



Australian Government
Productivity Commission

Riding the Third Wave:
some challenges in national reform

Gary Banks

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Foreword

This is an edited version of a paper that I presented to the opening plenary session of the Melbourne Institute's Economic and Social Outlook Conference in March 2008. The theme of the Conference was 'New Agenda for Prosperity' and the paper focuses on COAG's (re-energised) National Reform Agenda, the considerable benefits on offer and some challenges in realising them.

The original version of the paper has been available on the websites of the Melbourne Institute and the Productivity Commission. This version is being published to assist its wider dissemination, given ongoing interest in the subject matter.

In preparing the paper, I was assisted by various colleagues at the Commission, to whom I am grateful. Responsibility for the views expressed nevertheless remains mine.

Gary Banks AO
Chairman
May 2008

The National Reform Agenda is aimed at further raising living standards and improving services, by lifting the nation's productivity and workforce participation over the next decade. (COAG 2006)

Introduction

Australia's economic performance over the past decade and a half is an undoubted success story, whether measured by our own past or the experiences of other countries. On the whole, Australians are materially much better off than they were, and many more are in work. And internationally, we have regained the relatively high ranking in per capita GDP that had been eroded in previous decades.

While Australia's more recent good fortune owes much to external events — notably China's economic take-off, and the (related) pick-up in our terms of trade — the reversal of our fortunes predates this. Described for rhetorical effect as an 'economic miracle' by the MIT's Paul Krugman, it is now generally recognised as the deliberate outcome of a program of economic reforms, which gathered pace from the early 1980s.

Reforms to the conduct of monetary and fiscal policy have been crucial in restoring the basis for stable progress. But the reforms that impacted more directly on the behaviour of businesses, workers and consumers were arguably most influential in the productivity-fuelled growth of the 1990s.

The microeconomic reform process essentially began with (unilateral) reductions in import protection and barriers to foreign capital. But the consequent competitive pressures on Australian firms soon shifted attention to the policy-related domestic impediments to their performance. From this, a second wave of 'behind the border' reforms began in the late 1980s, focussed on improving the efficiency of public utility services and the flexibility of labour markets. This culminated in the National Competition Policy (NCP) in the 1990s, with recognition that the imperative of forging a national market required a more coordinated approach to promoting competition across jurisdictions.

The NCP was a landmark reform initiative, involving an unprecedented degree of cooperation across our federation over a decade. It brought substantial benefits which are still being felt. But any tendency toward complacency (or reform fatigue) at the conclusion of the NCP process, has been overtaken by the realisation that Australia faces some major further challenges to its hard won prosperity in the years ahead, not least the ageing of our population. A 'third wave' of national reform has accordingly been agreed to by COAG. While partly directed at completing unfinished business from the earlier reform programs, the new National Reform

Agenda (NRA) pushes the boundaries of national reform to encompass the drivers of workforce participation and productivity. Its emphasis on human capital development is a natural and necessary extension of Australia's reform efforts, going to the heart of what is required to meet the challenges of an ageing population. But while the potential gains are great, the challenges facing policy in a number of key areas are also substantial and will require sustained effort.

Lifting productivity and participation

At an earlier conference in this series, Treasury Secretary Ken Henry provided an elegant exposition of how GDP and its growth are fundamentally determined by the '3Ps': population, participation and productivity. The 3Ps have since become part of the lexicon of economic discourse in Australia.

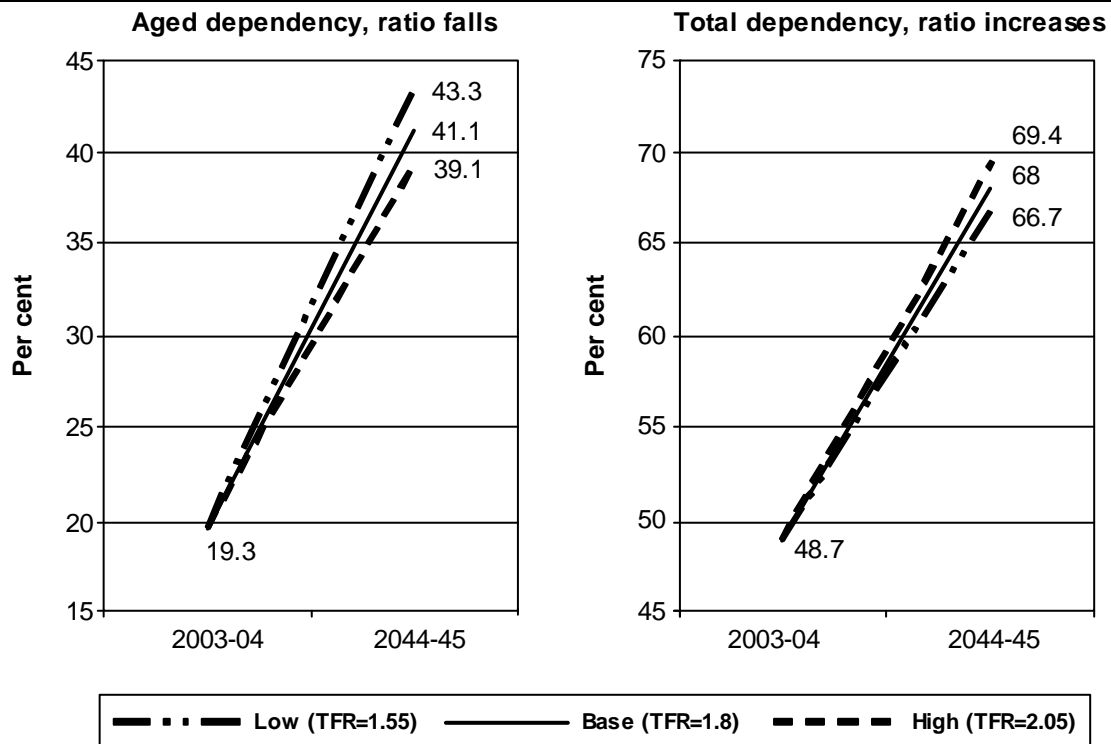
The main messages emerging from projections by the Australian Treasury and the Productivity Commission are by now well known. Population ageing will significantly reduce workforce participation and per capita income growth. At the same time, it will push up health and aged care expenditures, creating major fiscal pressures for governments. While this demographically driven scenario will unfold progressively over the next half century, its influence is already occurring.

Given the demographic causes, some have advocated demographic solutions. But the main reason for the aggregate ageing phenomenon is that people are living longer — not a trend we would want reversed! Further, neither pro-natalist nor pro-migration policies can realistically make much difference.

For example, the recent increase in fertility rates in Australia (from 1.7 to 1.8) will yield only a marginal reduction in aged dependency over the next 40 years and will actually raise *total* dependency (children take a long time to grow up) (figure 1). Feasible additions to this rate could do little more. In any case, fertility is notoriously hard to influence through public policy.

Commission research suggests that the recent increase in the fertility rate is mainly attributable to increased prosperity and the fact that older women are catching up on their previously postponed births. In contrast, the 'baby bonus' is likely to have been a much weaker 'aphrodisiac', affecting the timing of some births more than their ultimate number.

Figure 1 **Fertility has minor effects on dependency ratios**
 Per cent of workforce/population not in labour force, 2003-04 to 2044-45



Source: PC (2005a, table 2.5, p. 32).

Similarly, feasible *increases* in migration (from what is already a historically high intake) can have only minor effects on the age structure of the population. The main reason for this is that migrants age too. The Commission has calculated that, to avert population ageing, we would have to raise permanently our migration rate from 0.8 to 3 per cent of the population per year. This would rapidly transform Australia into a population superpower (around 100 million people by 2050)!

We therefore need to look outside the demographic box for policy tools that could transform growth. This brings us back to participation and productivity as the key objects of policy directed at meeting the economic challenges that lie ahead. Both are amenable to policy influence and they provide a dual focus for COAG's National Reform Agenda.

Labour force participation: keeping it up

If demography is indeed destiny, then it would seem that policy needs to target participation directly. This has been a key focus in COAG's National Reform Agenda as well as for policy at the Commonwealth level in the past few years.

However, increasing the participation of Australians in the labour force is not an end in itself. For example, the participation of older people is highest in the world's poorest countries, where many people do literally work 'til they drop'.

Policies directed at raising participation are only worth having when they yield benefits to society that exceed the costs. Determining this is not always straightforward. For one thing, people value leisure. Further, many are involved in caring for family members or in volunteering. Though they are recorded as 'economically inactive', by some estimates they generate economic value equivalent to 12 per cent of GDP. By the same token, the benefits to society of having people in paid work are generally greater than the direct value of their output. High workforce participation is associated with reduced crime and social problems (greater 'social inclusion'), as well as lesser burdens on welfare budgets.

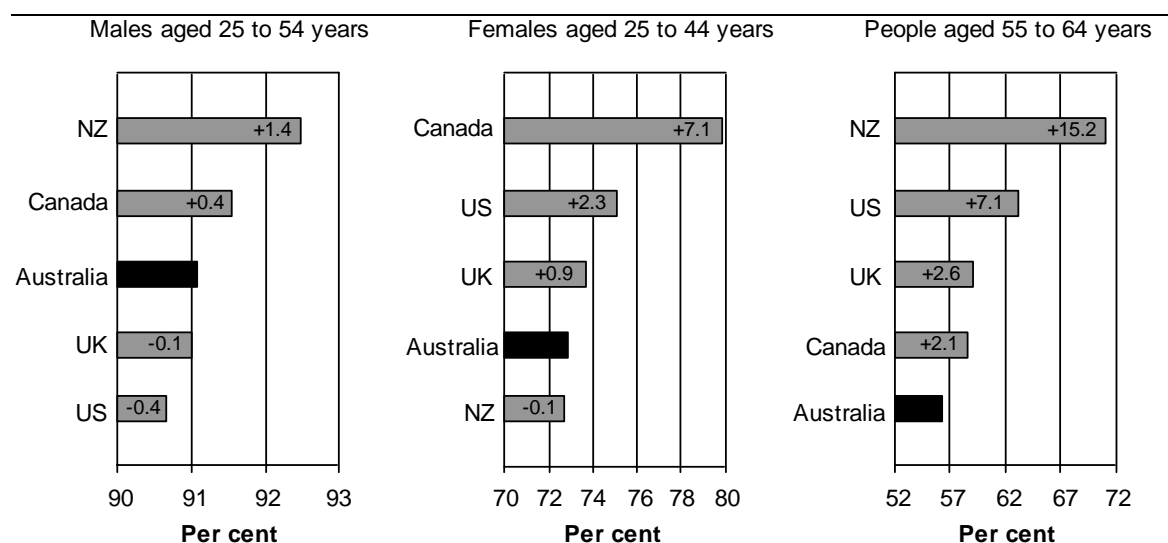
Thus policy directed at raising participation needs to focus on the reasons why it may be lower than it should be, taking into account peoples' innate preferences and potential societal spillovers.

Scope to do better

The fact is that Australia's overall participation rate is higher today than ever. This has been due to the increased participation of women; male participation has fallen significantly over time. A key influence on the increasing number of women entering the workforce has been 'the pill' and the associated drop in fertility rates, as well as growth in service sector jobs and progressively more flexible work arrangements. The dominant reason for men exiting the work force has been a loss of low-skilled jobs and easier access to the Disability Support Pension as a more generous longer-term alternative to unemployment benefits.

While Australia's aggregate participation rate is above the OECD average, it is relatively low for some key age groups: particularly men and women aged 55 to 64 years, and women in the 25 to 44 ('child bearing') age bracket (figure 2). A significant gap in participation rates, relative to countries we regard as broadly comparable to our own, is indicative of scope to do better. As noted, whether that scope is real or not depends on the causes, and the costs and benefits of specific policy initiatives to address them.

Figure 2 Differences between countries in selected participation rates
2005



Source: Derived from Abhayaratna and Lattimore (2006).

There are five broad areas for potential policy attention. Two of these — education and training, and health policy — relate not only to personal development and wellbeing, but also to the inherent contribution of people to the workforce. A third relates to the incentives they face to seek employment and perform well in a job. A fourth is the capacity of workplaces to employ people in ways that fit with their abilities and the needs of the firm. And a final one is support systems for helping people into work, where such assistance is needed.

Most of these are encompassed by the NRA. The Commission’s analysis of the options suggests that work incentives — particularly those related to the interaction between the tax and welfare systems, and retirement income provisions — are likely to be the most influential. The effects of a number of reforms in these areas at the Commonwealth level would appear to have contributed to a substantial increase over the past few years, against the trend, in the participation of those aged 55–64. The Commission’s recently announced inquiry into paid maternity leave provides an opportunity to address this potential influence on female participation for the other key age group.

What is happening to productivity?

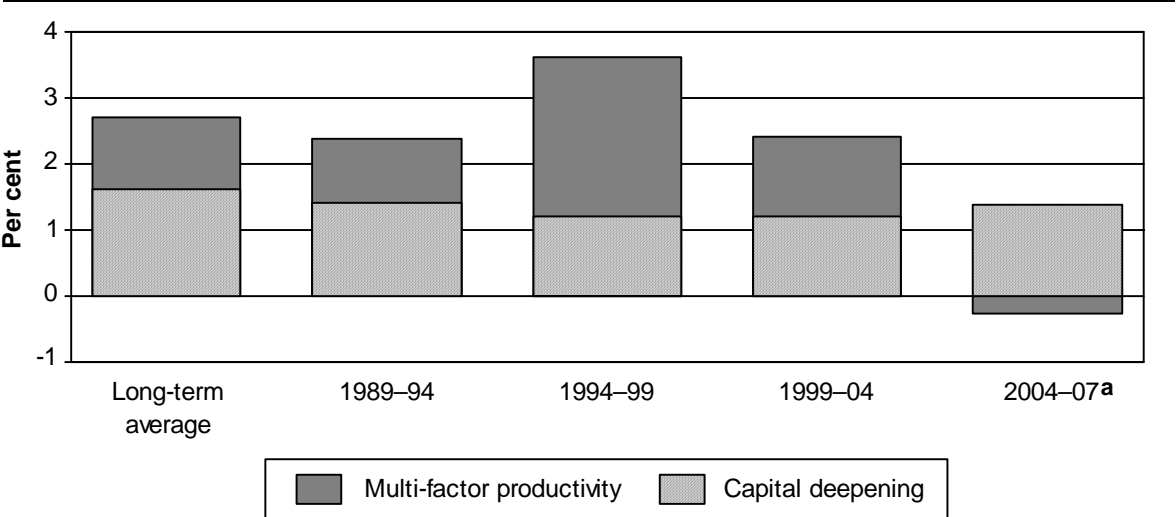
For a given degree of labour utilization, it is productivity growth that largely determines the rate of growth in a society’s living standards over the long term.

From lagging internationally for decades, Australia’s productivity grew at unprecedented rates through the 1990s, outstripping even the much-vaunted performance of the United States. This was a direct consequence of the first two waves of microeconomic reform. Consequent productivity gains involved a combination of ‘cost-cutting’ and a step up in innovation, especially in services industries.

While disputed by some at the time, there is nothing really surprising about reforms that remove barriers to the performance of individual firms leading to better aggregate performance. However, the subsequent productivity experience in the 2000s has been more mediocre and particularly weak in the last couple of years, raising questions about whether the effects of past reforms were a flash in the pan, and adding to concerns about Australia’s future growth prospects.

Productivity moves around a lot from year to year and trends are tricky to analyse. The ‘Australian way’, established by the Australian Bureau of Statistics (ABS), is to look at complete ‘cycles’ from one labour productivity peak to another. This reveals that, after its ‘surge’ from 1993-94 to 1998-99, labour productivity growth dropped to just below the long-term average in the next cycle (to 2003-04), and has been well below average so far in the current (incomplete) cycle — with multifactor productivity (MFP) actually recording *negative* growth (figure 3).

Figure 3 Productivity surged in the 1990s, but subsided in the 2000s
Annual labour productivity growth



^a This cycle is incomplete

Source: ABS, *Australia’s System of National Accounts*, Cat. no. 5204.0.

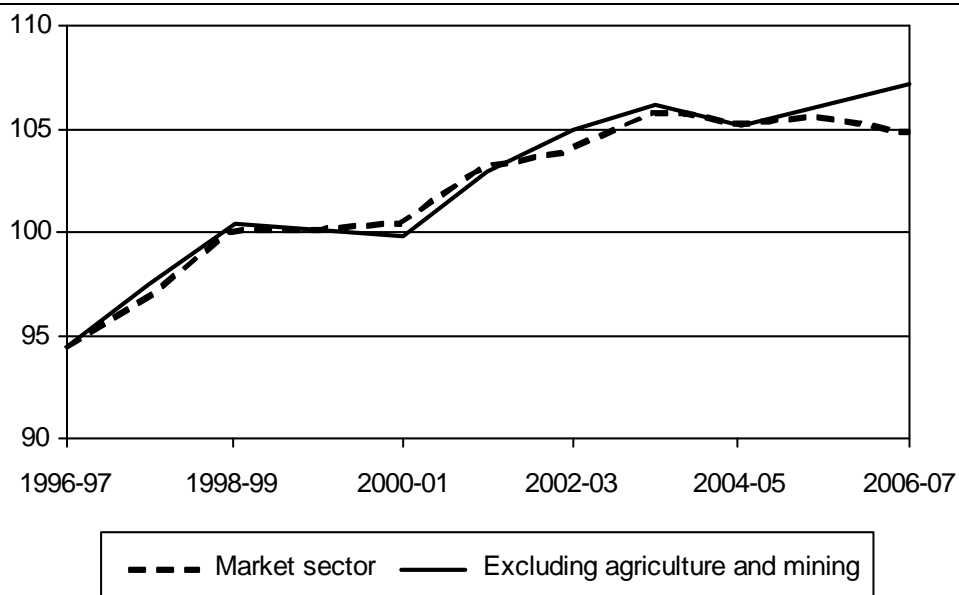
The explanations for this slowing can be found in part in some market ‘aberrations’ since the 1990s. Drought is one, although ‘short’ droughts perhaps need to be distinguished from ‘long’ ones. Agricultural productivity has grown surprisingly strongly over most of the current decade, despite prolonged adverse weather conditions in parts of the country, because farmers have adjusted by disengaging workers. But a particularly bad season means less productivity in that year, simply because output is less. For example, severe drought in 2006-07 saw agricultural output fall by more than one-fifth, subtracting around 1.25 percentage points from aggregate MFP growth in that year.

A second special influence has been a pronounced recent decline in mining productivity as the sector has sought to respond to an (unanticipated) export boom. With little excess capacity, production could only be raised in the short run by costly (labour-intensive) means, and with a considerable lag following the capital investments that have been underway in recent years. Furthermore, the boom in commodity prices has made profitable the extraction of minerals that are more difficult and costly to produce. The resulting productivity decline has been further exacerbated by the depletion of oil and gas reserves in Bass Strait and the Bonaparte Gulf over the same period.

Excluding these two sectors, MFP performed better (figure 4). Even so, productivity has still grown more slowly in recent years.

Figure 4 Agriculture and mining have lowered productivity

Multifactor productivity, 1999-2000 = 100



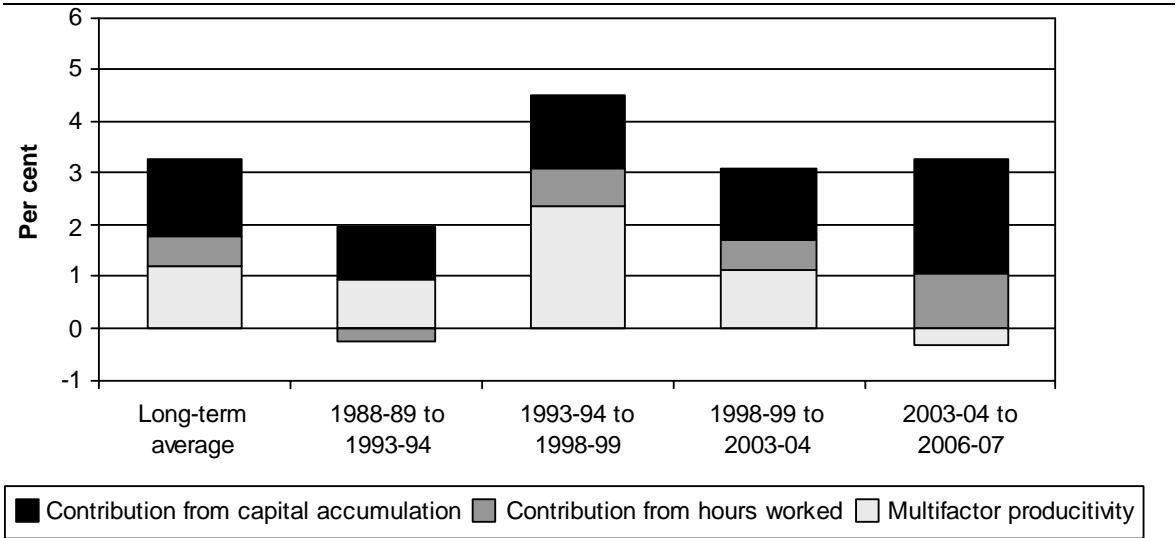
Source: Productivity Commission estimates.

One explanation is that enterprises appear to have found more room to increase prices amid buoyant (domestic) demand for their products. Compared to the 1990s, more effort also seems to be going into expanding production through investment and new hiring, rather than cost cutting. This strong employment growth and investment, together with the rise in Australia’s terms of trade, have generated significantly greater prosperity in recent years despite the relatively weak productivity performance (figure 5). Indeed domestic income has grown as rapidly as it did during the productivity surge of the 1990s. But the same factors that have generated the recent prosperity, at least in the case of mining, have contributed to lower productivity performance.

All this considered, the prospects for a recovery in productivity in the near future seem favourable. Agriculture should bounce back, and mining productivity should also recover as investments come fully on stream and prices stabilise.

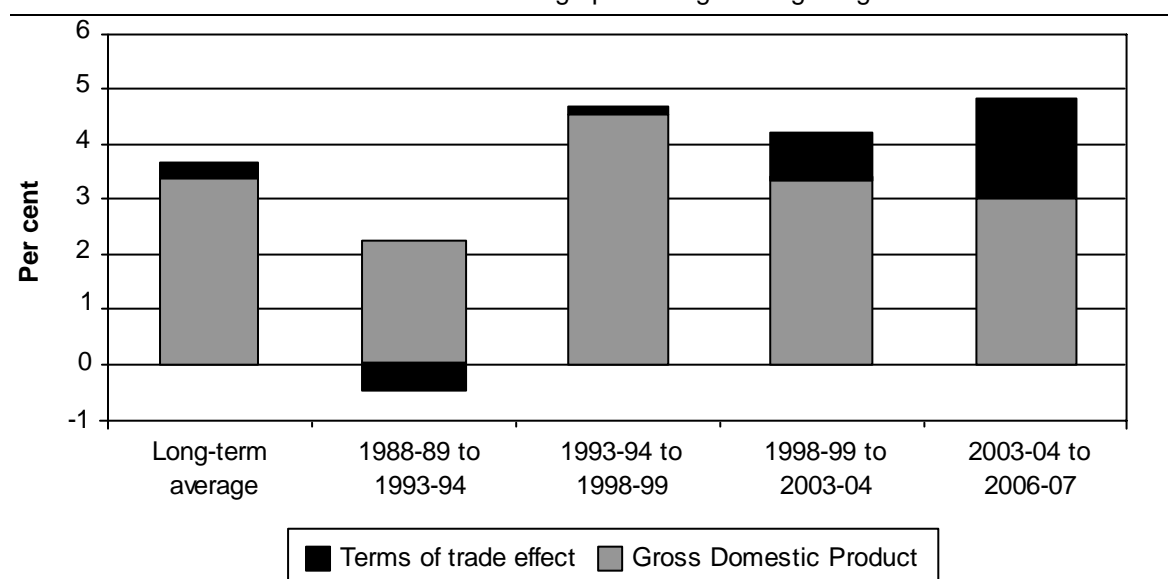
Whether productivity can (re)attain growth rates *above* the historical average is less clear. This ultimately comes down to the dynamics of firms — the entry of new players, the exit of poor performers and innovation among all incumbents (not just the technology leaders). Past policy reforms could be expected to have an enduring positive influence. But it would be mistaken to believe that nothing more should be done by governments to facilitate better firm performance and assist the process of ‘creative destruction’.

Figure 5 Output growth has held up
Contributions to annual average percentage change in market sector output



Source: Productivity Commission estimates.

Figure 6 Income growth was even stronger (terms of trade)
Contributions to annual average percentage change in gross domestic income



Source: Productivity Commission estimates.

In broad terms, there are four areas where government policies can be influential:

- the market incentives and disciplines on enterprises
- the performance of government-supplied infrastructure and administrative services
- the scope for enterprises to be responsive to market pressures and opportunities
- the capability of human resources.

As noted, the liberalisation of Australia's import barriers and then the NCP reforms were directed at the first two. Industrial relations reforms since the late 1980s have been the main contributor to the third. The current NRA remains relevant to the first two as well as having a particular focus on the fourth.

Large *potential* gains from the NRA

There are three reform streams within the NRA: a *competition* stream, directed at enhancing the operations and efficiency of infrastructure markets; a *regulatory* reform stream, focussed on reducing 'red tape' burdens on business; and a *human capital* stream, which is aimed at enhancing workforce participation and productivity, through policies that improve health and education outcomes and reduce disincentives for work.

The Commission’s modelling and other analysis in its recent report for COAG suggest that the benefits from reforms in the areas identified are potentially large, and at least as great as those from the NCP (table 1).

The more conventionally modelled competition and regulation reform streams were projected potentially to bring price and productivity improvements that could see national output increase by up to around 2 per cent of GDP (\$17 billion) over a decade.

- The smallest potential gains were projected for the competition stream, given that much of this is concerned with completing unfinished business from the NCP itself. Consistent with this, the most prospective reform area within that stream was found to be road transport infrastructure, where relatively little reform has occurred.
- Given the pervasiveness of regulation throughout the economy, reducing red tape burdens was projected to yield GDP gains three times greater than those on offer from the competition stream, on the (reasonable) assumption that one-quarter of estimated compliance burdens are likely to be unnecessary to meet the policy objectives of regulation.

Table 1 Potential ‘outer envelope’ GDP gains from the NRA

	\$b	Per cent of GDP
Competition stream	4	0.5
Red tape reduction	13	1.33
Health service productivity	4	0.5
Workforce participation	60	6
Workforce productivity	25	3

Source: PC (2006a).

The largest headline numbers, however, related to the potential economy-wide impacts of reforms directed at enhancing human capital. Putting aside the potential gains from increased cost-effectiveness of the health system (which are nevertheless substantial, equating to those from the competition stream), the Commission found that there was potential to increase labour force participation by up to five percentage points over the next 25 years — potentially offsetting the projected impacts of population ageing — while workforce productivity could be raised by up to two per cent.

The impacts of participation and productivity on GDP (6 and 3 per cent, respectively) appear to dominate those from the other reform streams. However, as the Commission emphasized in its report, the human capital numbers are not comparable with those from the other reform streams. Apart from the longer time

frames involved, they exclude the (potentially large) program costs that may be called for, and they are far more speculative and exploratory in the methodologies used. Indeed, the Commission found that, in contrast to the more conventional competition-related reform areas, policies directed at enhancing the capabilities and work incentives of Australians often lack a strong conceptual or evidence base. While the potential for substantial benefits from reform is there, the extent to which these can be realised will depend on having a mix of specific measures that can be shown to yield benefits exceeding their costs.

The policy challenges are becoming more apparent now as COAG focuses on specific policy areas, with seven working groups having explicit work agendas and timeframes. In what follows, I focus on some key issues in each area.

Health and aged care

Health and aged care are arguably the most challenging areas for national reform. While our health system does not perform at all badly by international standards (as anyone who saw Mike Moore's film 'Sicko' might agree), it is experiencing growing problems. Not least among these are rising costs, falling accessibility, and workforce shortages. The cost pressures and capacity constraints will soon be compounded by population ageing, with total health spending projected to rise from 10 to around 18 per cent of GDP over the next four decades.

In its 2005 review of the NCP and emerging reform priorities, the Commission argued that there was an urgent need for nationally coordinated reform. The agenda the Commission identified included financing issues (including the roles and responsibilities of the states, territories and the Commonwealth); coordination of care (including informal care and aged care); the interface between the public and private sectors; the balance between prevention and treatment; and information management.

While the Commission's recommendation for a major independent public review of the health system as a whole was not taken up, a number of the issues were subsequently included in COAG's National Reform Agenda. Further, the December 2007 COAG meeting assigned its working group on health and ageing the task of developing implementation plans and formal work plans in some key areas. Importantly, a National Health and Hospitals Review Commission was created by the Commonwealth, with a mandate to 'report on a long-term health reform plan'.

The new Commission has much to cover during its 18 month term. Many of the issues on which it must report have been debated hotly (including among its

Commissioners!). The processes it follows and the participation it engenders will be crucial to building a constituency for major reforms. In a number of areas it will need a better research base to inform judgements about which reforms will work best.

Prevention better than cure?

The NRA and the current COAG work plan rightly place emphasis on health promotion and disease prevention activities. These focus on seven chronic diseases accounting for around 80 per cent of the total disease expenditure burden.

Chronic diseases are reducing the quality of life for an increasing number of Australians. And at the broader community level, they are also having an economic impact beyond the burgeoning cost of care. Chronic disease lowers the productivity of those in the workforce through higher absenteeism and reduced performance on the job. Overall, the Commission has estimated such productivity losses at 2 per cent of total hours worked. In addition, it was estimated that nearly 6 per cent of the working age population were not even in the workforce because of the debilitating impact of these conditions.

The challenge for policy-makers is to determine how, and by how much, these personal impacts and productivity losses could be reduced or avoided by better health policies. The Commission's early analysis indicates that we should not underestimate the difficulties of producing benefits that materially exceed the costs of intervention.

For example, COAG's nominated priority, type 2 diabetes, is closely linked to obesity, as are cardiovascular and other chronic diseases. Targeting the growing incidence of obesity therefore has obvious attractions. However, the causes of obesity are difficult to remedy, being intimately connected with modern lifestyles as well as genetic makeup and other individual circumstances. Studies repeatedly reveal the difficulty for many people of maintaining weight loss. Moreover, the costs of information campaigns and other strategies can be substantial. For example, the incremental cost of an intensive lifestyle program directed at type 2 diabetes was estimated at \$800 per participant, and a program targeted at high risk groups was expected to cost some \$1.3 billion over four years. *If it works*, that is probably a good investment, both individually and for Australians as a whole.

The critical need therefore is for a hard-headed analysis of the effectiveness of specific interventions, as well as a willingness to experiment with new approaches, including pilot testing.

Just do it?

In contrast, there are some health issues where policy solutions seem clear, having benefitted from detailed reviews, but progress has been impeded by political pressures. Two which stand out are health workforce arrangements and aged care funding.

The first is bedevilled, among other problems, by a silo mentality and protection of professional territory ('a doctor is a doctor is a doctor' being the AMA's declared position). What is needed is a culture of teamwork and innovation in scopes of practice and models of care, and the institutional structures to support it. The Productivity Commission's review for COAG strongly argued for national accreditation and registration boards that span the professions. Despite resistance from the AMA and after some delay, it is pleasing to see that COAG is now pushing on with establishing these — an important step.

As currently structured, the aged care system is not well equipped to deal with an ageing society. The population of 'over 85s' is set to triple in the next few decades, and their circumstances and needs will be more diverse than in the past. Our aged-care system needs to be responsive to this, yet also sustainable. The key to this lies in the reform of funding and charging arrangements. In particular, there is a strong case for unbundling accommodation from care costs. Personal care also needs to be delivered on an entitlement basis, with targeted subsidies, rather than through provider-based funding. These issues have been well canvassed, and we urgently need to move on to the next step of exploring the best options for implementation.

Human capital development

The second COAG working group is primarily focused on education and training or, in economists' jargon, the development of 'human capital'. The quality of Australia's human resources is clearly fundamental to our progress, both socially and economically. While past microeconomic reforms boosted productivity and competitiveness by reducing 'waste' and price distortions, our future performance will depend to a greater extent on innovation and service quality, which in turn depends on people's capabilities.

This has traditionally been a relative strength for Australia, but there is considerable scope for improvement. For example, in the core skill areas of literacy and numeracy, average schooling outcomes for Australia exceed OECD averages, but there is a relatively long tail of poor achievement, with one third of 15 year olds rated below international benchmarks.

COAG's goals in this area primarily focus on young people, which is appropriate. There is abundant evidence that literacy and numeracy skills are influential in the extent to which children complete school and go on to higher study or well paid employment. However, apart from the lags involved in seeing benefits, assessing the likely participation and productivity impacts of education initiatives must confront a number of complexities. For example, the observed workforce participation rates of people who have higher educational attainment are not necessarily translatable to target groups with lower attainment, since individuals' inherent abilities and attitudes also play a role.

Teachers are instrumental

Much policy effort and resourcing over the years has been directed at reducing class sizes. But the evidence suggests that this has not yielded significantly better outcomes. The key to better learning is quality teaching and teachers, but this has arguably been the most neglected area of education policy. The February 2006 NRA communiqué makes no reference to teachers and neither did the initial policy check-list for the Education Working Group (since remedied).

It is fair to say that contemporary society values teachers less than did any previous generation. Taking the economist's measure of value, female teachers' pay fell from 114 per cent to 103 per cent of non-teachers' pay between 1983 and 2003, and male teachers' pay fell from 108 percent to 91 percent of non-teachers' pay. Teachers are motivated by things other than money. For many, teaching is a vocation. But widening income disparities can be expected eventually to have an effect, both on the average quality of those entering the profession and on how their contribution is perceived by the public. The widening disparities also help to explain the flight of males from the profession and the shortage of qualified teachers of 'hard' subjects (maths, science and IT). These shortages have meant instruction is being given by people unqualified in these subjects, with likely adverse impacts on student competencies.

Recent evidence shows that, unlike other professions, there appears to be no relationship between the aptitude of teachers and their pay — which is exactly what you would expect in a system characterised by uniform salary schedules. These problems are compounded within government schools in some jurisdictions by restrictions on the ability of principals to appoint the best person for a particular vacancy. Schools must be the only part of the public sector where merit-based appointments are constrained, despite their particular importance in this field.

There are many other challenges to ensuring quality teaching. The need to upgrade existing teachers' qualifications is one. Constraining administrative 'creep', which

steals the valuable time of teachers, is another. And it is important to find ways by which good teachers (and matching resources) can be directed to schools in disadvantaged areas.

Progress is being made in some of these areas in individual jurisdictions. COAG's new education working group is ideally placed to initiate an assessment of what approaches to Australia's education workforce would best meet future needs.

Climate change and water

The working group on climate change and water is concerned with the two 'sustainability' issues that loom largest for the future wellbeing of Australians. While related, they pose quite different policy challenges for governments. In the case of climate change, the problem is global; Australia is a relatively small contributor, and our rate of contribution has generally reflected efficient use of abundant fossil fuels. In the case of water, the problem is domestic, and largely the result of our inefficient management of an increasingly scarce resource.

A cost-effective climate change policy

The objectives of the COAG working group are to 'ensure an effective national response to climate change' based on a national Emissions Trading Scheme (ETS) and nationally-consistent complementary measures. The move to a national approach is of fundamental importance. The emergence, in its absence, of a multiplicity of measures was a growing source of cost in its own right. The focus on a regime based on a market price for carbon is also essential, to ensure that any emissions reduction target can be achieved at least cost. Indeed, the COAG objective would have been more appropriately expressed in terms of a 'cost-effective' response.

Following the Stern Review, a number of reports have downplayed the significance of the costs of reducing carbon emissions, including for Australia. These deserve closer scrutiny than they have been receiving.

The facts are that any abatement action by Australia (beyond 'no regrets' measures) will be more costly than that by most other developed economies. That simply reflects the reality that the structure of our economy has been shaped by the abundant availability of low-cost fossil fuels. And while it may be true, as emphasised by the Garnaut Review, that Australia could also be more adversely affected by global warming than other developed countries, our total contribution to global emissions is very small (around 1.4 per cent). That means that a negative cost-benefit outcome for Australia is assured unless the major emitting countries

ultimately take comparable actions. It underlines the need for our mitigation actions to be carefully designed and implemented to avoid incurring unnecessary costs.

This is the biggest regulatory challenge Australia has ever faced. Though unaccounted for in the modelling, there is the potential for poor regulatory design to generate costs at least as great as the economic impact of raising energy prices. While we can learn from the experiences of other countries (notably the mistakes of the European Union), many of the policy design issues are novel and the likely outcomes from different choices cannot be known entirely in advance. This puts a particularly high premium on good regulatory process. While Australia could be said to have an impressive track record overall in policy development, our performance has not been so good in the more practical art of regulation-making. One of the main deficiencies has been lack of understanding of the compliance burdens of regulation on business. These could loom very large here.

As the Commission observed in its submission to the Prime Ministerial Task Group on Emissions Trading, the regulatory challenges facing us are likely to be greater under an emissions trading regime than if we had chosen a carbon tax, at least as a transitional measure. Apart from the administrative complexities and costs of establishing new institutional arrangements, effective regulatory enforcement will pose major challenges. And, under any regime where carve outs (for exporters) or compensation are contemplated, dealing with lobbying and ‘positioning’ will demand exemplary governance arrangements.

What ‘complementary’ measures?

The great advantage of a national ETS is that it should, in principle, enable the market to price allowable carbon emissions such that abatement occurs in least cost ways. However, to be successful in this, there will need to be some rationalisation of the many and varied schemes previously devised to reduce (net) emissions in the absence of such a price signal. Once an ETS is in place, many of these will make no *additional* contribution to abatement, but simply reshuffle the existing contribution and potentially raise its costs.

This task is on the Working Group’s agenda. It is also part of the Garnaut Review’s remit and the subject of a separate Commonwealth review.

A preliminary assessment by the Productivity Commission has identified a range of programs deserving particularly close scrutiny. One of the more significant is the Mandatory Renewable Energy Target (MRET). An MRET has been in place since 2000, with the Australian Government planning to increase the target nearly five-fold, so that 20 per cent of electricity would be drawn from renewable sources by 2020. In replacing multiple state-based regimes, it will lower the overall costs of

such an approach to emissions reduction. However, whether even the national version would be ‘complementary’ to an ETS is doubtful. In fact, as the Garnaut interim report points out, it would effectively cut across an ETS and impede its ability to deliver least cost abatement through carbon pricing. While it would be unlikely to achieve extra abatement, it would constrain the choice of abatement options (which could potentially cost billions of dollars) and reduce the incentive to use other new low-emission technologies. The apparent special status accorded the MRET needs to be rethought.

A more promising area for complementary policies is in programs to support research and development (R&D). Arguably, given the scale of the technological transformation necessary to reduce Australia’s emissions, price incentives may not be sufficient. Knowledge spillovers are likely to be particularly marked in this area and thus enterprises may require more support. There is a balance to be struck between technology-neutral support and support aimed at areas in which Australia has strategic interests, due to our energy resources and existing industries. There is also need for international cooperation, as advances made in one country can benefit all others, and the costs of the research effort should be spread.

Water, water everywhere?

COAG’s objective of ‘sustainable water use across Australia’ is best interpreted as achieving outcomes that maximise the net benefits to society from this country’s water resources over generations. The benefits include better social and environmental outcomes, as well as economic benefits. In this sense, sustainable water use refers to a pattern and quantum of use that is most valued by society over time.

It is fair to say that we are very far from that ideal. Underpricing and over allocation have encouraged excessive demand and a system ill-equipped to deal with emerging scarcity.

The best solution to scarcity is a market. Prices revealed in well-functioning markets can provide a coordinating role to achieve an efficient allocation of water among competing uses. They can also provide signals to guide investment in water supply augmentation.

Reforms to create water markets began in rural areas, where water is an essential input to the dominant production activity and the opportunity cost of its under-provision or misallocation is more readily apparent. While there were some earlier state-based initiatives, the need for a scheme embracing the Southern Murray Darling Basin, and the jurisdictions that draw water from it, became obvious. The issue has rested with COAG since 1994. Progress has occurred, but slowly. The

‘market’ remains fragmented and distorted by constraints on trade, excessive transactions costs, and incomplete arrangements for environmental allocations. The move towards a single governance arrangement is fundamentally important to resolving these problems.

From country to city

In contrast to developments in rural areas, it is no exaggeration to say that markets do not exist for water in our cities. However, scarcity issues are at least as significant there as they are in the country. Most capital cities and urban centres have for several years dealt with lower catchment rainfall by imposing severe restrictions on use. The hidden cost of these restrictions for many households outweighs the charges they actually pay for the water they use, and nationally could amount to billions of dollars a year.

Introducing market mechanisms for urban water therefore has the potential to generate substantial efficiency gains, both through enabling available water to reach the most valuable uses and through providing better signals to investors about the need to augment water storage capacity or develop other sources.

Equity or ethical issues are often seen as problems when the question of pricing water is raised, especially in relation to scarcity. However, current arrangements give rise to significant inequities of their own, with restrictions impacting more adversely on garden lovers and older people and least on wealthier households, who can afford to pay for alternatives such as bores, tanks or commercial water. In any case, price structures or rebates can deal with the need to ensure that all households can afford basic needs.

In moving to more efficient water markets, there are two sets of issues that require particular attention. One is the dominance among water utilities of old-style, vertically-integrated monopolies. As the experience in other utility sectors has shown, structural changes to enhance commercial pressures and promote competition, including through third-party access to networks, offer the prospect of significant efficiency gains.

A second untapped opportunity to get better outcomes, at least for some cities, is to breach the artificial divide that exists between urban and rural water systems. Some 60–70 per cent of Australia’s water is consumed by agriculture; only 10 per cent by households. Even small diversions could make a significant difference to urban supplies.

Creating markets for urban water would not be straight-forward, politically or institutionally. The fact that no real precedents exist overseas is telling. It also

means that there are no ‘off the shelf’ solutions. That said, the potential gains for Australia from urban water reform are substantial, and there is no reason why we should not lead the world in this area, as we have done in others. The inclusion of urban water on COAG’s agenda is therefore a welcome development. Because some of the most promising options will be novel — and threatening to some — building public awareness of what is at stake will clearly be very important, as it has been for other major reform initiatives in the past.

Efficient national infrastructure

Efficient economic infrastructure is clearly fundamental to Australia’s economic performance. Over the past two decades, the performance of much of our infrastructure has greatly improved. This was achieved mainly through reforms that introduced commercial disciplines and competitive incentives to a sector that had long been dominated by inefficient statutory monopolies.

The Productivity Commission’s 2005 Review of NCP found that prices of infrastructure services had generally fallen significantly, reflecting efficiencies achieved in service delivery. (In some cases, however, formerly cross-subsidised prices had to rise.) The Commission estimated that the observed productivity gains during the reform period had boosted Australia’s GDP by around 2.5 per cent.

However, the Commission also identified considerably more that needed to be done, including to achieve more competitive, nationally integrated markets in energy, transport and water (as well as, within the Commonwealth domain, telecommunications and broadcasting).

These have become subject to ongoing attention by COAG under the NRA. In addition, since the federal election, particular focus has been placed, via the relevant working groups, on the goal of improving the coordination and streamlining of infrastructure planning and investment processes, and undertaking a national audit of infrastructure. A new Infrastructure Australia Council has been created to assist in this.

Better evaluation of public investments is needed

Assessing the adequacy of national infrastructure, particularly in a forward-looking context, is a very complex undertaking. The intention is to help guide priority-setting for public infrastructure investments, but there would still be the need for detailed cost–benefit analysis of particular projects. Such analysis has typically not been done well in the past. Even where it has revealed that costs would exceed benefits, some projects have proceeded (the iconic example being the Alice Springs

to Darwin rail line). In its Road and Rail report, the Commission observed that a sound conceptual framework for investment decisions was contained in Auslink's processes. It just needed to be more widely adopted.

Periodic audits of the regulatory and, for public infrastructure, governance arrangements within which infrastructure investment and management decisions have been made could prove particularly useful. The Commission's annual review of the financial performance of government trading enterprises (a descendent of the so-called Red Books) has found that the aggregate return on their assets has slowly improved, but over half of GTEs still do not earn a commercial rate of return.

In an across-the-board review of GTE governance arrangements, the Commission detected many ongoing deficiencies, including a lack of clarity (and even transparency) in corporate objectives, a need for greater independence of boards, and generally greater accountability. When it comes to investment decision-making, problems include undue political influence, ill-defined or unfunded non-commercial obligations, constraints on pricing and restrictions on borrowing.

Private provision requires balanced regulation

This underlines the importance of periodically testing the case for public ownership of infrastructure assets. Private ownership and control avoid many of the incentive and governance problems that bedevil public assets. While both can be subject to competition from product market rivals, only private ownership involves the additional discipline of competition from within the capital market. By the same token, private owners tend to be single-minded about making profits, and this has meant that in areas where market power or equity issues loom large, governments have regulated heavily to keep prices down.

Price regulation almost inevitably becomes rate-of-return regulation, which can undermine incentives for productive efficiency and innovation. In the end, the regulator effectively becomes the arbiter of new investment. Concern that regulatory truncation of 'above-normal' returns was diminishing incentives to invest in long-lived assets, was at the heart of a number of recent Commission reviews of competition regulation of infrastructure introduced under the NCP. While some changes have been made as a consequence, it has been raised again as a key contributor to the export bottleneck problems experienced over the past few years.

Reform of road freight infrastructure is a priority

The Commission's analysis suggests that some of the largest gains from further reform are likely to come from achieving more efficient provision and charging for

land freight infrastructure. Efficient freight is especially important for Australia, given its dispersed population and production centres.

Road infrastructure is likely to continue to be largely provided by government, given its public good features, but there is a need to get a closer relationship between user charges and usage costs, and a better basis for investment, both of which are subject to heavy political influence. Contrary to conventional opinion, this is not driven by a need to reduce distortions that disadvantage the rail industry. These were found to be of minor significance. Rather, the gains would come from improving the incentives and signals needed for the efficient use and provision of the road network itself.

Developments in road pricing technology are only now creating the opportunity for more cost-reflective pricing. If combined with institutional changes to link road supply and demand, there is potential for substantial efficiency gains. However, as in so many parts of the national reform agenda, the challenge is to find solutions that yield unambiguous gains and that would win community acceptance. To this end, the Commission recommended that COAG adopt a carefully sequenced approach in moving towards location-based charging, with each step preceded by a detailed examination of costs, benefits and distributional impacts. This was largely adopted by COAG and is now on the agenda of the Working Group on Competition and Regulation.

Enhancing business regulation and competition

The first waves of microeconomic reforms were directed at reforming anti-competitive regulations that assisted some businesses at the expense of others. With considerable progress in that area, the emerging priority is to reform regulation that is unnecessarily costly to *all* businesses.

In its report *Rethinking Regulation*, the Regulation Taskforce (2006), found that much regulation suffered from unclear or questionable objectives, lack of targeting, excessive paperwork requirements, undue prescription and complexities, and inconsistency, overlap and duplication, particularly across jurisdictions.

Harmonising 'hot spots' is challenging

Many of the worst inter-jurisdictional problem areas have now been picked up by COAG as 'hotspots' for priority action. For most, there is a strong case for achieving at least harmonisation, if not national uniformity. This has been generally accepted for some time, but progress has been stymied by lack of agreement about which national rules should apply and who should apply them. The biggest hurdles

have been bureaucratic resistance and political considerations within individual jurisdictions.

For many of these regulations, the potential benefits of harmonisation from the perspective of a particular state or territory may not appear sufficiently large to offset the loss of sovereignty over issues that can involve local sensitivities. The fact that the new Federal Government is willing to provide reform-contingent transfers to the States may therefore represent the best chance yet for a breakthrough.

That said, it will be important that a strong case is made for any proposed national standard, demonstrating a national payoff from reform. National uniformity or harmonisation is only worth having if it involves the best rules, not merely the lowest common denominator. That in turn puts a premium on good policy development processes, including rigorous assessment of the pros and cons of different options. As noted, this has not been done well in the past.

Of all the regulatory ‘hotspots’, perhaps the hottest from a business perspective is Occupational Health and Safety, and this will be the litmus test for whether moves for regulatory harmonisation can be successful generally. Notwithstanding common ‘duty of care’ statutes, prescriptive subordinate regulations have proliferated, and these vary greatly from one jurisdiction to another. The biggest problem is that the interpretation of the employer’s duty of care differs significantly. The Taskforce saw this as the priority in any harmonisation efforts, noting Victoria’s (reformed) arrangements as a potential model.

The ability to learn from policy experiments across different jurisdictions is one of the strengths of a federal system of government. However there are few examples in Australia of this leading to best practice regulation being adopted nationally, even with the prompting of mutual recognition provisions. This is something which the COAG Working Group process should be able to promote. The program of benchmarking business regulation across jurisdictions, which the Productivity Commission has commenced for COAG, should be helpful, provided it can, in time, cover some of the more contentious regulatory areas.

Addressing the causes of bad regulation

Periodic redtape reviews have proven useful in detecting some of the more costly regulations for business. But in the meantime costs are incurred. Moreover, there are plenty of regulations that detract from community wellbeing without necessarily imposing costs on business.

The fact is that bad regulation — regulation which is ineffective or for which the costs are excessive — has proven easier to make than to reform. This reflects the political pressures on governments to ‘do something’ in our increasingly risk-averse society, and the resulting knee-jerk reactions by governments, which are prone to ‘regulate first and ask questions later’.

The problems are deep-seated and need to be tackled on a number of fronts. However the absolute priority is to improve the processes and institutions responsible for making regulation in the first place.

COAG has made a useful start in agreeing to some ‘best practice regulation reforms’. However, concrete commitments need to be made to strengthen the obligations on policy makers and regulators, and to ensure that regulatory proposals satisfy those requirements. For example, the Australian Government now requires that regulatory proposals with non-trivial impacts on business include an estimate of those impacts, using a checklist known as the Business Cost Calculator. Following a recommendation of the Regulation Taskforce, it has also mandated that a regulatory proposal which fails to meet the government’s ‘best practice’ requirements, as assessed by the Office of Best Practice Regulation, cannot proceed unless the Prime Minister grants an exemption (in which case a ‘post-implementation review’ is required within 1–2 years). Such requirements need to be extended to all jurisdictions.

Clearly, prevention of bad regulation is better than cure. However, the incentives and culture within government militate against it. These ingrained reflexes can only be overcome through sustained political support for good process. Giving a Cabinet Minister direct responsibility for promoting good regulation, as the current Australian Government has now done, is an important step which again should be emulated in other jurisdictions.

Competition still needs support

In the specific area of competition, the NRA has a significant role in completing and extending the agenda of the NCP. As noted, this includes further refinements to pro-competition regulation of infrastructure markets. There is also unfinished business from the NCP’s review of anti-competitive regulations, which required a public interest case to be made for their retention. Many of the gaps or deficiencies in that program have involved considerable political sensitivity. Examples include remaining statutory monopoly controls over exports (notably wheat), and regulatory constraints on competition in such small business heartland areas as pharmacies, newsagencies and taxis. As the current move (at long last) to liberalise wheat export marketing illustrates, the change of government federally has provided a fresh

opportunity to revisit such restrictions, and to remove or modify those which cannot be shown to yield net benefits to the wider community.

At Federation, the imperatives of foreign policy combined with the need to reduce domestic market fragmentation, saw the Commonwealth assume power over tariff making. However, many regulatory and other impediments to a national market endured. As discussed, a number of these have been and are being addressed by COAG. But there is scope to widen the net to include various forms of industry assistance.

The States and Territories provide billions of dollars in assistance to industry. The extent to which the costs and benefits of the assistance programs have been scrutinised varies. From a COAG perspective, there is a particular need to review progress in reducing subsidies and tax exemptions designed to influence enterprises to locate in particular jurisdictions. These ‘bidding wars’ generally involve negative sum outcomes for Australia as a whole. Moreover, in the few instances where programs have been properly reviewed, most have been found to yield little or no benefit even to the ‘winning’ jurisdiction itself.

Understanding the economy-wide implications

The opportunity cost of helping particular firms or industries to operate at higher levels of activity looms largest at times like the present when the economy is stretched to capacity. A job gained or retained in an industry as a result of government assistance is a job lost to another, particularly in an environment of labour shortages. Understanding such ramifications is not straightforward, but it is essential if policy judgements are to be properly informed.

It is therefore significant that the Productivity Commission has been asked to model the economy-wide effects of any modifications to the established assistance regimes for the automotive and textile, clothing and footwear (TCF) sectors. Economy-wide (general equilibrium (GE)) modelling is a powerful tool for analysing the impacts of policy changes across the economy, but it has limitations and cannot encompass all the forces at work. In the past, GE modelling has found net gains to the economy from reducing tariffs, but it has generally underestimated those gains. For example, the Commission’s 2002 review of automotive assistance found that steadily reducing tariffs had provided a major spur to innovation, yielding productivity gains that the industry itself had not anticipated.

Accordingly there is merit in the Government’s review of innovation policy being undertaken concurrently with the automotive and TCF reviews. It should help reinforce the message that any change to the established assistance regimes for

these industries should be directed at enhancing the scope for innovation, not weakening the competitive incentives that help motivate it.

The strong link between competition and innovation is underpinned by the reality that (technological) R&D is only a small part of the total innovation that occurs within industry. That said, R&D can be relatively costly, and incentives for firms to undertake it can be weakened by the difficulty of withholding its fruits from market rivals. Government support can help address this 'market failure'. However, as the Commission's recent report *Public Support for Science and Innovation* showed, such support needs to be carefully designed and targeted, with robust analysis of its cost effectiveness in generating (additional) social benefits.

Further candidates for review?

Current resource constraints within our economy, and pressures on government budgets, strengthen the case for undertaking reviews of other industry assistance programs. In 2006-07, Commonwealth assistance to industry monitored by the Commission totalled nearly \$16 billion, with budgetary assistance amounting to some \$6.5 billion. While a proportion of this will represent a good investment by the community, some of it will not. In deciding which programs to examine, relevant criteria include whether:

- areas receive relatively high assistance, or involve multiple measures offering scope for rationalisation
- programs appear to lack a strong rationale or were devised without robust analysis
- a review has not been undertaken for some time, or market circumstances appear to have changed (or previous recommendations for reform have not been implemented).

On this basis, some additional candidates for early review could include defence procurement, drought assistance, biofuels subsidies and assistance for tourism. Given the complexity of the issues and the various interests involved, such reviews should be independent and properly resourced, with adequate opportunity for public participation and terms of reference that give priority to analysing the economy-wide implications of specific assistance measures.

Two other important COAG working groups

The final two COAG working groups — on housing and indigenous reform — are outside the boundaries of the previously agreed NRA. But both deal with issues that are central to the wellbeing of Australians, with outcomes dependent on Federal–State cooperation.

Accessible and affordable housing

In the case of housing affordability, there are two challenges that stand out, based on the analysis in the Commission’s 2004 report *First Home Ownership*. Both are fundamental to affordability outcomes, but have been seen as politically too hot to handle.

- The first is the zoning and heritage laws that stop sufficient dwellings being built in the inner urban areas where people increasingly want to live. These rules are not easily changed. They not only reflect the strong preferences of those who already live in more desirable areas, but also of many who are seeking to do so, making the problem almost intractable.
- The second major influence — the elephant in the room? — is Commonwealth taxation. When the Commission was asked to conduct its investigations, the presumption was that various State taxes, particularly stamp duty, were a key contributor. Instead, the Commission found that a much more pronounced influence on the price surge was income tax provisions that favour housing, particularly the concessional arrangements for capital gains taxation that were introduced in 1999 and appeared to be having a strong pro-cyclical effect. Given that these and other provisions are interactive and not confined to housing investments, we recommended a follow-up review directed specifically at taxation, but this remains to be taken up.

While affordability problems are significant, for many people the main impact is to defer entry into home ownership, rather than preclude it entirely. Arguably, the more important social problem relates to the adequacy of accommodation for people on low incomes who will never own a home and have trouble affording rental accommodation. Again, the key to identifying policy interventions in this area that can make a difference is to understand potential ramifications in the wider market. This is not easy, but it would be helped by a more rigorous approach to reviewing existing programs.

Indigenous policy

The most extreme housing policy failures apply to Indigenous housing. Overcrowding in Indigenous households is much greater than anything observed in non-Indigenous Australia. Houses are also often in very bad shape, a sign that their inhabitants neither value them, nor feel good about living in them. This is a major policy issue. As the Commission's work for COAG's Government Services Review shows, poor housing conditions contribute to several facets of disadvantage and dysfunctionality in Indigenous communities, including bad health, poor school performance and family violence. It is therefore encouraging that this has become a priority area for policy attention both at the Commonwealth level and within COAG. More money is an essential ingredient for better outcomes. But much greater attention also needs to be given to the specific housing needs of Indigenous people — by actually involving them — as well as to the adequacy of related infrastructure services.

This is a particular manifestation of a much greater failure in Indigenous policy over the years. Despite the good intentions of successive governments, much Indigenous policy has not met even the most rudimentary tests of good public policy. Programs have lacked clear rationales and objectives, have been designed without effectively consulting those affected and, perhaps most damning of all, have not been properly reviewed to gauge their effectiveness. The result is that after three decades of policy experimentation, we have very little knowledge today about which of the myriad of programs worked best or why. Rectifying this — bringing a sustained evidence-based approach — is the most important challenge we face in seeking to realise COAG's aspiration to close the gap for Indigenous people.

Moving forward

It emerges that while the potential pay-offs to Australia from embarking on a new wave of national reform are large, there are also some major challenges in devising reforms that will yield the anticipated benefits. If anything, the challenges are greater than under the NCP, because of the additional complexities and uncertainties that confront policy development in the human capital area — where there is potentially most at stake.

The difficulties under the NRA were also initially made greater than under the NCP because of some compromises and deficiencies in the governance and other arrangements. However, a number of these problems are currently being addressed.

One important development is that financial transfers from the Commonwealth to the States and Territories, analogous to the NCP's 'competition payments', are

being put back on the table. The payments had an influence disproportionate to their magnitude in encouraging States and Territories to adopt an ambitious reform agenda under the NCP, and are likely to prove an equally good investment under the NRA. The broadbanding of the myriad of ‘special purpose payments’, with agreed performance outcomes, will play a complementary role, while enabling different approaches to achieving performance targets to be developed and tested.

Another positive feature is the strengthening of COAG oversight of the various reform steams, with working groups involving central agency representation reporting on a quarterly cycle. Ministerial Councils have played an important role within our Federation, but they naturally tend to be dominated by a portfolio perspective. This can lead them to neglect the bigger picture for the nation and has limited their ability to advance fundamental reform. Any progress has also tended to be very slow.

The introduction of three-monthly meetings for COAG is an important signal about the role that it intends to play, and stands in marked contrast to previous arrangements. It should enable closer monitoring of progress and provide a better basis for maintaining momentum. The main downside would be if a ‘need for speed’ began to take precedence over marshalling evidence and rigorously testing policy proposals where this is needed.

Where appropriate reforms have already been identified, and jurisdictions agree on best practice, the best course is to ‘just do it!’. In the past, however, this has been stymied by a lack of agreement, often for parochial reasons. Hopefully, this can be lessened by the financial rewards on offer.

Where policy solutions are not clear even in principle — or there is no basis for an agreed position — there will need to be considerable work done at the ‘front end’ of policy development. Good policy development processes are especially important where the intent is to implement a uniform national policy or regulatory approach.

Our federal system is replete with policy experiments across jurisdictions which should have been able to provide useful guidance. However, this strength of a federal system has been poorly utilised in Australia. Ministerial Councils, potentially an ideal forum for comparing policy experiences, have done little of this, with some Councils actively resisting.

Remedying this unexploited opportunity should be an important task for the ‘new federalism’ and could be facilitated by the working group framework. In the meantime, working groups will need to shape their agendas to include not only implementation of identified national reforms, but also priority reviews where evidence or agreement is lacking.

A key challenge for the NRA will be to ensure that reforms are actually implemented as agreed. In the past, it has often been difficult to achieve this, or at least to keep reforms intact over time. Under the NCP, the National Competition Council played a crucial role in monitoring reform implementation and advising on the related competition payments. Indeed, this was integral to the overall success of the reform program. A similar role is envisaged for the fledgling COAG Reform Council, which was created in the lead up to last year's Federal election and since expanded. To be fully effective, it would need independence and adequate resources, as well as a clear mandate.

As a final observation, the benefits of the NRA will take a long time to be fully realised. In the meantime, governments will need to be willing to bear not only its financial costs, but also the political heat that major reform often generates. This is not assisted by short electoral cycles, which mean that more pain than gain will generally occur within a government's term. The move to four-year fixed terms has ameliorated this at the State level. Now could be a propitious time to seek a similar change at the Federal level.

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