASIC and your area on this matter. I do not know if it was before Mr Lucy's verbal suggestions in the media, but it was certainly before the letter. But now we have a formal letter, so you are re-examining the issue.

Mr Murphy—We responded to Chairman Lucy's suggestion that you lift the limit, and we felt that was not an answer.

Senator SHERRY—I do not think that is the only answer. It may be part of the issues to be dealt with.

Mr Murphy—From our examination we felt that people providing these promissory notes to retail investors were required to make disclosures.

Senator SHERRY—There are other issues in these three that you have currently got under examination that are relevant either to the regulatory structure or the compensation arrangements.

Mr Murphy—Yes.

Senator SHERRY—Such as?

Mr Murphy—We are looking at the rules in relation to debentures. We are looking at whether there is some problem there, or uncertainty, as to who was responsible and what are the proper responsibilities of a trustee for the debenture holders.

Senator SHERRY—The trustee structures?

Mr Murphy—Yes.

Senator SHERRY—You are aware that the state attorneys-general have got some discussions underway about uniformity in the trustee regulation area?

Mr Murphy—Yes.

Senator SHERRY—Has your area been involved in that at all?

Mr Murphy—Yes, we have been involved. This has been a long-running issue that goes back a while.

Senator SHERRY—Yes, I noticed that.

Mr Murphy—It was with the state ministers and the Standing Committee of Attorneys-General. The states worked up a bill. They got cold feet about how they would regulate on that. They approached the Minster for Revenue, the Assistant Treasurer, about this issue. The Commonwealth Treasury approached the New South Wales Attorney-General's Department, who were the lead players, and the Trustee Companies Association, to talk to them about how you could have national, Commonwealth regulation. We approached APRA to talk to them about their being the regulatory body. Those discussions were going on. This is all over the last 12 months.

Senator SHERRY—I understand the discussions started back some years ago, in 2001?

Mr Murphy—There were discussions and the Commonwealth withdrew and advised the states that they should regulate trustee companies because a large part of the trustees' business is already regulated under the Financial Services Regulation, so we pick up a lot of their activities. So we said, 'It is over to you.' They have taken some time to work up a regulatory regime for the trustee companies. As I said, they are moving ahead; they have worked on this thing. We came back into it about 12 or 18 months ago when they said, 'We are unhappy with what we have worked up. We want you to reconsider whether the Commonwealth should take over regulation.' We said, 'Okay.' There was to some extent a change in policy approach by the Commonwealth. A couple of years previously we had said no and we decided to rethink the situation. We talked to them, talked to New South Wales A-G's, talked to APRA and provided a tentative proposal on how you could regulate. The upshot of that was that the trustee companies did not know whether they wanted that approach either.

Senator SHERRY—Look at what we are left with: nothing.

Mr Murphy—No, no.

Senator SHERRY—What you are describing, which you are doing very eloquently, is the greatest saga of buck-passing that I have heard in recent times.

CHAIR—We should let Mr Murphy finish his story.

Senator SHERRY—I would like him to finish.

Mr Murphy—I am still going.

Senator SHERRY—Keep going, because this is a great saga that you are outlining.

Mr Murphy—I know it is a saga. The position that we have reached is that the minister has been talking to industry players and my understanding is that we will be working with New South Wales A G and the state bodies to try to resolve a regulatory regime for the trustees.

Senator SHERRY—But the Commonwealth pulled out of those discussions some years ago.

Mr Murphy—Yes, but we came back in.

Senator SHERRY—Yes, I know. That is the point that I am trying to get to.

Mr Murphy—We are back in it.

Senator SHERRY—I do not blame you, because there are a lot of parties. I am not being critical. There are a lot of parties in this space.

Mr Murphy—Some of the activities of the trustee companies are things which normally would not be regulated on a national basis, such as wills and this type of activity.

Senator SHERRY—I accept that. I do not know whether you saw or read the transcript. I drew the analogy with solicitors' mortgage funds. We had a big scandal in Tasmania. Now obviously the Commonwealth and ASIC do not want to—and I certainly would not support it—regulate lawyers per se. It is a state responsibility, but some of them were running financial entities.

Mr Murphy—This is where you get these blurring of the distinctions.

Senator SHERRY—Ultimately the mess ended up as the responsibility of ASIC, transferred to the Commonwealth. The reason I raise that one is that it is not identical to, but it is analogous to, the issues around the trustee entities that are currently being examined.

Mr Murphy—Yes, it is. To me, some of these issues relating to trustees of debenture holders are analogous to funds management companies back about 10 years ago when we moved to a single responsible entity.

We had a big discussion with the funds management industry and with the trustee industry about that and I think we have got a better regulatory regime now. With these trustees of debenture holders, to my way of thinking that has always been a bit of a sleeper. It is only because we have got these particular property companies buying into this space that questions now are being asked on clarification of what the role is of the trustee of debenture holders. Should they be protecting the debenture holder? How far does that go? That is why I think you saw the statement by ASIC saying, 'Come on, fellas, what are you doing?', referring to the debenture holders. To be blunt, the trustees are saying, 'Well, we have called for independent audits. We have done as much as we can.' To cut it short, there is, possibly, a need to clarify the duties of the trustees in relation to debenture holders.

Senator SHERRY—ASIC could not answer this, obviously, but it does beg the question: what degree of oversight do the state treasuries or state A-Gs have of these trustee entities in the way they are operating?

Mr Murphy—Yes.

Senator SHERRY—I would be surprised, frankly, at the level to which they are suggesting these trustee entities have compliance officers going in to check the efficacy of the arrangements within these property groups we are seeing.

Mr Murphy—To be candid, what concerns us at a policy level is that where a Commonwealth has taken over in effect to run national markets and to regulate markets in a national way, it often seems to be the case that the state governments, where they have residual responsibilities, have withdrawn and so the crunch for the Commonwealth is: do you pick up these smaller areas, because you have already moved into the major space and put in national regulations, do you pick up these small fry and regulate that nationally?

Senator SHERRY—Relatively small fry—

Mr Murphy—Yes.

Senator SHERRY—as Mr D'Aloisio went through with us, but with a billion dollars and 20,000 people, from their perspective it is not small fry—

Mr Murphy—I know, yes, but they are—

CHAIR—I think that is Mr Murphy's point.

Mr Murphy—Yes, they are regulated to some extent by the Commonwealth, but do you pick up the outstanding residual matters to regulate them? Some people have argued that trustee companies should be regulated for solvency. That is not going to actually help the debenture holder people. But, my point is that to some extent in this financial markets area, or business regulation area, in these remaining areas, although there are not many, the states are not as active as possibly they could be.

CHAIR—I take it from what you have said, Mr Murphy, that there is an agreement with the Commonwealth. They agree to keep some residual matters, or they want to keep some residual matters, and then they overtly or covertly withdraw from that space? How does that work?

Mr Murphy—They are largely moved out of the area. They find it difficult to get staff with expertise to do these things. They have remained with the Office of Fair Trading. They have quite a presence in state jurisdictions but in lots of other areas—and that is what they said and that is why—

Senator SHERRY—But none of the state treasuries would have the capacity and capability of your area, would they, or ASIC, or APRA?

Mr Murphy—It is the ASIC, APRA view—

Senator SHERRY—I do not think they would have even your capabilities.

Mr Murphy—Yes. That is why, to some extent, we rethought our position. They came to us and one of the options they were talking about in regulating trustees was to get accounting firms to do it for them. They were going to hire accounting firms to, on licence, go and regulate trustees. And then they thought that was going to be too expensive for them.

Mr Legg—I think it is important to understand in this area how the regulation overlaps. Essentially the states regulate these trustee corporations as an entity, but a large amount of their activity—and some have said it is 95 per cent of their activity—is regulated by the Commonwealth. Their activity in this space as trustee of debentures is regulated by ASIC. Their activity as a funds manager for superannuation is regulated by APRA. It is within that environment that the states have not, perhaps, put as much effort into their regulation as an entity, because it is not quite clear exactly what it is they would regulate in that way. Do they regulate their solvency? That is prudential regulation of the trustees. What is the point of that? It is not quite clear what the objective of regulating them as an entity is if large amounts of their activity are being regulated through other means and at this level of government. And then the issue is, in their role as trustee for debentures, perhaps there is a need to clarify their role in that area. That really is an issue at the Commonwealth level.

Senator MURRAY—Let’s get down to the money. It seems to me that for the states to constitute an effective regulatory regime, it is highly costly relative to the amount of activity they would be regulating; whereas if the information I have just received is correct, if the Commonwealth is already regulating 95 per cent, picking up the extra 5 per cent is very low cost for the Commonwealth. Is that a reasonable view to take?

Mr Murphy—It may be, but the Commonwealth assumes responsibility for certain things. Candidly, I think, ASIC is a tough job. APRA has sort of re-established itself after HIH. ACCC is a tough job and, candidly, one of the reasons we were reluctant to take on trustees a few years back was because at the Commonwealth level, as policy adviser I felt that our regulators had enough to do.

Senator MURRAY—So it is the straw that breaks the camel’s back?

Mr Murphy—They have got big tasks. Now I would candidly say, possibly, in terms of making a judgement, it would probably be better if the Commonwealth did take over the regulation of trustee companies. There has been a change in our advice. The original advice was because we felt that everyone had enough to do.

Senator MURRAY—Speaking as a legislator interested in policy, I was never attuned to how important trustees might be in these circumstances. If you had asked me before all this happened—

Senator SHERRY—In fact, I think, to be frank, when we raised a lot of issues with ASIC about Westpoint and Fincorp, the trustees were one area that was not raised. I do not know the extent that there is some level of responsibility there yet. I suspect the courts will start determining that.

Mr Murphy—It has not been tested. There are provisions in the law saying the trustee should do certain things. It goes back to our earlier comments. They are principle based, but no-one has actually run them to ground to say, well, what does that really mean?

Senator SHERRY—We might have some better idea of that when the common-law actions have run their course.

Mr Murphy—You will find some of these liquidators will take action against the trustees.

Senator SHERRY—And there are question marks about accounting, auditing, the role of planners, et cetera. But, at the end of the day, with three serious collapses—without a property market collapse, which I find is one of the interesting areas—the market has not collapsed. It might have come off the boil and dropped in certain areas. So there has been a significant level of collapses, and ASIC has outlined its approach. In relation to Westpoint, I turn to the saga of PI insurance. I do not want to go through what we went through last time, but I understand that we are now seeing light at the end of the tunnel, 1 January?

Mr Murphy—There are a number of issues there as well.

Senator SHERRY—Yes.

Mr Murphy—We will be improving regulation there.

CHAIR—The Commonwealth is sort of between the devil and the deep blue sea. There are these regulation agreements about what responsibilities the Commonwealth will have and what the retained responsibilities will be of the states.

Mr Murphy—In general terms, yes.

CHAIR—Yes, in general terms. And part of that will be that you really have no oversight of that residual state responsibility. If at some stage something happens where that has got to be reviewed it is really very difficult for the Commonwealth to pre-empt issues in relation to matters for which the states have residual responsibilities.

Mr Murphy—In general terms, yes. In that area of the trustee companies, probably the majority of their activities actually fall within the Commonwealth regulatory framework. So you pick up some of it. It is just that the residual activities are not regulated. That has always been, not a conundrum, but an issue. I can go back to the Wallis report on the financial sector regulation 1997, I think, which said that people should look at this and decide what to do with it. And people's views on it waxed and waned and so, yes, it does become an issue. To finish there, hopefully we can resolve the matter one way or the other.

Senator SHERRY—You would appreciate the need for urgency in the current circumstances?

Mr Murphy—We have actually started looking again at trustees and the minister asked us to look again at trustees before this blow-up about debenture holders occurred.

Senator SHERRY—Before ACR?

Mr Murphy—Yes.

Senator SHERRY—Before Westpoint?

Mr Murphy—No, not before Westpoint, but it did not really come out of Westpoint. We were not reacting to the problems with these property companies; we were actually reacting to the fact that the industry came to us and said, 'Look, can you have a rethink about this?'

Senator SHERRY—Westpoint certainly motivated you on PI insurance, as I understand it.

Mr Murphy—PI insurance is a different matter.

Senator SHERRY—It is a different matter but it is related to this as part of the construct of issues around these types of collapses, because one of the burning issues around PI insurance at the present time is the Westpoint liabilities and claims.

Mr Murphy—Ms Smith might want to comment.

Ms Smith—Section 912B of the Corporations Act requires financial services licensees who provide services to retail clients to have compensation arrangements. That provision was turned off. In November last year, draft regulations which would complement that provision were released for public disclosure. We received about 32 submissions. These were assessed and the Parliamentary Secretary to the Treasurer made an announcement on the way forward on 18 May. We expect the regulations to be made during June and to commence on 1 July, but with a substantial transitional period. The outcome—

Senator SHERRY—You say 'substantial transitional period'. How long is that?

Ms Smith—It would depend on your status, whether you are becoming licensed in the next few months or if you are an existing licensee.

Senator SHERRY—Just on that matter of the substantial transition period, do you think an average consumer would know or understand the status of a person as regards to PI insurance, given the transitional period?

CHAIR—I think that is a very difficult question for this witness to answer—

Senator SHERRY—I am sure they have considered it.

CHAIR—to form an opinion in relation to what members of the community may or may not think.

Ms Smith—There will be a requirement for disclosure in the financial services guide which is handed over—

Senator SHERRY—That begs me to ask—I am sure the Chair will intervene—do you think the average consumer or member of the public actually reads and understands the current disclosure regime?

Senator BERNARDI—That is just a repeat of the first question.

Mr Murphy—This is an issue and we have discussed this in previous estimates—

Senator SHERRY—We have?

Mr Murphy—and it really is an issue for everyone. The regime seeks to get the information out there for investors and consumers. I was pleased when ASIC’s new chairman said that they were again looking at their financial literacy, or their program of informing people.

CHAIR—It was part of their six-point program, I think—

Mr Murphy—Yes, I think it is important. We have a financial literacy program and we are looking at what more can be done in terms of trying to inform consumers to just be aware of the risks they are engaging in as to risk-reward in their investments. With these financial disclosure documents we, together with ASIC, can only encourage people to, firstly, make them lucid, clear, concise and informative and, secondly, to encourage people to either read them or get some advice from a financial planner.

Senator SHERRY—I have just one point that I would be giving you. You use the word ‘encourage’. ASIC can actually set them out. It can actually determine the content if it wished to do that.

Mr Murphy—Yes, I know.

Senator SHERRY—I was not going to go into a long discussion about this tonight. There is only one other area I wanted to touch on, the FICS $100,000 limit?

Mr Murphy—Yes.

Senator SHERRY—Where are we up to? This one, again, has been going on endlessly. I think it has been $100,000 for 13 years. I do not want to be back here in 13 years still discussing the $100,000 limit. It is a matter of importance.

CHAIR—I hope you are doing well enough to be here—

Senator SHERRY—Some of the younger people—

CHAIR—You opened yourself up there.

Senator SHERRY—I do not want to be back here in 13 years, or 13 months.

Senator MURRAY—Chair—

CHAIR—I am happy to book the chair for you.

Ms Smith—The Financial Industry Complaints Service issued a consultation paper in May entitled *Review of the FICS Monetary Limits*. It is out for public consultation until 15 June and there is a series of consultation meetings.

Senator SHERRY—That is 15 June this year?

Ms Smith—That is right.

Senator SHERRY—Mr Murphy, I am expressing a view but has your area had any input into bringing this to a conclusion? Whatever the conclusion may be, there is going to be an increase of some description? Has your group been actively involved in this matter at all, in the discussions the negotiations—

Mr Murphy—Yes, we have had discussions with FICS and what we think would be appropriate compensation arrangements.

Senator SHERRY—What figure have you nominated?

Mr Murphy—I do not know if we have nominated a figure—

Senator SHERRY—You just said you did. That is why I am asking what it was.

Ms Smith—We have not nominated a figure.

Senator SHERRY—I will put it this way: do you know the figure for the other disputes resolutions? It does vary, but I think their figure—

Mr Murphy—Superannuation complaints are $250,000.

Senator SHERRY—No, the $250,000 or $280,000, I think, is the banking ombudsman, insurance. Is that the figure?

Mr Miller—However, FICS is now postulating at least an upper limit of around $250,000, so they are talking about a change from $100,000 to $250,000, and that is not a figure we would be unhappy with.

Senator SHERRY—Okay. That is a clear enough indication. Of course, this does relate to the issue of PI insurance as well. I mean there are compensatory issues that relate to both of them.

Mr Murphy—They are interconnected.

Senator SHERRY—I do not have any more questions.

Senator MURRAY—I have a question. On the same line as to matters pending, part of the area of law that needs review which affects people like those involved in the three property groups that we have been discussing is the area of insolvency law. Once things go in you want to ensure that your insolvency laws are as helpful as possible to the survivors. As you know, the Joint Committee on Corporations and Financial Services produced its report. Two years later I think it had a largely favourable response from the government, which was about a year ago, just roughly. I had hoped that we would see a draft law soon. I presume your group is involved in it?

Mr Murphy—I will get Andrew Sellars to talk on the detail but, today, we introduced a bill on insolvency—

Senator MURRAY—You have today?

Mr Murphy—Yes.

Senator MURRAY—Wonderful.

Mr Murphy—There were other issues which—

Senator SHERRY—We are stuck in here today.

Mr Murphy—It will probably come as a surprise to you but it is the first review of insolvency in 25 years. I am very proud of that. I do not know if it covers all the issues you raise.

Senator MURRAY—I do not want to go into detail; I am just excited that the law has arrived.

Mr Murphy—Yes. We are very pleased. Certain issues were not covered because of difficulties. We are talking to CAMAC to get further advice on those issues.

Mr Miller—It is very comprehensive. We have got generally very good support from the insolvency practitioners. I think the bill is some 140 pages long. It is one of the major comprehensive changes in insolvency law in many years.

Senator MURRAY—I am delighted. That is what I wanted to know. Thank you very much. I will look forward to reading it and getting to understand it more.

CHAIR—Thank you. I just have some housekeeping matters. I thank the shadow minister who has been with us for the last three days for his facilitation of these hearings. I thank Senators Murray, Bernardi, Joyce, Chapman, in particular Senator Webber, for earlier in the week, and I thank the secretary and his staff. I thank most sincerely *Hansard*. I remind everyone that the date for return of answers is 27 July. That concludes the consideration of these budget estimates.

Committee adjourned at 5.50 pm