REALISING THE VISION

IAN LITTLE MEMORIAL LECTURE

MELBOURNE

4 MARCH 2008

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Realising the vision

I am honoured to have been asked to present the 2008 Ian Little memorial lecture. This is not the first memorial lecture I have had the opportunity to present. But this one has particular poignancy. Memorial lectures do when they are delivered in honour of friends or colleagues. And Ian Little – I am proud to say – was both a good friend and close colleague.

It is an honour to be invited to present a lecture in memory of someone widely held in high regard; someone whose outstanding contribution to the wellbeing of Australians serves as an inspiration to so many people.

Shortly after Ian's death, I spoke here in Melbourne at a memorial service organised by the Victorian Government. That was a difficult occasion. Ian's departure was still raw. I hadn't had the opportunity to come to terms with it.

On several occasions since, I have reviewed the remarks I made then. Some of them bear repeating today.

Many of us would have become acquainted with Ian in his role as Secretary of the Victorian Department for Treasury and Finance (DTF); a position to which he was appointed in 1998. But prior to this, Ian had gathered a wealth of experience through positions within both the private and public sectors, including in the Reserve Bank of Australia and the ANZ bank. His aptitude for economics was demonstrated with an honours degree from Monash University and a masters degree from the London School of Economics.

With his appointment as Secretary to DTF, Ian joined an exclusive club – the Heads of Treasuries; HoTs. And it was in that club that I got to know him.

In all the work of HoTs, Ian displayed a keen sense of Victoria's interest. But he also had a sense of how Victoria's interests related to those of his HoTs colleagues and how they would be viewed by the Commonwealth. On especially difficult Commonwealth-State issues, Ian would often be the one to put the States' view. He had the intellectual capacity, the negotiating and communication skills, and the passion to present a case cogently and with force. And he had the strategic sense to find pathways forward. He didn't like coming to HoTs with problems; usually he brought elegant solutions. While always willing to entertain an alternative point of view, he was also always searching for common ground. Yet he was never so pragmatic as to leave his principles stranded.

Ian wasn't motivated by the adrenalin rush of the quick-fix. For him, problems worth worrying about had a strategic dimension. They demanded a long hard look, an evidence-based analytical crunch, and their solutions demanded painstaking implementation.

The span of issues with which Ian engaged was vast. His work with HoTs included implementing initiatives of the ten year National Competition Policy developed in the mid 1990s, dealing with the fallout from the High Court's decisions on business franchise fees and the difficult issues that landed on our plate following the collapse of Australia's largest general insurer, HIH. It included trying to find ways of simplifying the extraordinarily complex methodology that is used to determine the way in which the GST proceeds are shared among jurisdictions, and ways of harmonising the financial reports of state and commonwealth governments. And his work included management of the accounting and tax implications of public-private-partnerships.

This work program would have been enough to consume most people. And what Ian put into it would have exceeded the capacity of most. But it was not this work program that defined his contribution to HoTs. The fact is, Ian was never comfortable letting issues come to him; he went looking for them. What defined him, then, was his public policy ambition; more than ambition – vision.

Ian's legacy lives on most strongly through his efforts to develop an ambitious, comprehensive, program of economic reform to boost future productivity and workforce participation. He worked with skill and determination towards this goal. As the National Competition Policy was winding up, Ian was banging the drum in HoTs on the need for new thinking on a long-term economic reform program.

Our discussions in HoTs, over a number of years, had convinced us that the case for such a program was compelling.

We had discussed the challenges posed by pronounced population ageing which, as outlined in the *Intergenerational Report* published in 2002, is about to reduce labour utilisation dramatically and have an equally dramatic impact on population geography, with implications for hard and soft infrastructure provision that governments have barely begun thinking about.

We had discussed the challenges posed by a near full employment economy being hit by historically high terms of trade that have produced an excess demand for most categories of labour; put considerable strain on national infrastructure; prompted calls for structural adjustment assistance and other forms of government intervention; while at the same time, raised both the inflationary consequences and the opportunity cost of government activity; boosted budget revenues; and eroded fiscal discipline.

We had discussed the consequences of the coming to an end of a long global deflationary cycle that had been underpinned by three major trends: first, a much talked about productivity boost from the ICT revolution, especially in the so-called 'new economy' of the United States; second, an increasingly talked about rapid industrialisation of China; and third, a barely recognised boost to labour force participation in many industrialised countries (not including Japan) arising from the favourable demographics that immediately followed the collapse in baby boomer birth rates.

We had discussed the challenges posed by our occupying the driest inhabited continent on earth, whose populated areas appear to be getting even drier, with poorly developed water markets and unsophisticated adaptation programs.

We had discussed the challenges of living in one of the most energy-intensive economies in the world, facing accelerating energy costs as a result of the re-emergence of China and India and, looking only a little further ahead, as a consequence of climate change mitigation action.

We had discussed the challenges arising from the fact of our mineral wealth being concentrated in some of the most pristine, yet fragile, ecosystems on earth; especially in the Kimberley and the Top End.

We had discussed the challenges posed by our highly dispersed yet heavily urbanised population geography, with land transport under stress, including in the cities.

We had discussed the risk of lost opportunity; of a failure to address long-standing reform needs in numerous areas, including natural resource management and Indigenous development.

And we had wondered how we were ever going to meet these challenges in a federation characterised by pronounced vertical fiscal imbalance and a chronic lack of coherence in accountabilities.

Motivated by these challenges, our discussions were wide ranging – especially across the numerous elements of productivity and participation that might drive sustainable growth. We discussed the relationship between health status and workforce participation, and the importance of preventative health policy; we discussed the link between education – including early childhood education – and participation; we discussed the national infrastructure challenge – in water, land transport, energy and access regulation. And we discussed the financial arrangements that might be required to underpin progress in these and many other areas.

Ian emphasised that there would be no success without intergovernmental collaboration and cooperation; that it was imperative that all governments work together to deliver future prosperity.

Had he been around to hear it, Ian would certainly have rejected the model of 'aspirational nationalism' enunciated by former Prime Minister John Howard on 20 August 2007. Implicit in this model was a startlingly new concept of vertical competitive federalism – that is, competition between the Commonwealth on the one hand and the States and Territories on the other. While Ian saw considerable value – too much in my view – in the traditional (horizontal) model of competitive federalism, involving competition among the States, he was never in any doubt that the national reform agenda had no hope of being implemented absent a genuinely cooperative effort among all governments.

The National Competition Policy (NCP) endorsed by the Council of Australian Governments in 1995 came out of just such a cooperative effort. It quickly became seen as a landmark achievement in nationally coordinated economic reform, celebrated around the world in numerous OECD and IMF publications.

The NCP drove improvements in efficiency that contributed to significant falls in the costs and prices of many goods and services. For example, real port charges fell by over 50 per cent during the 1990s; there were substantial reductions in rail freight rates in the second half of the 1990s – ranging from 8 per cent for wheat, to as much as 42 per cent for some coal traffic; in the electricity sector, average real prices Australia-wide fell by around 20 per cent, in the 10 years to 2003-04; since the mid 1990s, average telecommunications charges have fallen by more than 30 per cent.

In February 2006, Australian governments endorsed a new National Reform Agenda – an NRA to succeed the NCP – that embraces competition, regulatory reform and human capital streams.

Among officials, Ian Little, and his Victorian colleague, Terry Moran, deserve special recognition for broadening the scope of the agenda to include human capital enhancement. Increasingly, this stream is being seen as by far the most important of the three.

In the regulation stream, COAG committed to addressing ten priority cross-jurisdictional regulation 'hotspots': rail safety regulation; occupational health and safety; national trade measurement; chemicals and plastics; development assessment arrangements; building regulation; environmental assessment and approvals processes; business name, Australian Business Number and related business registration processes; personal property securities; and product safety. In these areas (and many others), jurisdictions apply quite different regulatory regimes. As a consequence, businesses operating across state borders must comply with multiple regulations.

That costs time and money. The Productivity Commission has estimated that compliance costs could be as high as four per cent of GDP – perhaps as high as $5 billion a year.

The current state of rail regulation provides a striking illustration of the present mess. The May 2005 report of the Exports and Infrastructure Taskforce noted that an operator of interstate trains – that is, operating on the so-called national network – could have to deal with: seven rail safety regulators with nine different pieces of legislation; three transport accident investigators; fifteen pieces of legislation covering occupational health and safety of rail operations; six access regulators; and seventy-five pieces of legislation with powers over environmental management. And we call this a national network!

It's little wonder that harmonization of road and rail administrative and regulatory arrangements is estimated by the Productivity Commission to promise cost savings of more than $2 billion.

Another example lies with occupational health and safety (OH&S) regulation. There are currently ten principal statutes governing OH&S – six State, two Territory, two Commonwealth – and numerous regulations and codes of practice. The compliance burdens and costs imposed by multiple regimes of regulation, administration and enforcement are compounded by frequent amendments. The effect is that multi-state employers, employing more than a quarter of the nation's workforce, bear very substantial compliance costs.

There is a long history of reform efforts to achieve nationally consistent or harmonised OH&S arrangements, dating back to at least the early 1990s. In May 2002 governments agreed, once more, that national action was required. Considerable resources were devoted to developing national standards. But progress was painfully slow. In April 2007, after five years had elapsed, COAG restated its commitment to a nationally consistent OH&S framework and governments gave themselves a further five years – that is, to mid-2012 – to achieve it. And this is an agreed 'hot spot'.

Frankly, a snail would drop off to sleep at this pace.

More worryingly, among the ten identified regulatory 'hot spots', OH&S is one of the better stories.

The NRA competition stream promises further reforms in the areas of energy, transport, infrastructure regulation and planning and climate change innovation and mitigation strategies.

In the area of transport, COAG agreed to a phased reform program to provide better price signals for transport freight infrastructure providers and users to enable Australia to meet more efficiently the projected doubling in the national freight task over the next 20 years.

COAG also agreed the Competition and Infrastructure Reform Agreement (CIRA), which provides for a simpler and consistent national system of economic regulation for nationally-significant infrastructure, including for ports, railways and other export-related infrastructure. The agreed reforms aim to reduce regulatory uncertainty and compliance costs for owners, users and investors in significant infrastructure and to support the efficient use of national infrastructure.

COAG agreed energy market reforms which aim to improve price signals for energy consumers and investors. This included a commitment to the progressive national roll out of 'smart' electricity meters from 2007 – currently expected to commence at the end of this year – to allow the introduction of time of day pricing and to allow users to better manage their demand for peak power.

COAG also agreed to ensure the electricity transmission system supports a national electricity market, providing energy users with the most efficient, secure and sustainable supply of electricity from all available fuels and generation sources, and include where appropriate an increased share of renewable energy. COAG committed to adopt suitable policy settings, governance and institutional arrangements and to undertake other actions to improve the framework for planning and network investment and to streamline regulation.

These energy market reforms are a significant undertaking. Progress in implementing energy reforms, however, has been variable, with significantly different approaches emerging in different States and Territories. The national electricity market essentially remains a series of regional markets with limited interconnectedness and ineffective market-based pricing for network services due to poor market design.

And then there is water.

It has been said that while I know about Treasury, I don't know about water. Instead of talking to you about water, then, I'll talk to you about Treasury. The business of Treasury, as classically understood, refers to the management of finance, especially borrowing.

When I came to work in the Australian Treasury in 1984 and applied for a home loan from one of our trading banks, I was told that I had to join a queue. Bank-originated mortgage interest rates had been capped under the former Coalition Government at 13½ per cent. (The cap was removed by Treasurer Keating in April 1986.)

When a product has an administered price ceiling below the level that would emerge in a free market, it will be in excess demand and some mechanism will have to be found for rationing access to it. Sometimes, the rationing will be left to the seller. Thus, in response to regulated interest rates, Australian banks developed lending criteria that rationed access according to increasingly tough credit risk standards that gave very high weightings to accumulated wealth. Remarkably, people in power were surprised to find that the interest rate cap was having a regressive impact. It's a wonder the political response wasn't to set up a bureaucratic apparatus to undertake the housing loan rationing task on a more 'equitable' basis.

An innovative minister might even have proposed using vast sums of taxpayers' money to develop imaginative programs that would have reduced the funding needs of borrowers with larger houses as a means of releasing more funds to go around the system.

Think that far-fetched? If you do, then you don't know much about water either.

For what it's worth, I'll tell you just a little bit of what Treasuries do know about water.

If we had a well functioning market in water, all users would pay a price that reflected not only the amortised costs of water storage and reticulation infrastructure, but also its scarcity value. Moreover, while water wouldn't have the same price everywhere, arbitrage would ensure that any difference in the prices paid for water between any two places and/or any two points in time would be no larger than could be explained by the costs of 'transport' and storage in moving water between those two places or points in time.

In times of drought, water prices would rise in order to equate demand and supply; just how high they would rise depends not only upon the severity of the drought, but also the price-sensitivity of both market demand and market supply.

In a well functioning water market, drought-induced increases in the price of water would reallocate water among users, with a higher proportion of it flowing to those who valued it more highly. In any place, or at any time, at which its marginal value fell short of its price, water would not be used. On the other hand, if a suburban gardener valued her roses sufficiently highly, she wouldn't have to stand by and watch them die.

The supply response is even more important. The drought-induced increase in price would provide the signal for investment in additional supply, including things like desalination plants, new dams and water recycling plants. When brought on stream, these investments would reduce the price of water. That is the logic of markets: additional supply reduces price rather than, as under current water arrangements, increasing it.

Obviously, we don't have well functioning water markets; not in the cities, and not in irrigation areas either. Instead, we have administered prices, legal protections on restraint of trade and, as a consequence, rationing. Rationing tends to be egalitarian. For example, in the towns and cities, the common practice is that 'odds and evens' water restrictions are first imposed, then progressively more restrictive, but persistently uniform, levels of access are mandated.

And, in the irrigation areas, where nascent markets remain severely restricted by institutional, legislative and administrative barriers, the rationing can be even blunter: the Dethridge wheels stop turning and the computerised flume gates run bone dry.

Egalitarian rationing must be popular. Perhaps it appeals to basic communitarian instincts accepting of the need for common sacrifice in times of adversity. Even so, it isn't long before neighbours start checking up on one another over the back fence to see if there is any 'cheating'; neighbourhood vigilante groups spring up; and the water administrators are forced to employ a team of highly visible taxpayer-funded 'water monitors' to defuse neighbourly tensions. Tragically, there are never enough taxpayer resources to prevent every instance of 'water rage', and it isn't long before we have human casualties.

‘Water rage’ is an appropriate label. Its better known cousin, ‘road rage’, is also a consequence of excess demand; in that case, an excess demand for the road surface. Traffic congestion performs the allocation task. Like water rationing, the allocation is extraordinarily inefficient: the Bureau of Infrastructure, Transport, and Regional Economics has estimated that traffic congestion costs the Australian economy about $9.4 billion a year.

In addressing the Productivity Commission roundtable on the topic of ***Productive Reform in a Federal System*** [1] nearly two-and-a-half years ago, I identified energy, water and land transport as three key candidates for the development of national markets, arguing that ‘the case for governments facilitating the development of highly efficient national markets for key business inputs in a country as remote and geographically fragmented as ours is overwhelming’. I noted that our achievements had, to date, fallen well short of that goal. I suggested that ‘it may not be too much of an exaggeration to say that the only significant business inputs for which we do have national markets are financial capital, post, telecommunications and aviation’.

Not much has changed.

You will hear many explanations for the slow rate of progress in the development of national markets. Energy, water and land transport have generally been regarded as ‘essential’ in a politically meaningful sense. Existing institutional arrangements are complex, characterised by many agents with competing objectives, often parochial, super-sensitive to blame-shifting and cost-shifting, and accustomed to travelling well-worn paths to deeply entrenched positions. But while these features are descriptive of present arrangements, they don’t explain them. In addressing the Productivity Commission round table, I suggested that the central explanation for slow progress in these areas is an aversion to the logic of markets.

That aversion seems to be based on a fear of distributional consequences.

Of course, there are legitimate reasons for governments to be concerned about the distributional consequences of markets. But Australian governments have numerous policy instruments available to them to ameliorate distributional consequences. And they have not been afraid to use them. For example, since the early 1970s, social security and welfare payments excluding unemployment and sickness benefits and payments for aboriginal advancement have been lifted from 3½ per cent of GDP to around 8½ per cent of GDP. That increase in redistributive transfer payments is worth more than $55 billion a year.[2] To put it another way, expressed in 2006-07 dollars, these transfer payments averaged $1,400 per head of population at the end of the Whitlam Government in 1975 and, 32 years later, at the end of the Howard Government, averaged $4,000 a head.

Transfer payments are not without their problems, including adverse impacts on work and saving incentives, but they generally achieve more transparent distributional, as well as more efficient, outcomes than interference in markets through administered prices and rationing.

The area of the NRA with the greatest potential benefits for the Australian economy, and the one that Ian Little pressed the hardest, is the human capital stream. In February 2006, COAG agreed a comprehensive framework of objectives for the human capital agenda, focused on improving health, education and training outcomes and encouraging and supporting work.

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[1] ‘Time to “get real” on national productivity reform’, an edited version of which appears in Productivity Commission, *Productive Reform in a Federal System*, roundtable proceedings, Canberra 27-28 October 2005, published April 2006 (pp. 337-344).

[2] It is an important, though quite separate, question whether redistributive transfers of that magnitude are appropriate.

However, 14 months later, in April 2007, when the first tranche of specific reforms was unveiled, there was reason to be under whelmed. Agreement was limited to four ad hoc initiatives: $200 million to address significant growth in type 2 diabetes; $40 million over four years to assist indigenous adults in regional and remote areas to access further education and training opportunities; the development of a core set of nationally-consistent teacher standards for literacy and numeracy; and an intergovernmental agreement on a national approach to quality assurance and regulations for early childhood education and care.

There remains significantly more that can be done to realise the large potential benefits of the NRA human capital stream.

The failure of the NRA to achieve more meaningful reform in the human capital stream and the disappointing pace of implementation of the substantial and worthwhile reforms endorsed two years ago in the competition and regulatory reform streams can be attributed, in large part, to funding issues.

The absence of financial incentives and effective sanctions for failing to meet agreed timeframes and milestones probably explains most of the disappointing implementation progress to date. The aversion to the logic of markets to which I referred earlier can be managed only by financial flows.

Today, however, there is cause for optimism.

Less than a month after the November 2007 federal election, the Council of Australian Governments met here in Melbourne to reinvigorate the National Reform Agenda.

Heads of government recognised they had a unique opportunity to put behind them the tensions of the past, and deliver a substantial national reform effort.

At that meeting, COAG identified seven areas for its 2008 work program: health and ageing; education and training; climate change and water; infrastructure; business regulation and competition; housing; and indigenous reform. A set of working groups, headed by Commonwealth ministers, has been established to identify reforms for COAG's consideration, and to drive their delivery.

COAG also agreed to have the nation's Treasurers develop a plan to rationalise the 89 specific purpose payments, worth about around $30 billion a year, under which the Commonwealth mandates conditions that usually provide the States and Territories with very little or no flexibility in program design or delivery mechanisms. The States and Territories have maintained, for a very long time now, that better national outcomes could be achieved with greater emphasis on outcomes and fewer input controls. Treasurers will report to COAG at the meeting to be held later this month.

In the COAG work program agreed last December, there is an opportunity to revisit the February 2006 NRA commitments and to endorse more ambitious reforms – particularly in the field of human capital, which, while offering the largest gains, has been largely neglected to date.

Reforms are hard work. Simply pouring more Commonwealth money into these areas isn't going to provide the answers. These problems, which are very much worth worrying about, have a strategic dimension. They demand a long hard look, an evidence-based analytical crunch, and their solutions demand painstaking implementation. In short, they demand precisely what Ian Little would have brought to them.

All of us who would want to honour Ian have a wonderful opportunity, in the COAG work program, to do so. We can honour him best through our leadership.

Leadership that has a clear sense of the national interest. Leadership that is prepared to step away from entrenched positions of the past. Leadership that is willing to stand up against vested interest. Leadership that embraces tough decisions.

Last year, I re-read an excellent paper written by Ian Castles 20 years earlier[3] that had addressed some rather ill-informed claims made by a couple of commentators concerning the motivations (and certain other characteristics) of the Australian 'policy advising elite'. In this paper, Ian reproduced a short extract from Sir Keith Hancock's *Australia*, published in 1930. The passage resonated with me. It would have resonated also with Ian Little. And I hope it would resonate with many of you. Here are just a few sentences from it:

> The Australians have always disliked scientific economics and (still more) scientific economists. They are fond of ideals and impatient of technique. Their sentiments quickly find phrases, and their phrases find prompt expression in policies. What the economists call "law" they call anarchy……..The Australians are a good-tempered, open-handed people. They dislike refusing favours, and they do not count costs.[4]

Ian Little would have added: 'especially opportunity costs'.

Like his fellow Australians, Ian was good-tempered, open-handed and generous with favours. Yet he was also proud to be a 'scientific economist'. Were he here tonight, Ian would have wanted to make sure that the nation's reformers appreciate the uncommon opportunity that presently confronts them. And he would have made sure also that we understood all of the costs of failing to grasp that opportunity. This is not a time, Ian would have said, for failing to count costs.

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[3] Ian Castles, 'Facts and fancies of bureaucracy', in ***Treasury – Its Policies and Personalities***, Canberra Bulletin of Public Administration, December 1987, pp. 35-45.

[4] W K Hancock, *Australia*, 1930; cited in Castles op cit, pp. 43-44.