

MEMO TO A PROGRESSIVE PRIME MINISTER

Leadership for the long-term

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MARKET DESIGN NATION BUILDING RESPONSIBLE INVESTMENT CIVIC CULTURE LONG-TERM

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About Per Capita

Per Capita is an independent progressive think tank which generates and promotes transformational ideas for Australia. Our research is rigorous, evidence-based, and long-term in its outlook, considering the national challenges of the next decade rather than the next election cycle. We seek to ask fresh questions and offer fresh answers, drawing on new thinking in science, economics and public policy. Our audience is the interested public, not just experts and practitioners.

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Section I: Introduction

Dear Prime Minister,

Congratulations. With the election now resolved, you will be forgiven for drawing breath and surveying the prospects for the upcoming Parliamentary term.

The conventional wisdom is that the Australian economy is in rude health. Unemployment and interest rates are low. There is a well-established path back to budget surplus. China continues to boom and our terms of trade remain high. Australia's performance during the global financial crisis appears to confirm that the reforms of the 1980s and 90s quarantined us from the vicissitudes of the global economy.

This interpretation is a recipe for dangerous complacency. Our recent economic resilience is a mixed blessing. Though we have not been ravaged by recession as in the North Atlantic, the challenge of structural economic reform remains. As an economy supported by Chinese growth and reliant on foreign capital inflows, we cannot take our national long-term economic prosperity for granted.

Furthermore, action on climate change has been repeatedly delayed in the face of scientific advice and community support. The flagship Garnaut Report has essentially been shelved, with key recommendations ignored. The same applies to the Henry Review of taxation.

Our complacency reflects a collective myopia: we have an almost exclusive focus on short-term interests at the expense of long-term ones

This state of affairs raises several questions. What are the forces within our public debate that feed this complacency? What are the challenges that this complacency masks? And how must these be addressed?

In the first place, our complacency reflects a collective myopia: we have an almost exclusive focus in the public debate on short-term interests at the expense of long-term ones. This is why our national savings rate is so low; why we borrow to consume rather than to invest; why we have failed to build infrastructure and to address climate change.

Part of our problem stems from language. As with other English-speaking democracies, our civic vocabulary has hollowed out. We now tend to consider questions of public concern in terms of profit and loss. This has made it harder to transcend short-term interest in the name of a long-term common good.

This constitutes the environment in which you and your government will find yourselves over the next parliamentary term. The vista is far from perfect. Our national landscape is blighted not only by strategic complacency but also by a depleted civic culture.

Three particular challenges give the lie to our present complacency: addressing our long-term economic vulnerabilities, delivering a coherent population and infrastructure policy, and fixing our broken climate change debate. Each carries serious long-term implications. But in each also lies a reform opportunity. In this memo, we explore how a progressive agenda can incorporate the building of a stronger, fairer, and more prosperous Australia.



challenges

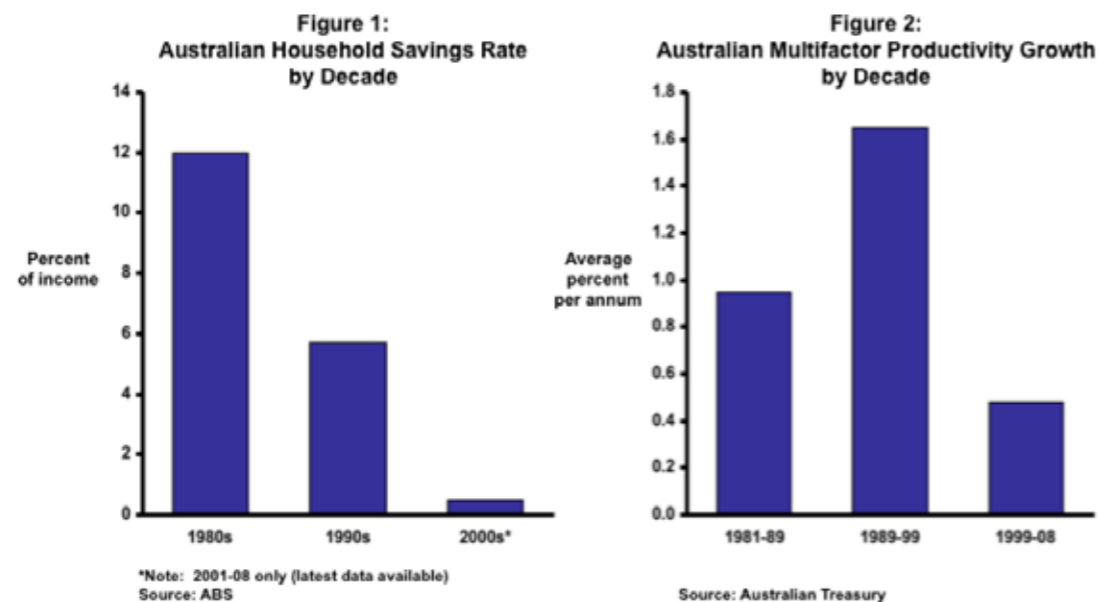
Section II: The challenges

i) The economy: Vulnerability and opportunity

Australia's economic performance remains strong, compared with expectations at the depth of the GFC and with developed economies around the world. In the paradoxical nature of economics, this is accompanied by both serious vulnerabilities and new opportunities.

Australia's strong consumption is underpinned by sustained house price rises which give consumers confidence to borrow and consume against home equity. Yet our housing prices are markedly out of alignment with historical price-to-rent ratios. The Economist's 'fair value' housing index rates Australian property as the most overvalued of any of the 20 markets it tracks (The Economist, 2010). An overvaluation of 60%, combined with worldwide housing deflation, suggests a correction in Australia is more likely than not. Any correction will put considerable pressure on heavily indebted households.

This vulnerability is compounded by a second factor, low household savings. Australia's household savings rate has dropped markedly in the past 30 years (see Figure 1, ABS, 2010a). While some of this decline is attributable to compulsory superannuation, the current savings rate of around 1% does not leave households with any buffer to deal with external shocks. The proposed increase in the superannuation contribution rate from 9% to 12% and the savings incentives in the May 2010 Budget will begin to address these problems, but considerable work remains to build the savings rate to healthy levels.



Domestic savings will prove particularly important in case of a further financial shock, our third major economic vulnerability. In recent months, capital markets have become increasingly volatile. In May this year, the Chicago VIX index of future stockmarket volatility breached 45 points, a level only ever seen during the worst months of the GFC. A second shock and a double dip recession would constrain Australia's access to foreign capital, restrict business investment, drive up interest rates and increase loan defaults.

The final major vulnerability is our exposure to Chinese resources demand. Much hyperbole surrounds this exposure, so some context is in order. It is true that the mining sector constitutes only 7% of our GDP, and employs only 1.3% of our workforce. However, mining has the highest profit margin of any sector at 37% compared with an average margin of 11% for Australia as a whole (ABS, 2010b). Mining profitability swings wildly with the global commodities cycle. From a slump in 2001-02, mining profits grew fivefold to over \$60b in 2008-09, and now constitute over half our exports. So while mining remains a mid-sized sector of the economy, its volatility can make a difference of up to \$50b to our national income.

If resources demand slumps, we will see national income contract markedly with a flow-on effect through our economy. And even if the resources boom runs its course naturally, we will face enormous restructuring challenges when it eventually ends.

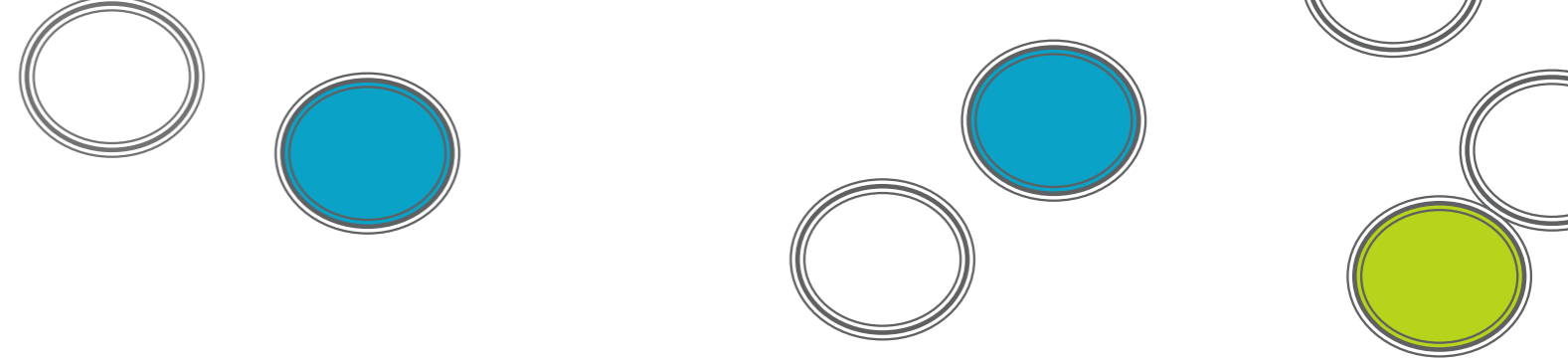
Even if the resources boom runs its course naturally, we will face enormous restructuring challenges when it eventually ends

This preparation must centre on productivity growth. Australia's productivity growth has been low over the last decade (see Figure 2). This follows a surge in the 1990s driven by trade and financial liberalization, a national competition policy and industrial relations reform. The gains of these reforms have now been banked; the lack of new major reform since 2000 explains the recent stagnation.

Given this, the task for a reformist government will be to focus on five drivers of productivity growth: infrastructure, human capital, competition policy, IT investment and innovation. Every one percent increase in our public infrastructure stock increases future national income by 0.2% p.a. (Kamps, 2006). Average weekly earnings are 10% higher for workers with a Certificate III qualification or higher than for those without one (ABS, 2005). Competition policy drove productivity increases of almost 2% p.a. in Australia in the 1990s. And the entire growth in US productivity after 1995 was attributable to IT-dependent sectors (Stiroh, 2002). Panel data from the Productivity Commission shows that rates of return on Australian R&D spending (a proxy for innovation) range from 160-180% (2009: 127).

So the challenge now is to restart the productivity reform agenda. Recent policy initiatives – from the Education Revolution to the NBN – are important first steps in restarting a productivity growth agenda. Below we describe how an emerging economic concept – market design – can add a powerful new impetus to the productivity agenda, and assist in managing some of Australia's most important vulnerabilities.

So the challenge now is to restart the productivity reform agenda



ii) Population and infrastructure

There has been much debate about Australia's population growth in light of the Intergenerational Report's projection of an Australian population of 36 million by 2050 (Commonwealth Treasury 2010). Yet this debate has unfolded in the absence of any national population strategy. It has also assumed that population growth necessarily reduces quality of life.

Any national strategy must take into account the imperatives of economic prosperity, demographic balance, environmental sustainability, urban and regional development, social cohesion and quality of life. There is no straightforward "evidence-based" approach to population policy that can be applied. Unavoidably, any decision about population policy will reflect value judgments. Policy on this matter will draw upon some philosophical conception of the good society.

All this need not involve a formal population target. For one thing, it is impossible to have full control over population movements (short of imposing controls on rates of birth and on movement in and out of the country by citizens). For another thing, as the 1994 Parliamentary Inquiry into population carrying capacity reported, "there may be a variety of optima within a broad range of population policies". The search "for a magic figure or Rubicon between safety and danger is chimerical" (Jones 1994).

Nonetheless a medium-to-long-term strategy should be guided by some alternative trajectories.

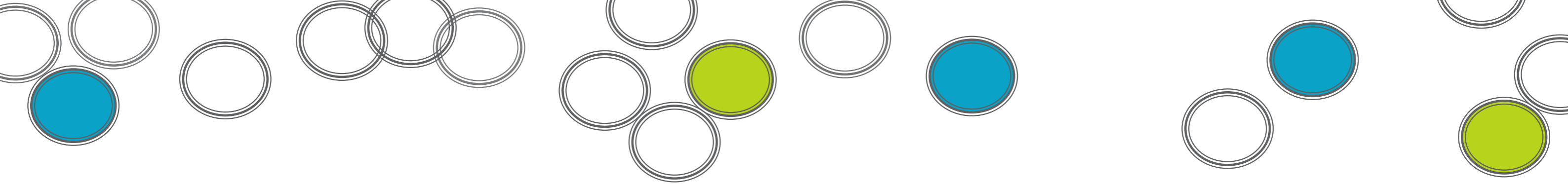
There are three realistic choices for a formal population strategy (ruling out a policy of reducing population): the "High Growth", "Moderate Growth", and "Reduced Growth" options.

1. High Growth – A population of 40 million+ by 2050. This would involve, at a minimum, a fertility rate of 2.0 babies per woman and a net overseas migration of 220 000 per year.

2. Moderate Growth – A population of 30-40 million by 2050, with lower resource consumption. This would involve a fertility rate of 1.6-2.0 babies per woman and net overseas migration of 140 000-220 000 per year.

3. Reduced Growth – A population of 20-30 million by 2050. This would involve, at a maximum, a fertility rate of 1.6 babies per woman and net overseas migration of 140 000.

Source: ABS 3222.0 - Population Projections, Australia, 2006 to 2101



The structure of our economy and society indicates that it will be difficult to maintain or raise the standard of living (measured among other things by level of income) without population growth over and above the natural rate of increase.

The Intergenerational Report 2010 has modeled future standard of living based on projected population growth of 1.2 per cent per year (based on net overseas migration of 180,000 per year and a fertility rate of 1.7 births per woman). On this basis, a lower level of population growth of 0.8 per cent annually (based on net overseas immigration of 100,000 per year and a fertility rate of 1.7 births per woman) may reduce the annual average rate of growth in real GDP: the level of real GDP per capita would be 17 per cent lower in 2049-50 (Commonwealth of Australia Treasury, 2010).

Moreover, Australia's demography suggests labour market imbalances in the future (McDonald and Temple, 2008). We will have an ageing population: today there is an estimated five people of working age for every person aged 65 and over but by 2050 the number is projected to decline to 2.7. This will generate higher demand for labour in health services and caring sectors. Two other factors will also be significant. Labour demand is likely to be strong if there is major investment in new physical infrastructure as part of a productivity push and climate change mitigation (e.g. upgrading of water supplies, transport facilities, ports, energy supply, housing, communications); and if Australia continues to enjoy a minerals export boom.

A level-headed assessment of population suggests that short of accepting a lower standard of living or achieving a viable political economic model of "prosperity without growth", moderate population growth seems appropriate. In one sense, it makes little sense to pretend we can avoid a "bigger Australia".

A level-headed assessment suggests moderate population growth seems appropriate. It makes little sense to pretend we can avoid a 'bigger Australia'

It is not realistic, of course, to expect that an increased population can be accommodated without placing extra demands on social and physical infrastructure. Growth without proper planning and coordination would be disastrous. But much of the ongoing debate has assumed that population growth and quality of life are incompatible. This is to assume that quality of life can only be secured or enhanced through maintaining existing population densities in our cities.

Among other things, a more mature debate would understand that a higher urban density can have benefits, especially in the context of an ageing population: it can enhance economic dynamism by reducing the costs of production and consumption; it can enrich cultural vibrancy by facilitating an easier spread of ideas; and it can promote more efficient public transport networks in cities.

It is worth noting that among the cities consistently rated the most livable in the world, just about all have

significantly higher population density than Australian capitals. Vienna, rated as the world's most livable city in Mercer's annual Quality of Living Survey, has a density that is double that of Sydney (4000/sq km compared to 2000/sq km) (Mercer, 2010). Vancouver, rated by the Economist Intelligence Unit as No 1, is almost three times more densely populated than Melbourne (5300/sq km compared to 1500/sq km) (EIU, 2010).

The population challenge, then, is not one about choosing between a "big" and "small" Australia. The real challenge is about managing such growth through investment in infrastructure and ensuring that growth is consistent with a sustainable and cohesive national community.

iii) A stalled debate on climate change

Anthropogenic climate change is real. On this, there is a clear scientific consensus. The necessary responses are well understood: a price on carbon, a shift to renewable sources of energy, greater efficiency in energy usage. But definitive reform remains elusive.

The lack of progress has coincided with an apparent breakdown of public consensus on the necessity of climate change action. Not all that long ago a resounding majority of Australians supported an emissions trading scheme. Today majority support for the proposition has disappeared (Hanson 2009).

Why has public support in favour of climate change action proven so fragile?

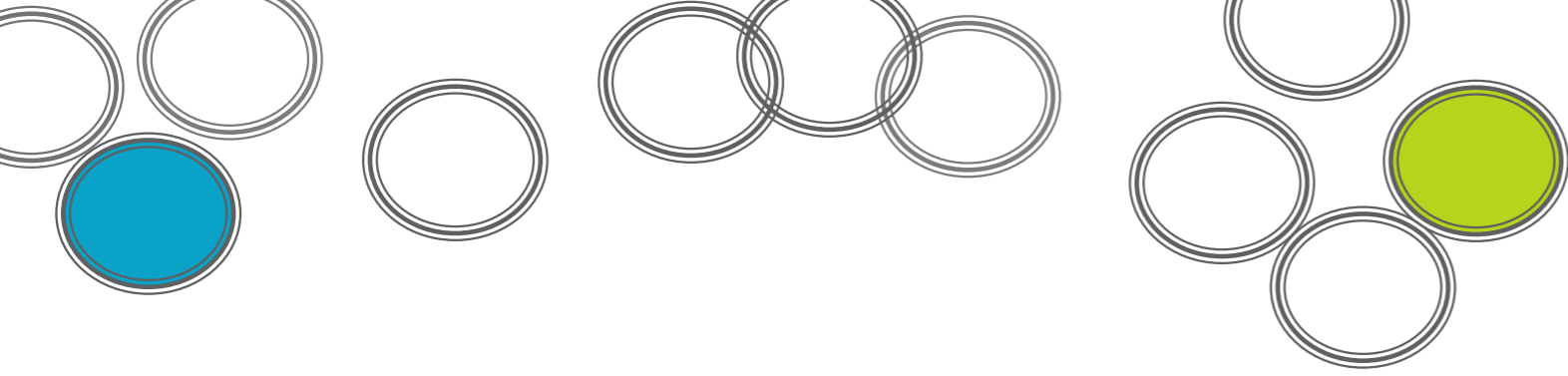
Climate change mitigation should be regarded as a long-term national project of economic, social and environmental importance

Much can be explained by the disjuncture between the political rhetoric about climate change and the strength of the proposed policy response, notably the Carbon Pollution Reduction Scheme. Though the arguments in favour of action were outlined in existential terms – climate change is a threat to the planet and we must act for the sake of future generations – the CPRS offered such generous concessions to affected parties that its core objectives became compromised. The policy response was weakened further by the delay of the scheme until 2013.

Restarting the transition to a low carbon economy requires, in the first place, public recognition of the costs of mitigation.

Genuine reform cannot be achieved without incurring significant costs. Mitigation of climate change would cost Australia \$12-13 billion per year at the outset, falling to \$1-2 billion per year until mid-century (Garnaut 2008). The costs will fall disproportionately on workers in trade-exposed, emissions-intensive industries (e.g. coal, steel and aluminium industries) and low-income households (Sullivan 2008).

However, any costs of mitigation are much lower than the best estimates of the costs of "business as usual". The Garnaut Report found that unmitigated climate change will cause domestic real wages to be 12% lower



by the end of the century than they would otherwise have been. Then there are costs such as insurance value, adverse health impacts, displacement of peoples and the destruction of biodiversity. Garnaut argues that a reasonable contribution by Australia to a global outcome of atmospheric CO₂ stabilised at 550 parts per million would involve an initial cost of 0.8% of GDP in year one, with ongoing costs of 0.1% of GDP p.a. thereafter until 2050.

As the climate change scientist Mike Hulme has argued, it is important not only to ask “What can we do for climate change?” but also “What can climate change do for us?” (Hulme 2009) Climate change mitigation should be regarded as a long-term national project of economic, social and environmental importance. Climate change policy demands an integrated agenda not only on carbon pricing, renewable development and energy efficiency, but also infrastructure, skills and training, employment generation and regional development.

It is clear that relying on the moral urgency of climate change mitigation is not enough. Progress on climate change policy demands positive, practical arguments about the benefits of reform.





Section III: The response

The response to these challenges is multi-faceted; their solutions do not lie in one area alone. However, we believe four dimensions of public policy warrant special attention: market design, nation-building, responsible public investment, civic culture.

i) Market design

Market design is the progressive response to the role of state in the modern economy. The Left has traditionally seen government as an owner of assets and direct provider of services. The Right argues that governments should leave markets alone. Both views are outdated. While markets do deliver better outcomes than state-run economies, these outcomes can usually be improved by careful market design.

This is because most markets exhibit some kind of market failure. The textbook failures include poor information, excessive market power, externalities and public goods. This list omits the most important market failure of all – that people are not the omnipotent, rational actors assumed by neoclassical economics, so even in perfect market conditions, failures will occur.

A government's design task is to set the rules of the market interaction to prevent these failures and advance specific public policy goals. Sometimes this will involve introducing market mechanisms in areas of public provision – water, electricity, health, and education. On other occasions, it will require the identification and redress of failures in existing private markets – greenhouse emissions in energy, information overload in financial services, undersupply in housing, market power in telecoms.

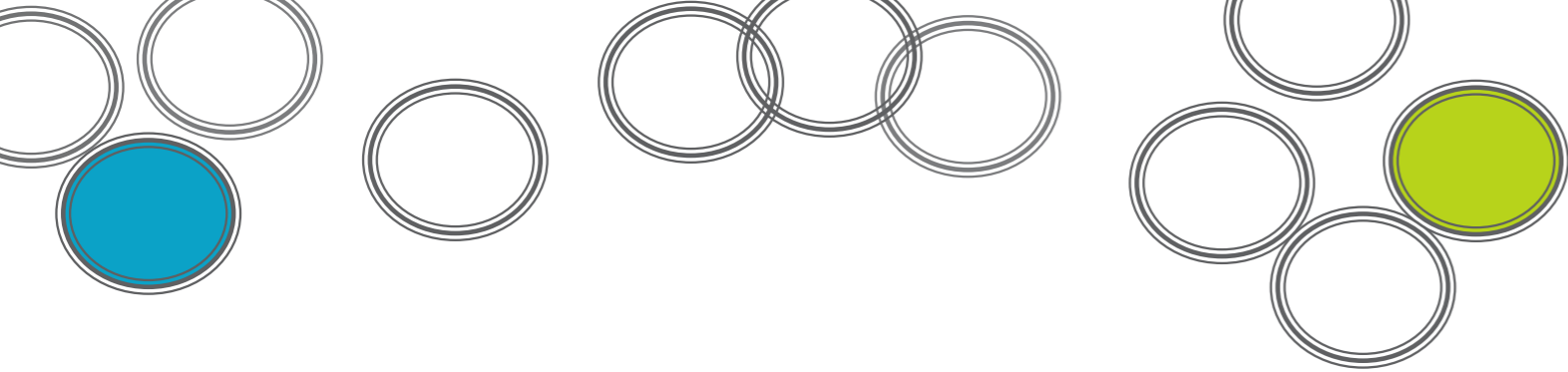
Market design is the progressive response to the role of state in the modern economy

Internationally, the market design approach is receiving increasing attention. (see Roth, 2008). Education departments have enacted school/student preference matching systems. Health networks have used market design tools for allocating newly qualified doctors across hospitals. Kidney transplant exchanges have been established to match suitable donors and recipients.

While these may seem exotic, there is no shortage of practical market design opportunities here in Australia. In fact, a number of design reforms have already been embraced. We have moved to restructure our telecommunications market, separating the monopolistic wholesale network from the competitive retail market. We have undertaken buybacks to return water to the Murray-Darling. We have introduced income-contingent loans for vocational training courses. Even inter-governmental arrangements have been subject to market design, with Commonwealth performance incentives introduced for program delivery by the states.

Further design opportunities exist. In health, the Commonwealth government could increase co-payments in line with income to allow self-insurance for health expenses. In the same way that they now manage





personal pension funds, individuals could build and manage insurance accounts exclusively dedicated to health coverage. This would raise private co-payments and improve incentives by aligning the funding and purchasing decisions.

In the preventative health area, there could be trial markets for quitting smoking or losing weight. These could be assessed through small-scale pilot schemes in communities with high smoking (or obesity) rates, where GPs monitor individual obesity and approve small, periodic cash payments for quitting smoking (or for maintaining weight loss). International evidence suggests such schemes have a positive effect on health outcomes (Volpp, 2006) and are certainly more cost-effective than treating related chronic conditions.

Market design offers an opportunity to recast the relationship between the economy and the state

In education, the Commonwealth government should rapidly expand non-teaching professionals programs for teachers and principals, building on recently announced initiatives. These programs remove barriers to entry for the many capable, experienced professionals who would make valuable contributions in the classroom in order to counter teacher loss and improve education outcomes. In addition, introducing merit pay for teachers would help retain high quality teachers within the profession. The best approach would be to trial a pilot scheme in a small number of public schools in which teachers receive bonus pay for delivering improvements in gains in students' test scores from one year to the next.

In energy, an emissions trading scheme remains the most important market design reform available to your government. However, should this not be achievable, a carbon tax is the second best option. The critical point is to put a price on carbon, so we can appropriately capture its social cost.

Equally important are measures to capture the social benefits of investment in energy efficiency. While the 'pink batts' scheme has been roundly criticized, this should not detract from the underlying value of energy efficiency measures. One initiative with potential is the establishment of an energy efficiency aggregator. This would capture the vast number of micro-savings that are too small to interest established businesses, but which together offer vast savings opportunities.

Finally, we need initiatives to encourage the spread of distributed power generation in government-owned facilities, and other medium-sized buildings like apartments, hospitals, and universities. This requires comprehensive feed-in tariffs and streamlined access to the grid. The natural fuel for this distributed generation is gas – it is abundant, already networked, and far less carbon-intensive than our existing coal-fired electricity.

In financial services, the Cooper Review of superannuation has made a sensible proposal for low-cost default accounts for all workers. These would suit those workers who do not require complex investment allocations, and are unwilling or unable to digest detailed product disclosure statements. This measure

A shortlist of market design opportunities

Health

- Increase the co-payment percentage of the Medicare safety net on a sliding scale in line with income
- Use increased co-payments to enable self-insurance for health expenses, allowing individuals to build and manage insurance accounts exclusively dedicated to health coverage
- Collate and publish data on patient surveys, clinical success rates, and number and type of treatments performed, allowing patients to better evaluate their treatment options.
- Implement small-scale pilot schemes where GPs monitor individual obesity (or smoking) rates and approve small, periodic cash payments for achieving and maintaining weight loss (or for quitting smoking)

Education

- Expand non-teaching professionals programs for teachers and principals
- Build on Victorian pilot scheme on merit pay for teachers in a small number of public schools
- Introduce a formal failure mechanism whereby schools are systematically evaluated against agreed performance benchmarks. Schools which persistently fail to meet benchmarks should be placed on probationary notice and closed if their performance does not subsequently improve. The resources freed by the school's closure could be allocated to the local community to establish a new school under any model they choose
- Introduce school/student matching using 'matching algorithms' which assign students to schools based on a combination of factors

Energy

- Introduce a carbon price
- Continue to subsidise energy efficiency measures
- Introduce spot pricing for coal and water used by generators
- Remove barriers to entry for distributed producers
- Introduce seasonal pricing variation alongside intra-day pricing variation
- Structure feed-in tariffs to be graduated to pay distributed producers higher rates at peak times

Finance

- Roll out low-cost default accounts for superannuation
- Allow the RBA to offer low-cost savings accounts
- Implement counter-cyclical capital requirement for banks
- Introduce over-the-counter transparency for derivative trading

would raise average retirement savings by around \$40,000 (Super System Review, 2010). There is no reason the Reserve Bank could not offer low-cost savings accounts on a similar basis.

In banking, Australia must follow the reform wave spreading around the world. Although we survived the recent financial crisis in good shape, this is no guarantee we will do so again. Design reforms in banking should include counter-cyclical capital requirements to ensure banks are adequately insured during the good times and can recover quickly during the bad.

Market design offers an opportunity to recast the relationship between the economy and the state. It will allow your government to address the economic vulnerabilities and productivity challenges outlined above. It enables you to advance specific public policy goals across a range of portfolios. Most importantly, it enables governments to deliver prosperity with fairness. You can grow the pie and ensure its equitable distribution.

ii) Nation-Building

The task of reform can also be understood as one of nation-building. While its meaning appears self-evident, nation-building can be a confusing phrase, given its application to contexts as wide-ranging as civil society in failed states to programs of national education.

Here, nation-building describes a capacity of the state to reshape and redesign its public institutions in the fields of the economy, society and culture. Endorsing nation-building is to adopt a particular view of the role of the state: one that assigns to government something beyond a nightwatchman role, and that takes an active stance in developing a more prosperous and secure nation. This need not stand for the proposition that governments must be more interventionist, that bigger government is better. As our section on market design highlights, what matters is how governments intervene.

Nation-building describes a capacity of the state to reshape and redesign its public institutions in the fields of economy, society and culture

Nation-building can involve both ‘soft’ and ‘hard’ elements – the soft referring to the cultural cultivation of citizenship and community, the hard to the physical building of economic and social infrastructure (Butcher, 2008). To be sure, much of our understanding of nation-building has been associated with the settling or “taming” of the vast geography of our continent. Nation-building retains a connection to iconic public works projects. Dams, bridges, roads, monuments: these remain the currency of Australian nation-building.

But we should also understand nation-building as a tradition of governance and political reform (Wanna, 2008). In our history, building the nation was never a mere exercise in physical construction, but involved the construction of an enlarged sense of self. It involved taking steps to secure the destiny of Australia as an example of civilised modernity in the family of nations (Soutphommasane, 2009). The nation-building tradition in Australian public life is indeed captured by initiatives such as the postwar program of mass immigra-

tion, the Snowy River hydro scheme, the creation of universal health care, the liberal citizenship policy of multiculturalism, the floating of the Australian dollar, the deregulation of the financial sector, the removal of tariff walls and the introduction of compulsory superannuation. These were all steps towards an enlarged Australia.

There is an opportunity for a renewed and ambitious program of nation-building as a response to our population challenge and our climate change deadlock.

iii) Population policy

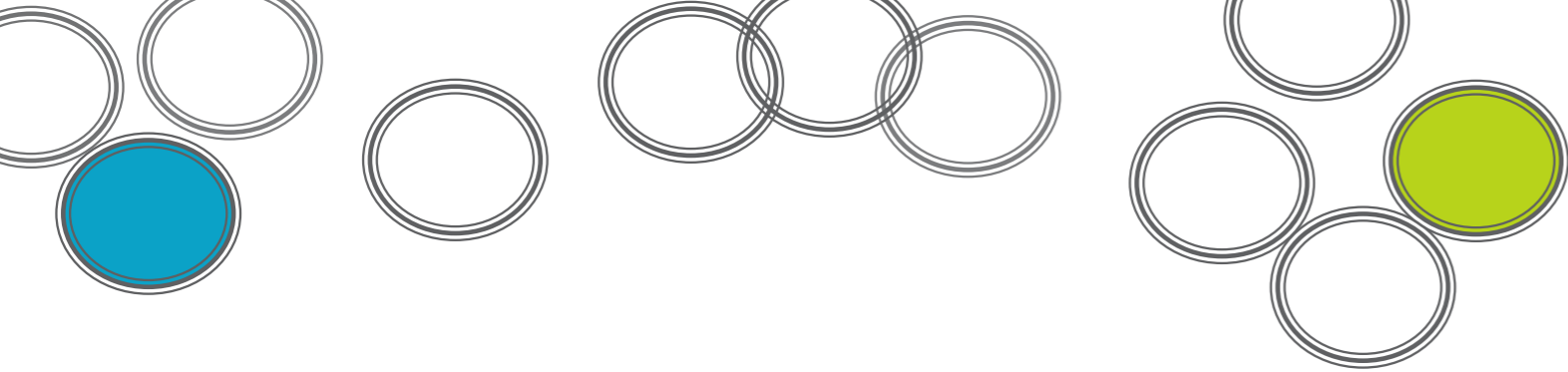
To date, much of the debate about population growth has focused on its impact on our cities. A coherent policy response must answer questions about the limits to growth in major cities such as Sydney and Melbourne. Among other things, what kind of changes to population density can we realistically entertain? Is it feasible to develop multiple business centres in our existing cities – to develop a “smart sprawl” in which economic activity is shifted from the centre of metropolitan areas to the periphery? (Page et al., 2003) How can we overcome the obstacles, political and otherwise, to better integrated public transport networks?

However, population policy is not simply about urban planning. Regional development is also important. This has been one dimension largely neglected. It would be an error to ignore the prospect of directing population movements and growth into regional centres. Such an approach could offset many of the problems associated with urban sprawl in Sydney and Melbourne.

There are good reasons to consider centres such as Coffs Harbour and Cairns as sites of planned population growth. A well-designed immigration program, perhaps involving incentives to attract people to centres outside Sydney and Melbourne, can help renew regional areas in decline, and deindustrialised cities such as Newcastle and Wollongong. Strengthened regional universities can form hubs of economic activity, as they have done, for instance, in the United Kingdom.

A renewed program of regional development would capitalise on the establishment of a national broadband network connecting rural and regional communities with the rest of Australia and the world. In the United States, improvements in communications have seen the migration of businesses from large cities to smaller cities in its so-called heartland (Kotkin 2010).

An explicit population strategy is an opportunity to articulate a nation-building agenda that aims to revitalise regional centres, consolidate urban centres and improve infrastructure capacity. Embracing moderate population growth, for example, can be understood not only as just an insurance policy against the effects of an ageing population or guarding against crippling skills shortages. At a time when governments across the world have embarked on a highly competitive quest for global talent, maintaining a relatively high immigration intake would be an important investment in economic prosperity.



Governments have a fundamental role in not only determining levels of immigration, but also putting in place the policy settings for settlement and infrastructure development. There is a nation-building imperative, too, to ensuring that a growing population, fuelled primarily by immigration, is one that is well integrated and does not undermine social cohesion.

iv) Climate change

A nation-building approach is fundamental to decisive climate change action (Hetherington and Soutphommasane, 2010). The failure of Copenhagen underlines the need for climate debates to be reframed in more nationally-focused terms. For too long, the case for an emissions trading scheme was made in moralistic terms, with an appeal to cosmopolitan ethics.

It is important that climate change action – namely, placing a price on carbon, promoting renewable energy sources and improving energy efficiency – is understood as an opportunity for structural economic reform and for building long-term economic prosperity.

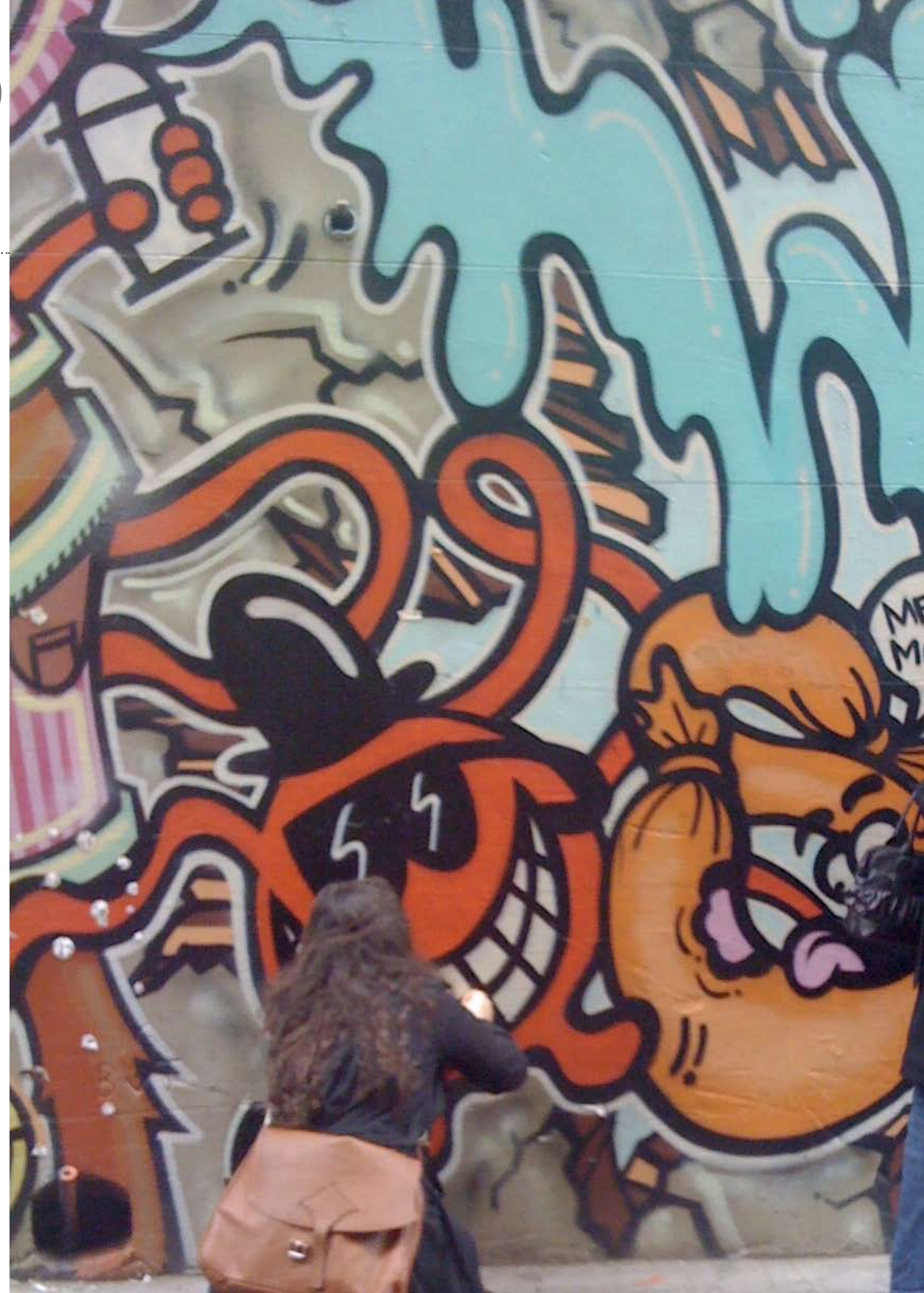
Much of the current perception of the adjustment process to global warming presumes that making the transformation to a low carbon economy will incur an unjustifiably large cost in terms of economic growth, employment and living standards. If Australia is one of the countries who move first in reducing their carbon emissions, it will, the argument goes, lose out through “carbon leakage” as investment flows to those countries unencumbered by stringent emissions targets.

Climate change action is an opportunity for structural economic reform

Yet there is an advantage in acting sooner rather than later. Early action delivers first mover advantage and reduces the risk of economic exclusion in carbon-intensive industries when the transition to a lower carbon economy eventually takes place. Either way, a nation-building approach transforms the climate change equation from one of mere threat to one of opportunity.

Restarting the climate change debate requires a new consensus – not only among the public at large but also among key sectional interests. The task is challenging. But the history of Australian public policy reveals our ability to build unorthodox coalitions as a mechanism for delivering major structural reform. For example, the economic and trade liberalisations under the Hawke and Keating governments were made possible by a series of Accords between government, unions and business which tied real wage growth to productivity improvements, breaking the back of wage-push inflation. This required both business and unions to make short-term sacrifices for the long-term economic prosperity.

In the same vein, a new coalition is required today to deliver the support of key interest groups for a universal carbon price. Brokered by government, this coalition would bring together leaders from the union, business, and community sectors including, critically, mining and agricultural interests. Such a coalition could provide the necessary institutional backing as well as the grass-roots campaigning capacity required



to cement public support. It would negotiate adjustment funds payable to displaced workers, affected companies and low-income households.

v) Funding responsible investment

Of late, too much has been said about the perils of debt and deficit, too little about the use of taxation and savings to fund responsible investment.

Over the past decade, governments of both stripes have made a near-religious observance of offering annual personal tax cuts to voters. Yet without accompanying structural reform, the logical endpoint is an erosion of the revenue base and underinvestment in services and infrastructure.

In place of a default policy of automatic tax cuts, what is required is a coherent philosophy of tax (Gregory, 2009). A philosophy of tax should be based on delivery of essential services; investment in hard and soft infrastructure; valuation of social costs and benefits; management of the macroeconomic cycle; an equitable distribution of income; and, wherever possible, simplicity.

Tax rates should be set at the minimum level necessary to sustain high quality, socially productive public goods and services, rather than the minimum necessary to convince voters to support you.

Too much has been said about the perils of debt and deficit, too little about the use of taxation and savings to fund responsible investment

The Henry Review (Henry, 2010) contains a wide range of important recommendations consistent with this philosophy of tax, and your government should commence a public debate around the gradual implementation of these ideas. The proposed tax summit in mid-2011 is a welcome start. Arguably, full implementation of the Henry Review is the single most valuable economic reform available to government: it is expected to provide of one-off lift GDP of \$24-40 billion (2-3%) by 2040 (PwC, 2010). However, an extended community debate is required to build support for taxation reform, particularly given the cognitive dissonance that exists where voters want more services while paying less tax (see Gregory & Hetherington, 2010).

Mandatory personal tax returns should be abolished. Individuals with straightforward tax arrangements could simply pay through the PAYG system with a standard deduction, while those with more complicated affairs could still choose to submit a full tax return. This builds upon the 2010 Budget measure of a standard deduction for all workers, and would save millions of hours in unpaid compliance time and millions more dollars in unnecessary accounting fees.

The proposed tax summit must address vertical fiscal imbalance, exploring legislative restructuring and constitutional reform. The so-called 'blame game' between the states and Commonwealth on health, education and infrastructure spending will not be stopped by a series of stop-gap measures. Instead, a mature democracy would rectify these issues by addressing its underlying governance arrangements.

Beyond taxation, a more mature debate on debt and deficit is equally important. There is little doubt amongst the economics profession that Australia's performance during the recent global recession was due in large part to the Federal Government's stimulus package (see Stiglitz, 2010). The use of a deficit to fund this package was perfectly legitimate, particularly since much of the package involved investment in long-term productive assets – the education sector, social housing, a national broadband network.

To keep interest rates under control, it is critical that the government seeks to move the budget back into balance, but the public must be aware that this necessarily involves a combination of tax increases and spending cuts. Public debate on these issues is especially topical, as the threat of a global double dip recession remains, and with it the potential need for future stimulus spending. Recent data shows that the Australian public understands the importance of debt-funded stimulus in a downturn, but less understood is the volatile state of the global economy and its implications for Australia.

This only underscores the importance of lifting our national savings rate. The 2010 Budget and the response to the Henry Review contained useful measures, including a lift in the superannuation contribution rate and a tax concession on interest from savings. However, we need to do more. A mineral resource rent tax is critical because it allows us to quarantine the windfall from our natural resources for investment in hard and soft national infrastructure. This would extend beyond the specific remits of the various Future Funds, and would be 'locked' to secure these savings for investment beyond the boom.

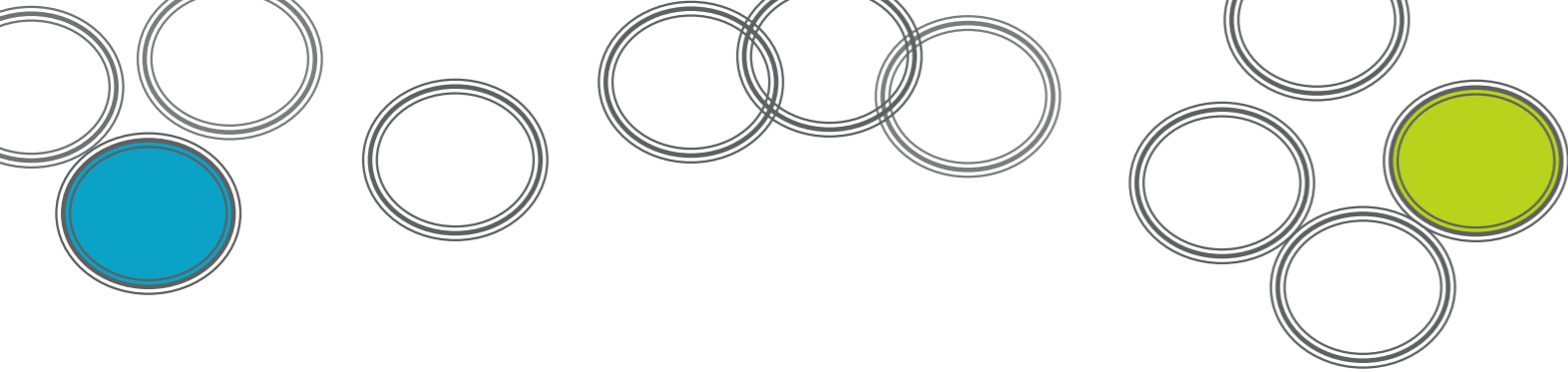
The investment vehicle might be a sovereign wealth fund, along the lines of those embraced by Norway, Singapore and the UAE – similar to the Future Funds but with a broader mandate. Alternatively, the proceeds from the tax might be paid into individual superannuation accounts. Under this arrangement, the tax could fund infrastructure investment in the medium-term and provide a long-term buffer against the costs of supporting the ageing population.

vi) Restoring our civic culture

Good government is not only about economic reform, important though long-term prosperity may be. It is not only our economy that is vulnerable. We need not be alarmist, but where we take our democracy for granted, we risk depleting our public life.

The quality of our public debate has certainly declined. Debates are less about policy, and more about personality. Where once the national interest was the currency in our marketplace of ideas, today it is self-interest. Few dispute that the citizen is little more than homo economicus – a self-aware rational individual out to maximize their material ends. Citizenship has been superseded by consumerism and profit-seeking.

Sectional interests meanwhile have strengthened their influence on public policy. Gone are the days of democratic capitalism or corporatist governance, in which big corporations made decisions in active co-operation with unionized labor and government, guided by something resembling a common good. Where once, corporate leaders believed that what was good for business was also good for the nation, this is no longer true.



There is no easy way for our society to rectify this deficit of democracy. We cannot legislate for virtue. We cannot make laws for people to be good citizens, for corporations to be motivated by social responsibility as much as by profit, and indeed for politicians to act consistently for the common good.

As Tony Judt has argued, our problem is discursive: we have ceased knowing how to speak about matters that are public (Judt, 2010). Hence taxes are regarded more and more as infringements upon individual liberty, rather than the necessary price of civilization – and investments in public goods. Equity is regarded more and more as a handbrake on efficiency, rather than a natural companion of economic dynamism.

But political leaders set the tone of our national conversation. Where our political leaders have the courage to base their political agendas around long-term aspirations of prosperity, sustainability and fairness, our public debate is enriched. At the same time, a healthy civic culture does not rest solely on leadership – it depends on good citizens.

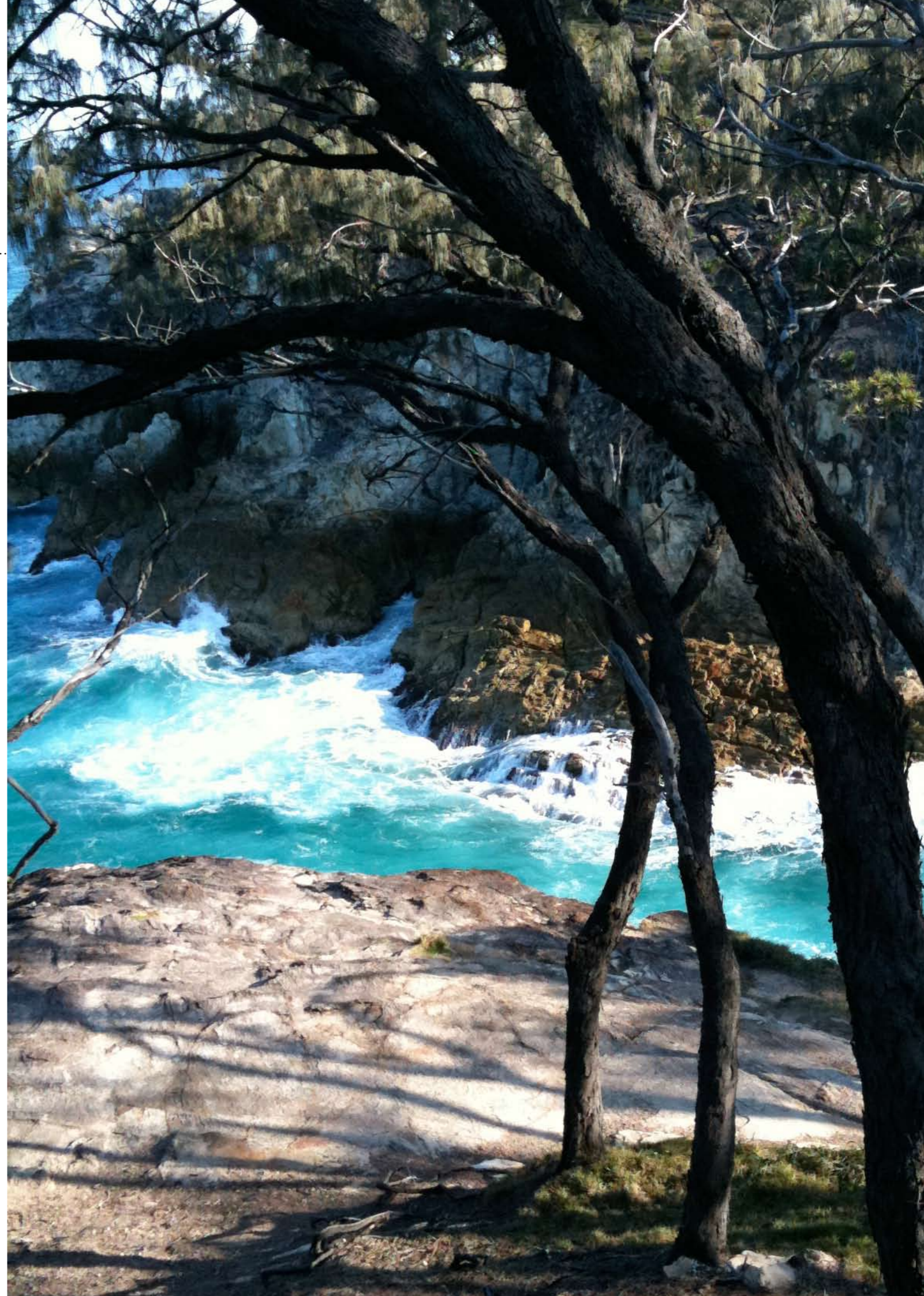
It is important to strengthen citizenship and trust in our communities – for instance, we should ensure there is robust civics education placed at the heart of the school curriculum. The first stage of a national curriculum, covering mathematics, literacy and history, is due to be introduced shortly; but it is also important that civics is made more prominent. Good citizens must be literate citizens, schooled in the habits of deliberative democracy.

Strengthening citizenship must be done at a number of levels – not only within schools but also within communities at large. Government in the 21st century must aspire to redefining the relationship between state and citizen. Where once, the delivery of public goods necessarily meant a central state administering public services, with the individual citizen at a remove, this need not be the case today.

A devolution of the state, emphasizing locally driven solutions, has its part to play. The complexity of modern society means that policy designed in and delivered from Canberra is likely to be less effective than bespoke solutions developed by local actors, including councils, small businesses, community groups, social enterprises and non-profit organizations. The Federal Government's Innovation Fund which provides seed funding for local job creation initiatives is one early example.

The devolved approach holds potential across a host of policy areas, from education and health to energy efficiency and welfare delivery. Of course, funding must remain centrally allocated and core administrative principles like impartiality and accountability observed. Yet devolving policy to the local level can empower citizens and reinvigorate the relationship between citizen and community, and between citizen and the state.

Where once, the delivery of public goods necessarily meant a central state administering public services, this need not be the case today





Kick-start reform ideas

Well-being audit

Public policy would be improved by a more holistic evaluation framework, which takes into account not only economic growth but also social wellbeing. Governments can take important steps by ensuring institutional mechanisms that review performance in measures other than GDP per capita and the usual suite of economic indicators.

The Commonwealth government currently has regular demographic reviews in the form of the Treasury's Intergenerational Reports. Long-term economic and social policy would benefit if a special unit in the Commonwealth Treasury were created to audit well-being at regular intervals, perhaps as part of the Intergenerational Report process.

A Climate Accord

Genuine reform occurs when leaders are able to build a consensus behind change. Voters and interest groups must be convinced that the long-term benefits of reform outweigh its short-term costs. The Prices and Incomes Accord struck in the 1980s exemplified one such consensus. The Hawke Government and the ACTU agreed that the short-term cost of restricting wage rises was worth the long-term benefit of controlling inflation.

The climate change problem involves similar trade-off between long-term benefits and short-term costs, suggesting a similar approach may be worth pursuing. A Climate Accord would bring together government, business, and community groups under a formal framework for emissions reductions. Government might be represented by the Climate Change Minister and Treasurer, business by the Business Council of Australia, unions by the ACTU and the community sector by ACOSS.

Each year, the Accord partners could agree a rolling three-year emissions reductions path, towards final targets for 2020 and 2050. Government would negotiate the deal. Business, unions and community groups would represent their members' interest in the negotiations. In the context of a working emissions trading scheme, the agreement of an annual CO2 emissions target is critical because it determines the supply of available carbon permits and ultimately the carbon price.

With this certainty, businesses could plan investment paths, unions could oversee workforce reskilling, and community groups could harness energy efficiency programs. As with the original Accord, each party would share a mutual interest in managing the short-term costs effectively and accepting due credit for the long-term gains.

Negative gearing restricted to new housing supply

While our exceptionally high house prices can be partially attributed to bubble effects, a supply/demand imbalance in some markets is unquestionably a contributing factor. In particular, supply has struggled to grow in line with demand.

Numerous measures taken together will be required to rectify this imbalance. However, one of the simplest is available to the Federal Government at the stroke of a pen: restrict negative gearing tax concessions to new housing supply only. Currently, taxpayers can deduct interest payments towards any property apart from their primary residence from their assessable income. This rationale for this concession is that interest is a reasonable expense of the business of investment. But most negatively geared properties are not investments in the true sense – they do not create a new productive asset. They are essentially speculation in the hope of continuing price increases.

The only exception is where a dwelling has been newly constructed or expanded. This is where negative gearing is appropriate and should be retained. This change would improve supply/demand imbalance in two ways. It would suppress speculative demand and stimulate new supply by attracting greater investment. Finally, it would have the helpful secondary effect of improving the Commonwealth's fiscal position by increasing the revenue base.

Civic service

Social fragmentation and the increasing influence of sectional interests have made it more difficult to appeal to a common good in public policy. Addressing this requires attention to promoting a better civic culture in which citizens are engaged participants in the life of their communities.

The creation of a civic service scheme, encompassing programs ranging from youth to the working-aged to older citizens, would help achieve this goal – as well as boost workforce participation.

This would go beyond some of the youth-oriented national service schemes (involving compulsory military service) that exist in countries such as South Korea, Greece and Israel. Rather it would be focused on civic non-military service, which could include work on green projects, care for the aged and teaching in disadvantaged schools.

A well-designed civic service scheme would encompass streams at the various stages of the life- and work-cycle. This may include a 10-month scheme for school-leavers and young people on gap years supported by a modest stipend. Government subsidies may also be offered to employers to allow mid-career professionals to teach in disadvantaged schools for one or two years. Older citizens aged 65 and over can be recruited to perform important mentoring roles for younger citizens.



Section IV: Conclusion

The reforms of the 1980s and 90's have worked their way through our economy and our society. We have enjoyed their benefits, but the jump in living standards they enabled has now faded from memory. This has been replaced by a dangerous complacency which holds that future reform to sustain living standards is no longer necessary.

This complacency is compounded by a political system and policy process that prioritises short-term interests over long-term ones. Each of the recommendations in this memo is intended to reposition long-term decision-making at the forefront of our national policy debate.

We conclude with an overarching theme to sharpen the focus on long-term decision making: the commencement of the third chapter of the Australian Settlement. It is not the role of a single Government to build a new settlement – that process takes decades. But a Government can nonetheless lay the foundations of a third Settlement.

Kelly (1992) identified the shift away from the original Australian Settlement undertaken in the 1980s and 1990s. Where the original Settlement was defined by industrial protection, wage arbitration and state intervention, the second Settlement of the Hawke/Keating/Howard era was based on free trade, financial liberalization and flexible labour markets. The critical point is that the benefits of this transition have now been secured and we risk drifting if a new round of reform is not embraced.

The critical task for government is not to design a Third Settlement from the top down. Instead, it is to ensure that we are addressing long-term challenges through policy innovation in a way that spurs the evolution of the Third Settlement. This memo has sought to shed light on that task.

It has outlined those challenges which demand attention if Australia is to again recast social and economic norms, as it once did with universal suffrage, the eight hour day, a living wage, Medicare, the Accord, HECs and superannuation. One of the weaknesses of the Rudd Government was its inability to prioritise two or three major reform tasks. Instead, too many problems were tackled with too little focus.

Prime Minister, we believe a successful government delivers a small number of outstanding reforms each term. If you are able to kickstart productivity, unlock 'hard' and 'soft' infrastructure investment, and put a price on carbon, you will have played your part in a proud Australian tradition of progressive reform.



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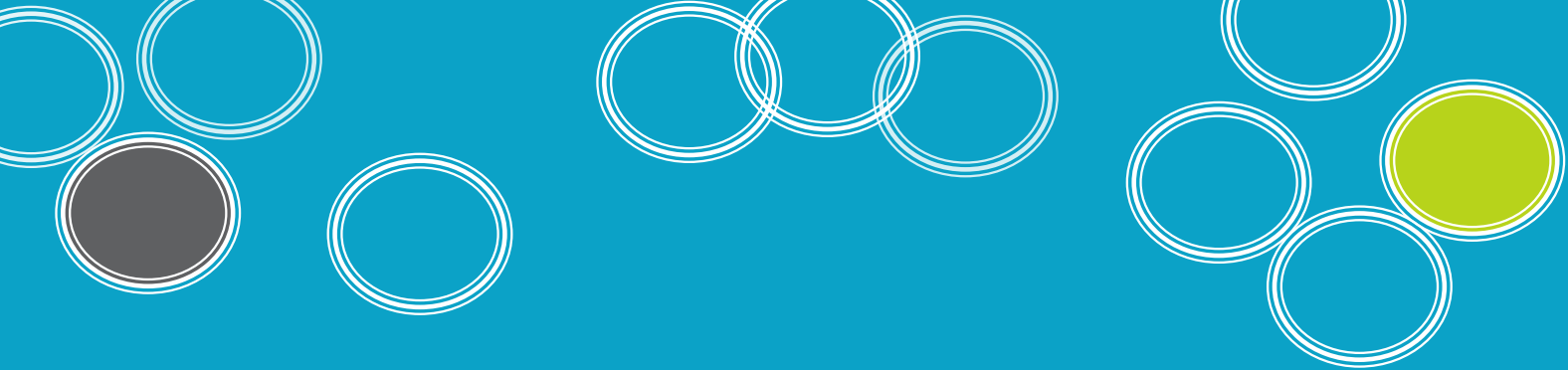
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