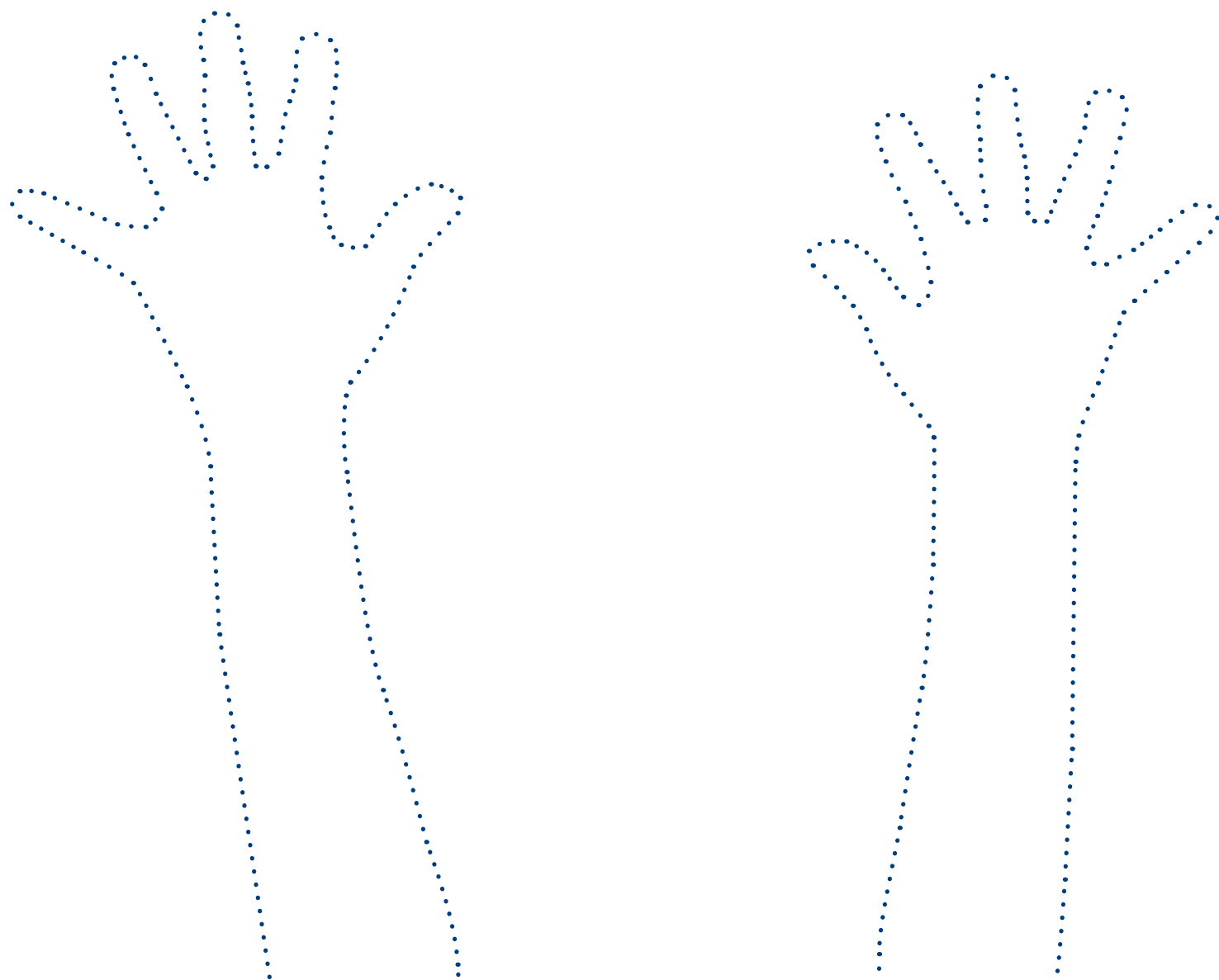


MEMO TO A PROGRESSIVE PRIME MINISTER

Australia: The Investing Society

David Hetherington

Michael Cooney



INVESTING SOCIETY **FUTURE** HUMAN CAPITAL **VISION** FULL-COST ECONOMICS **TRUST**

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2007



About Per Capita

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

Since its inception, Per Capita has hosted leading Australian and global thinkers, including Kevin Rudd, Will Hutton, Walter Russell Mead, Alan Milburn, John McTernan, Peter Hartcher, Nick Rowley and Andrew Charlton.

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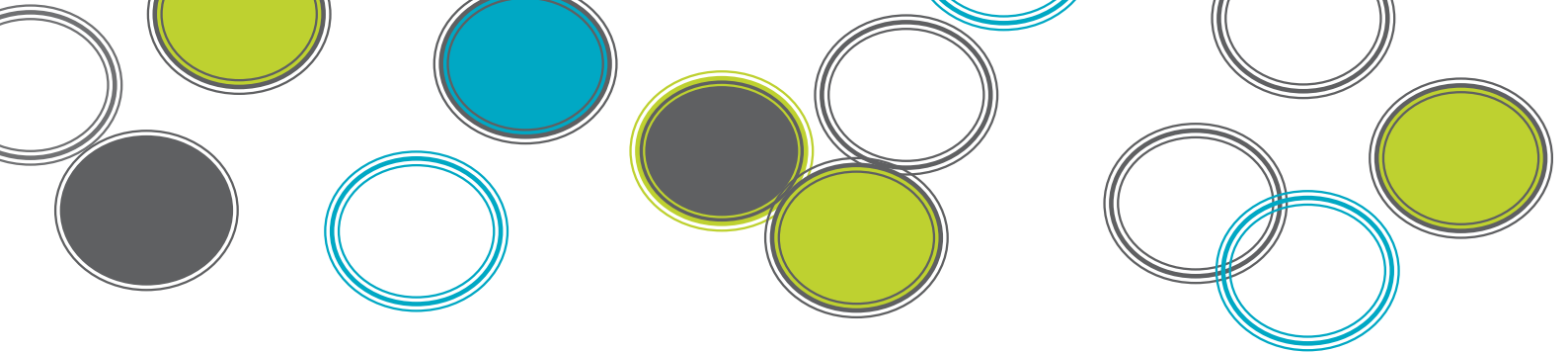
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Acknowledgments

The authors would like to thank Dennis Glover, Rod Glover, the Per Capita board and other friends for their thoughtful contributions to this paper. Naturally all errors remain our own. Most importantly, we would like to gratefully acknowledge the support of Per Capita's donors, without whom this work would not have been possible.

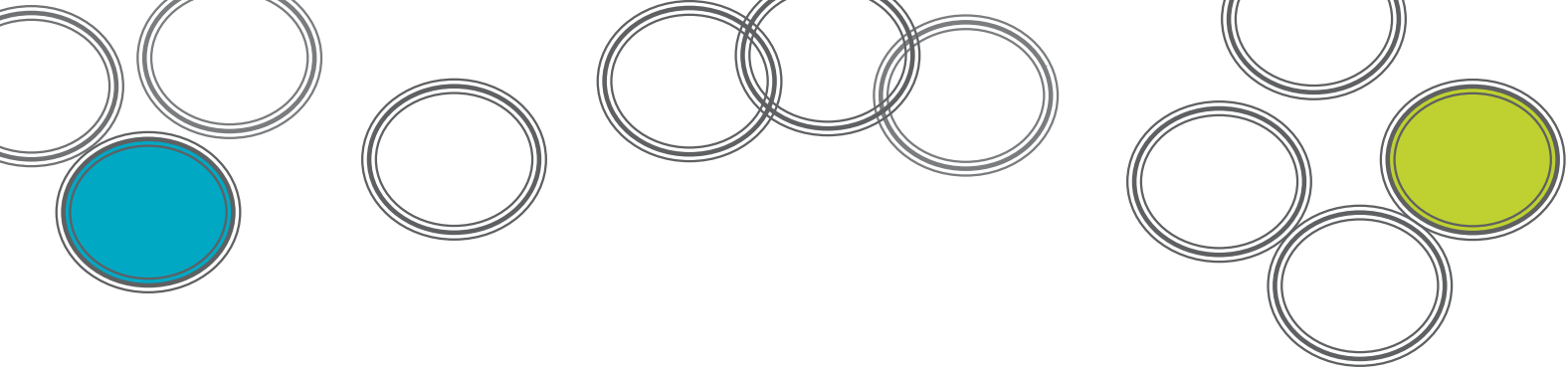
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Executive Summary

Dear Prime Minister

As a think tank dedicated to building a new progressive vision for Australia, we take the moment of your election to propose a new progressive governing project.

We call this project the Investing Society: a renewed investment in sustaining our prosperity and in strengthening our communities. Politicians of all parties share this rhetoric, but the basis on which past governments have applied that rhetoric through policy has been fundamentally flawed. Our most pressing problems can't be solved through the doctrines of individual responsibility or Big Brother statism – their resolution needs an entire community.

The Investing Society offers a different way of doing politics, not just the old way of politics with more money attached. You already know that government is a different challenge. Winning the election required tactical nous, policy coherence, minimisation of error and management of message. Successful government demands strategic vision, policy experimentation, embrace of risk and most importantly, an articulation of values.


Your career has been inspired by progressive values, and you now possess a rare opportunity to reshape the country in line with those values. You recognise the virtuous circle of prosperity and fairness. You understand the importance of community in Australian life. You look forward not back, and appreciate that the opportunities of reform offer more than the safety of status quo.

Your campaign offered progressive reform wrapped in fiscal conservatism and it is critical that you observe the campaign commitments. This plan will be the minimum threshold by which you are judged. It is necessary but not sufficient for your governing success. We believe you can go further and re-engage government with people's lives by delivering a big project, grounded in a firm understanding of individual and community needs.

Prime Minister, your role is to lead not only your government, but our nation. So the Investing Society is a national vision, not just one more call for government to spend its way out of our big problems. The era of multi-billion dollar 'headline' packages must end. Instead, your leadership should focus on the means through which we can increase overall investment, and the innovations that will make that investment work harder for returns. To do this, we argue that government must move towards economic incentives and away from social controls.

The five key features of the Investing Society are:

- **Full-cost economics:** a holistic understanding of private and social costs/benefits, capturing externalities, options, and risk, plus market design which correctly allocates costs/benefits between private sector, citizen and the state.
- **Debt for investment, not consumption:** a step-change in value-creating investment relative to debt-funded consumption, with an acknowledgement that debt is no bad thing when invested in productive capacity.
- **A national investment effort, public and private:** recruitment of private capital alongside government funds to create new infrastructure, enhance workforce skills and motivation, and widen the circle of social inclusion and participation.



• **An intergenerational investment horizon:** a long-term approach to value which captures the enduring returns of today's investments for future generations. If government isn't in for the long haul, who will be?

• **New measurement systems:** a comprehensive accounting of outcomes and returns based on empirical evidence. An Investing Society is meaningless unless competing investment decisions can be evaluated and prioritised in a systematic manner.

Your government can build the Investing Society by focusing on the two big policy themes of market design and human capital investment. Designing markets and investing in people brings together the economic and social roles of government in a new fusion.

Market design is about setting the 'rules of the game' to get the right outcomes – in new markets like carbon, water and broadband, and in old markets where existing provision has failed, like infrastructure and housing. With good market design, governments harness market forces by setting incentives and accounting for risk.

Human capital is Australia's most valuable asset and you have rightly made it the centrepiece of your education revolution. In addition to building human capital, your government should focus on protecting this precious asset: damaged human capital means opportunities lost and lives destroyed. Human capital investment not only makes economic sense, it's morally right.

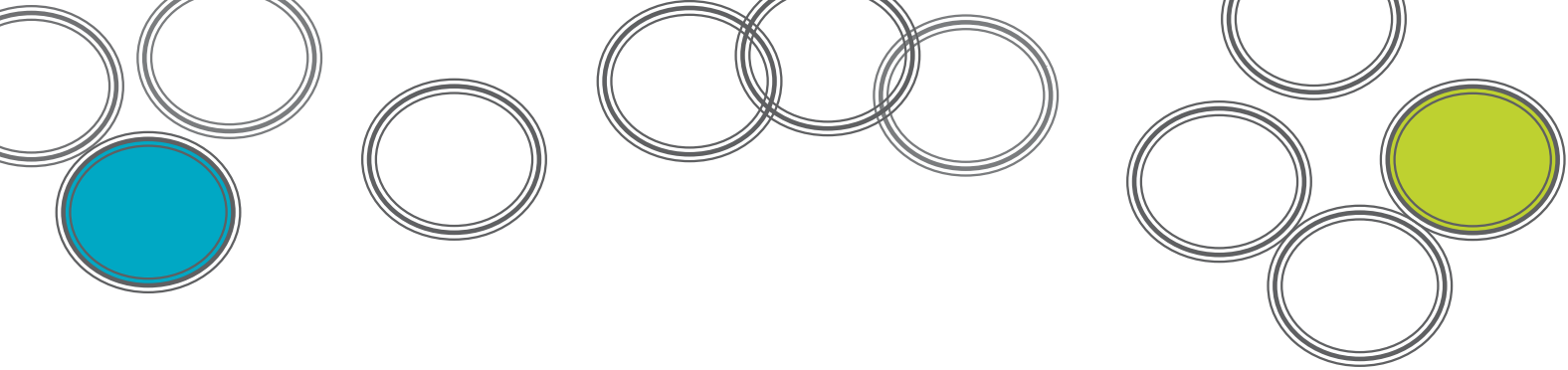
Our memo proposes four 'aerodynamic' policy strokes, offering powerful lift with minimal drag, to launch the project over the next twelve months:

- **a carbon price**, ASAP, to deliver certainty to consumers, producers and investors alike;
- **individual learning accounts** to stimulate new streams of public and private human capital investment;
- **a national water market**, with prices equal to production costs, and support for low-income households whose inability to consume would incur social costs;
- **a Kids' Day holiday** to replace the Queen's Birthday, with prizes for kids, teachers and schools – a holiday celebrating the future rather than the past.

We also enclose four examples of 'one-pagers' that you could write and keep. What it is you actually do; what you want people to say you achieved; what the big risks to your project are; and even how you should manage your in tray and your daily folder.

Prime Minister, every time you are presented with a hard decision, ask yourself: which response is consistent with my progressive values? These values are the passions which animate the Investing Society, these are the logic behind the bold strokes and they are what will underpin your success in the eyes of the Australian people.

Per Capita
November 2007



Section I: The nature of the challenge

Prime Minister,

The earth moved in Australia this week. Like any major seismic activity, this event is rare. Australia's Government has now changed just five times since 1950. And like seismic activity, its full impact will take some time to emerge. Will your election prove a tremor, or will it redefine the national landscape?

The answer depends on you. You have a rare opportunity to shape the country for the better. Grasp it and you improve Australian economy and society for a generation. Let it slip through your fingers and you finish as an historical footnote, overwhelmed by events.

You already know that government is a completely different challenge to winning the election. That required tactical nous, policy coherence, minimisation of error and management of message. Successful government will demand strategic vision, policy experimentation, embrace of risk and articulation of values.

You are progressive. Throughout your career, you have embraced the core progressive values: looking forward, not back; the importance of community; and the virtuous circle of prosperity and fairness. These values should infuse your government and define your legacy.

But the demands of the campaign have left you with a raft of conservative commitments, from school funding through income tax to pensions. You even embraced the tag 'economic conservative' to describe your fiscal and monetary policies. Some commentators have gone so far as to call this the final victory for conservatism in Australia.¹ Naturally, we disagree.


It is critical that you observe these commitments in order to rebuild trust between the Australian people and their politicians. From the first minute in office, you will confront a host of other pressures demanding conservative, reactive, short-term responses. But you cannot let your natural prudence confine you to conservative positions on wider policy issues.

All this makes your job even more difficult.

In government you must target prosperity with fairness, and those policy solutions which bring together individuals, families, businesses and governments in partnership. Our most pressing problems can't be solved through the doctrines of individual responsibility or Big Brother statism – their resolution relies upon our whole society.

Now is the hour. Between now and your first Budget, you must outline a bold project and a powerful execution strategy. This is what distinguishes the most influential democratic leaders.

Reagan declared 'Morning in America', symbolising optimism, confidence and global leadership after the oil shocks, recessions and malaise of the 1970's. Blair offered 'New Labour, New Britain' signifying



his party's willingness to accept Thatcher's economic reforms but also its determination to build into these Labour's traditional social justice concerns. These were more than just slogans: they came to represent the value systems underpinning their authors' program for change.

This memo proposes such a project: '**Australia: The Investing Society**'. The core philosophy of this project is that successful nations invest in their long-term futures, and that the role of responsible government is to champion this investment. Although Australia is enjoying an extended period of prosperity, we continue to face critical challenges: from climate change and rising energy prices, to household debt and housing affordability, right through entrenched disadvantage, and the threat to middle class jobs from China and India.

Now is the hour. Between now and your first Budget, you must outline a bold vision and a powerful execution strategy

Australians recognise the reality of these challenges; they played a major part in your election victory. But meeting them requires an investment in creative, long-term solutions.

The Investing Society calls for renewed investment in sustaining our prosperity and strengthening our communities. Politicians of all parties will share some of this rhetoric. But the basis on which past governments have applied that rhetoric through policy has been fundamentally flawed. To come good on your priorities you must use fresh ideas to alter the institutional framework through which market exchange and community life take place.

In the United States, the Heritage Foundation presents each incoming President with a policy program, *Mandate for Leadership*.² This memo presumes to do the same for Australia.

Section II of the memo assesses the need for a new progressive project and explores the contours of the Investing Society. Section III considers the big policy themes of human capital investment and market design, while Section IV proposes the bold strokes required to launch the project.

We enclose four example "one-pagers" that you could write for yourself and keep with you as a tool to keep your own focus. What it is you actually do; what you want people to say you achieved; the big risks you must keep in mind; and even how you should manage your in tray and your daily folder.

Section V concludes with an examination of the critical role of progressive values in the project's success.

opportunity



Section II: The Investing Society - A new progressive project

Prime Minister, the Investing Society describes not just your government, but our nation. What we are proposing is a new progressive project for Australia: a new kind of government, with new policy themes, to grab the new national opportunities. In the leaders' debate, you said you believe in

"...a strong economy... but still giving working Australians a fair go through the industrial relations system, through the education system, through the hospital system. And by looking after the next generation of Australians through intergenerational justice. Doing something about climate change and water as well. [These things] form the core element of my plan for Australia's future, and if the Australian people support us, it's the plan we'll be implementing..."³

This plan will be the minimum threshold by which you are judged. It is necessary but not sufficient for your governing success. You need to go further and re-engage government with people's lives by delivering the Investing Society: a big project, grounded in a firm understanding of individual and community needs.

So what does the Investing Society look like? It has five defining characteristics:

- Full-cost economics
- Debt for investment, not consumption
- A national investment effort, public and private
- An intergenerational investment horizon
- New measurement systems

Let's examine each of these in turn.

Prime Minister, the Investing Society describes not just your government, but our nation.

Full-cost economics

The Investing Society relies on a holistic understanding of both private and social cost/benefit. Most investment decisions are based on a calculation of private costs and benefits. An individual or a business will decide what their costs will be, how much they'll generate, and whether the net gain is worthwhile. In theory, governments make a slightly different calculation, as their costs are 'social costs', either met directly by the taxpayer or borne elsewhere as externalities and opportunity costs. 'Social benefits' are more complex again and require even more detailed consideration.

Take the example of a girl placed in an early childhood development program co-funded by parents and government. Evidence suggests that this girl is more likely to graduate from high school completion and

own a home, and less likely to have contact with the justice system than if she had not participated in the program.⁴ The direct benefits to the taxpayer are obvious: increased tax receipts and reduced welfare payments. Other social benefits are less tangible: more education leads to better health outcomes, and reduced contact with the justice system further frees up taxpayer funds. Most importantly, the higher educational achievement of this girl foreshadows higher educational achievement (and income) for her own children, demonstrating the intergenerational multiplier effect of social investment.

Will your election prove a tremor? Or will it redefine the country?

So the social returns of this investment include increased tax receipts, reduced direct welfare payments, indirect reductions in health and justice spending, and improved prospects for a household of kids. Quantifying social benefits is extremely challenging. But when we decide how much to invest in an area like early childhood or employment services, we should certainly try to account for the full range of these benefits.

In the case where an investment delivers both private and social returns, there is an inevitable tension over who bears the cost. Consider another hypothetical – one close to home. As a society we see water savings as a social benefit. Yet take the electricity generator which receives its water for next to nothing. It could invest in a new plant whose efficiency gains are largely based on reduced water usage. But when the water is virtually free, the water savings do not deliver a return, so the investment does not proceed.



Your opportunity is to bring forward economic policies and approaches which do more to encourage the investments that really work. The Investing Society designs markets to fully capture and correctly allocate costs and benefits between private sector, citizen and state.

Your in-tray: What should be in it at the start of every day

You'll be formed by the information you put before yourself. You are what you read. That can be all media and short-term political distractions – or it can support your political values and your long-term policy plans. So think hard about what you have in front of you everyday.

The folder you carry every day with your diary on the front page is crucial. So as well as short term detail about your day and week, it also needs to contain:

A one page job description – just what it is you do. Write it now.

Another one page on what you want to achieve. Write that now too.

The name of the person (staff member, bureaucrat, minister) who reports to you on:

- o Your aerodynamic policy measures: education accounts, the carbon price, the water market, and Kids' Day.
- o Your big risks and uncertainties: the Aussie dollar, the commodity boom, the housing bubble, jobless households, and national security.
- o Election commitment implementation. This should include a table of election promises, sorted by Minister responsible for their achievement, and with timetable for delivery.

For each of those people, the actions agreed when you last met, and the date of your next meeting.

The names of your half a dozen most promising back benchers – the new MPs who are your government's future – and how they plan to get ready for higher service.

The information you take in first thing in the morning is also key. Without careful management, day by day you can be dominated by news media as a source of knowledge and an object of attention. So as well as containing your folder, in your in-tray there should also be some regular reports – reports that match your progressive priorities – plus some key indicators of the realities of life in our cities and towns.

Tracking carbon emissions against your annual, 2020 and 2050 targets.

An overnight report on Australians in the field – in Afghanistan, non-combat troops in Iraq, East Timor and elsewhere.

A basket of rolling indicators of children's wellbeing.

Petrol prices, childcare fees and mortgage stress for the last year – plus market predictions for the next year.



Debt for investment, not consumption

The Investing Society requires us to rethink the mix in our economy between consumption and investment, and the role of debt in funding both. Consumption has underpinned our recent economic boom. Most retailers are recording ever-increasing profits, and month after month, commentators express surprise at the resilience of the Australian shopper in the face of interest rate hikes, petrol price rises and sharemarket jitters.

Two points are significant here. The first is that much of this consumption has been funded by debt. Over the last 10 years, our net private foreign debt (excluding government borrowing) more than tripled, from \$191bn in June 1997 to \$598bn in June this year.⁵ Critically this debt has not been invested to generate a matching growth in our national assets. Our national 'gearing ratio' – the ratio of total debt to total assets – has jumped from 12.7% to 22.3% over the same ten year period.⁶

Much of the debt is owed on mortgages and credit cards, but our ultimate creditors are the citizens and governments of Asia. The entry of over a billion people into the global labour market, from an avid saving culture, has funded the consumption boom in Australia, the US and elsewhere.

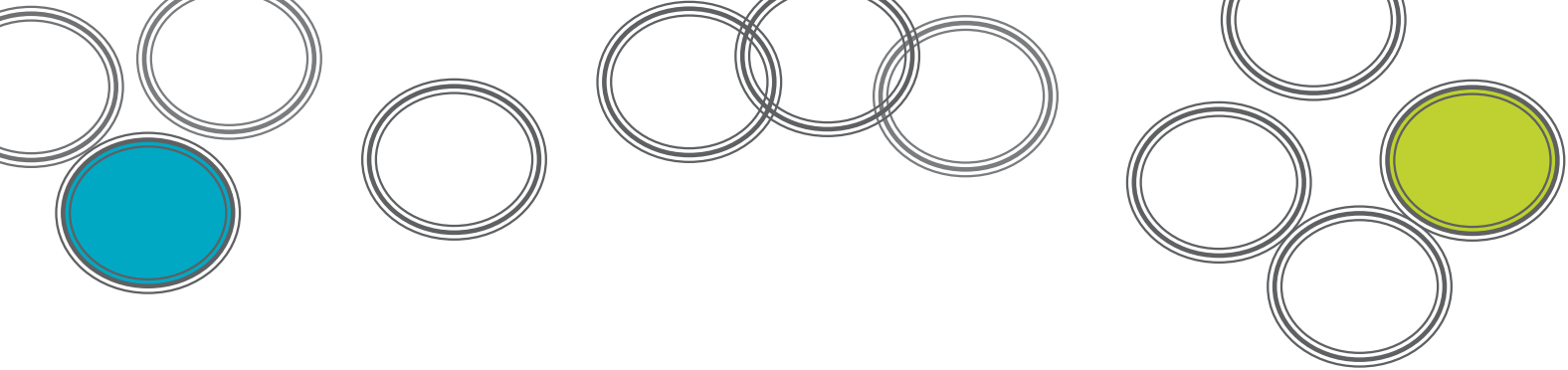
Debt is no bad thing provided the debt is invested in value-creating assets

For now, Australia's debt position appears sustainable. However an external shock, like an extended global credit crunch or an oil supply shortage, would place extreme pressure on mortgagees, credit card holders and leveraged firms. This is why your government should champion a savings culture in Australia. A leap forward as great as the development of our superannuation funds industry is required – both as a buffer against shocks and a catalyst for new investment opportunities.

The second key point is that, even with a new savings culture, Australia will continue to carry considerable debt. Of course, debt in itself is no bad thing – provided the debt is invested in value-creating assets. Debt-funded retail consumption offers enjoyment for today, not a source of new value for tomorrow: there is a finite capacity for our society to shop using debt. Equally, residential property investment is not value-creating, unless it is creating new supply or upgrading existing stock. Simply buying a property for capital growth might create a monetary gain, but it is not economically productive – no new asset is created.

So where possible, Prime Minister, your government should facilitate investment in the big value-creating assets that will sustain the country's prosperity like education, infrastructure, water and energy technology.

This is not just a question of how much spending the Commonwealth government can direct into each area. The era of multi-billion dollar 'headline' packages must end. Instead, your leadership should focus on the means through which we can increase overall investment, and the innovations that will make that investment work harder for returns.



We argue that these include national markets, incentives for research and development, public-private co-investment and removal of barriers to entry to improve the investment climate. However, these will only stimulate a step-change in investment if in parallel, you are able to make a strong case for expanding our public understanding of costs and benefits: a case for full-cost economics.

A national investment effort, public and private

The Investing Society is a national vision – it calls for participation by individuals and families, firms and unions and governments alike. It demands greater public *and* private investment in our society's future. It is *not* just one more call for government to spend its way out of our big problems. This model has been emphatically disproved. In a powerful critique of state economic planning, John Kay argues that the volume of information and complexity of feedback loops in a modern economy make it impossible for government alone to manage the response to fundamental national challenges.⁷


The conservative critique of your leadership credentials is that you and your team cannot be trusted to safeguard the national accounts, that you will introduce 'big government' spending and fritter away our hard-won public surplus on special interest groups and soft-left causes. This is a classic false debate. In fact, the size of government in Australia has grown consistently since 1980 under both Coalition and Labor governments, as measured by social expenditure as a percentage of GDP. This is a function of an increasingly complex society and popular demand for more, more, more from modern government.⁸

In recent years, the former conservative government succumbed to an increasingly short term and wasteful approach to this expenditure, taxing with one hand while with the other returning the money in handouts and consumer subsidies - think one-off family payments or seniors' bonuses. The challenge for you is to move forward to an approach to investment that adds to Australia's productive capacity, by creating new infrastructure, enhancing the skills and motivation of the workforce, and widening the circle of social inclusion and participation.

The Investing Society is a national vision. It is not just one more call for government to spend its way out of our big problems

These pressures on government will only continue to grow, so you will need to find ways to meet that demand. It is important to remember that there is no inherent virtue in a budget surplus: there is no point in saving for a rainy day when the country is drying up. To meet our great national challenges, you must invest your surplus into new solutions, based on a careful assessment of risk and return.

There is a limit, however, to what governments can do – individuals and businesses have crucial roles to play. Private investment in health, education and infrastructure has expanded in Australia over the last



generation, but there is much more to do. Government should not determine private investment decisions, but you can foster the Investing Society by creating a positive investment climate. This requires you to “price in” the benefits for socially positive investment, thus underpinning a persuasive case for an investment approach to national renewal.

In short, you should be moving toward economic incentives and away from social controls.

An intergenerational investment horizon

The Investing Society adopts a long-term approach to value which captures the enduring returns of today’s investments for future generations. Conventional finance theory discounts returns over time so that after 10 years, the residual value of most investments approaches zero. Put simply, current practice doesn’t ascribe nearly enough value to anything a decade into the future.

The Investing Society asks investors to be patient.
If government isn’t in for the long haul, who will be?

The effect of this is to discourage investments whose returns aren’t ‘front-loaded’ in the next few years, or where the majority of the returns accrue in the medium- to long-term. This approach is misguided for two reasons: it ignores the latent worth of an investment beyond its designated payback period and it undervalues the welfare of future generations relative to the current one.

The Snowy Mountains Scheme and the Sydney Harbour Bridge are each examples of major investment projects that continue to deliver benefits long after their original capital costs have been repaid. Yet in the original investment case, today’s benefits would effectively have been valued at zero. Often this occurs because the operating life of the asset is underestimated, a mistake that’s been historically made with housing, roads and transport investment.

All this makes the investment more difficult to justify and open to politically motivated attack. This is particularly the case for projects where the operating return might be negative in the early years of the asset life.

So you need the courage, Prime Minister, to champion major capacity-building investment projects, jointly funded by private and public money, even in cases where the short-term return is negative. The Investing Society asks investors to be patient, as history shows us that these capacity-building projects reward investors who stay in for the long haul. If government isn’t in for the long haul, who will be?

future

Write yourself a one page job description.

Here's what we think it is

A voice in the nation. Speak for country, government, party, and self. Perhaps above all else, you speak to and for Australians. Be honest with people about what you're doing and always explain why – motivation builds trust. Trust and respect are relationships – if you give them you'll get them. And you have to articulate a positive, progressive patriotism that shows the way Australians love their country without dividing it.

Develop government strategy. Set objectives. There are big opportunities and big challenges for our country. You need to be the one who says what you want Australia to achieve. Don't let others set tests for you. Be your own task master.

Deliberate decision-making and long-term planning. In Cabinet. You can't do it all. With your Cabinet, your job is to assign responsibility for delivering objectives to senior individuals, choose between options for action to achieve objectives, allocate budget and resources, assign constraints on delivery, and measure performance.


Team building. The country isn't run by your office, or by a dozen or so Cabinet ministers. So you need to build the core of five hundred people who run the country: judges, generals, executives of government departments, executives of public enterprises, ambassadors, vice-chancellors. They shouldn't all be partisans, but they should all work with you for progress towards the Investing Society.

And there are many people who are crucial to your success who are outside of your control. You need to build good relationships with opinion leaders, the leaders of business, the Premiers, including conservatives, right up to the foreign leaders in the four crucial capitals for Australia's interests: Jakarta, Tokyo, Beijing and Washington.

Immediate decision-making and crisis management. You must drive response to events and ensure the Government acts according to your own progressive values. Especially early on when things happen rapidly, the bureaucracy will be slow to remember that the people have elected a Labor Government. You'll need a firm hand to ensure they act in line with your mandate.

Oversee implementation. Deliver on your election commitments. All of them. Then make sure government is actively working in society to solve problems: Get private investment into education. Get jobs into the long tail of jobless households. Get industry responding to carbon and water price signals. Use the dividend from funding reforms to improve kids' health. That will mean you don't need to separately develop an agenda for next term and beyond – it will emerge from the scale and scope of your governing project.

Build constituencies and coalitions through real policy achievements. Re-election demands that you get more Liberal voters to vote Labor and get Labor voters to stay where they are. In Opposition you were judged on good intentions – in Government you will be judged on achievement. Of course you have to measure the politics, make judgements and communicate well. But while you could lose with a good government, you won't win with a bad one. In the long term, politics will always follow policy.



The second reason a short-term investment horizon is undesirable is that it's not fair to our kids. Initiatives whose benefits flow to future generations rather than our own are unlikely to be pursued within our existing framework. The classic example is expenditure to address the impact of carbon emissions. Carbon reduction strategies, while showing a negative short-term return, will deliver enormous benefits to our kids and grandkids. But because we discount these future benefits heavily, the investment does not appear justified.

To rectify this, public investment should be evaluated using a 'social discount rate' – based on rigorous economic and historical research – which values future benefits more highly than conventional discount rates that are based exclusively on cost of capital.⁹ Focusing on the future, not just on today... now that's progressive.

An Investing Society is meaningless unless competing investment decisions can be evaluated and prioritised in a systematic manner

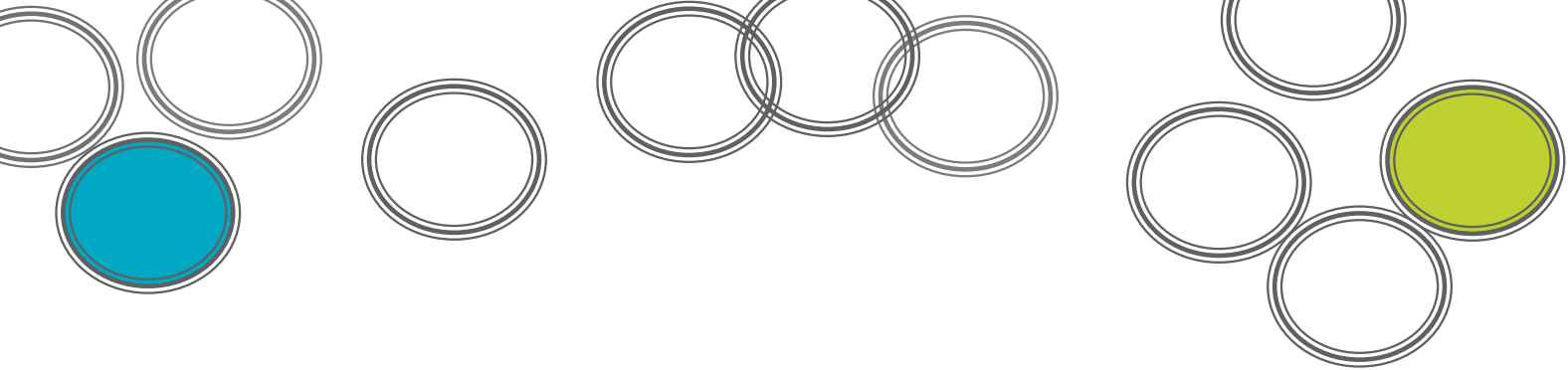
New measurement systems

The final pillar of the Investing Society is a comprehensive accounting of outcomes and returns based on empirical evidence. An Investing Society is meaningless unless competing investment decisions can be evaluated and prioritised in a systematic manner. To assess where the highest return investments are, you must be able to compare apples with apples. This requires the kind of detailed information on inputs, outputs and outcomes only attainable through intensive data collection. It also demands a concerted effort towards a common understanding across government and business of how to account for social costs and benefits.

The first step for government in implementing evidence-based policymaking is to facilitate the development of longitudinal data sets which track individuals' demographic and socio-economic data at regular intervals over time. A benchmark for these is Norway's FD-Trygd which records basic demographics, education level, income and wealth, employment status and industry, employment events and participation in welfare programs for every Norwegian since 1992, with personal identifiers enabling links to be drawn between generations.¹⁰

When this data is used to inform randomised policy trials, governments can test policy on a small scale before rolling out successful approaches on a national level. Overall, genuine and wide-ranging innovation in institutions and methods of delivery must be a feature of progressive government – and will be an essential condition of achieving success towards the Investing Society.

Just as important, when outcome measures are rigorously analysed across the critical dimensions influ-



evidence

encing people's wellbeing and development, they can become a benchmark for accountability and public debate. Picture wellbeing and development statistics dominating news coverage and public debate in the way that short term interest rates and surplus/deficit figures currently do.

The second component of evidence-based policy is an accounting system which requires government and business to recognise the social costs and benefits of their activities. In consultation with business, your government should develop a uniform approach to accounting for externalities which would become mandatory over time. This would force all market participants to carry the social impacts of their investment decisions on the balance sheet, and specifically to recognise the big-ticket externalities of employment and environment.

You could reinforce your commitment to these things with working habits and reforms which would both represent and encourage the kind of vision you want to see.

One is a commitment to transparency about outcomes. You could announce a National Commission on Accounts and Statistics, to report in the first year of your government. It should review whether the framework and methods used for reporting national accounts and official statistics serve the public accurately in reflecting the range of issues affecting national wellbeing, prosperity and security. Further, it should consider reforms to national accounting which go beyond the simple reporting of cash surpluses and demographic projections of the Intergenerational Reports, and instead examine social outcomes and productive investments.

This calls for a genuine commitment to the transparency of all government data, encouraging greater scrutiny and analysis of outcomes data in both communities and in industry sectors, including the public sector.

Finally, the Investing Society allows you to tear down two of the great shibboleths of Australian politics: that policy is the major influence over interest rates, and interest rates are the major objective of policy. You know they're wrong, the experts know they're wrong, and much of the public knows they're wrong – just be done with it. In the 21st century, and excepting gross fiscal recklessness, the cost of money is determined by central bankers and global credit markets.

What government can do instead is responsibly invest the vast sums of money under its control, and deliver an investment climate that encourages others to do the same. The Investing Society offers an economic policy beyond the interest rate obsession.



Section III: The big policy strokes to bring the project together

The Investing Society is built around two major policy themes: market design and human capital investment. These are the themes which sustain the project and guide its major decisions. Market design describes the key economic role of government, while human capital investment is society's tool for nurturing our most valuable national asset.

Market design

As the welfare state model has eroded, government has become less a public service provider and more a procurement agency. Roads, prisons and childcare are just a few examples of traditional government roles outsourced to the private sector. This shift has delivered some success, delivering better value for taxpayers' money and a wider range of services. But it's also failed in key areas - witness our broadband impasse or bottlenecks in housing supply. So the role of government must evolve further. We must count the full costs, and benefits, of economic activities. To get there, our markets must work better. Your government, Prime Minister, must become a designer of markets.

Market design is about setting the 'rules of the game' to avoid market failure – be it underprovision, concentration of market power, or inappropriate accounting of risk, externalities and options. Market design is needed in new markets that didn't exist a generation ago, like carbon, water and broadband, and in old markets where existing provision has failed to deliver, like infrastructure and housing. With good market design, governments harness market forces by setting incentives and allocating risk. The cornerstone of market design is full-cost economics – setting a price by allocating all costs accurately amongst the participants.

Your government, Prime Minister, must become a designer of markets

Market design requires smart, streamlined regulation based squarely on the 'less is more' principle. Incentives (and disincentives) can be delivered through the tax system, weighted in a progressive direction and based on outcomes: employment services are a good example. Barriers to entry can be removed in public markets by lightening cumbersome regulation: electricity markets come to mind. Transfers of risk should be recognised and compensated: industrial relations in a current case in point.

Two particular strengths of market design stand out in the Australian context. The first is that it rebalances national economic policy towards the supply side of the economy. One of the great failings of the conservative orthodoxy has been an exclusive focus on stimulating demand within the economy, through tax breaks, cash-back transfers and targeted subsidies. Conservatives have held consumer choice to be paramount and believed that capacity to supply would somehow emerge from the magic of the market. This is misguided. Australia has failed in capacity building in many critical areas – housing, childcare, infrastructure to name a few – which in turn has driven up inflation. Market design rectifies this by rewarding investment that delivers social benefits through capacity uplift.



The second strength of a market design approach is its ability to improve the economics of the Australian federation. The federation remains saddled with layers of transaction costs from multiple regulatory regimes. Does it make any sense in 21st century Australia that a building services provider must register with separate building commissions in Victoria, Tasmania and the Northern Territory? A national market design approach would treat building services as a single national market, with approval to practice granted by a single national certifier.

Market design provides the right framework for examining the future of federalism. Rather than getting bogged down in an endless search for the perfect constitutional settlement, the focus of intergovernmental reform should be the development of institutional frameworks which optimise market design in those critical areas we have outlined – where all Australian governments should share an interest in better outcomes for individuals and greater long term investment.

The ABS estimates that the total value of the nation's human capital is over five and a half trillion dollars, or more than three times the value of our physical capital

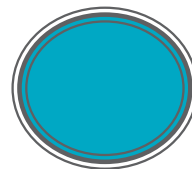
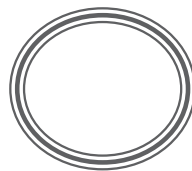
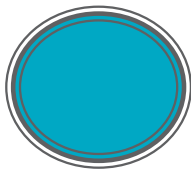
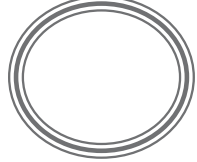
The Commonwealth bureaucracy you now have at your disposal has sophisticated policy tools, especially in economics. On the other hand, it is not good at delivering services, where the expertise tends to reside with State and local organisations. So market design is a natural role for the Commonwealth within our Federal system. At the same time, this requires co-ordination on market design between Commonwealth and State governments that you, Prime Minister, are uniquely positioned to deliver.

Human capital investment

Human capital investment is the second overarching policy theme of the Investing Society, as this builds Australia's most valuable national asset. The Australian Bureau of Statistics estimates that the total value of the nation's human capital is over five and a half trillion dollars, or more than three times the value of our physical capital.¹¹

One powerful argument for human capital is the return on investment it generates, both for the individual and the wider society. Returns to private individuals from human capital investment are widely estimated at around 10%. One Australian study calculates that an additional year of schooling at age 15 increases average lifetime earnings by \$119,000 to \$1.29m.¹²

Moreover, since human capital generates positive externalities through better health and lower crime, it generates additional public returns. Further academic research is required on the scale of these returns, but if we consider reduced spending on welfare, health and social services, plus intergenerational benefits, an estimate of 4-6% seems conservative. A total return (public and private) of 14-16% is higher than



for most commercial asset classes, never mind low-yielding public spending. It is a sound investment for taxpayers and the private sector alike.

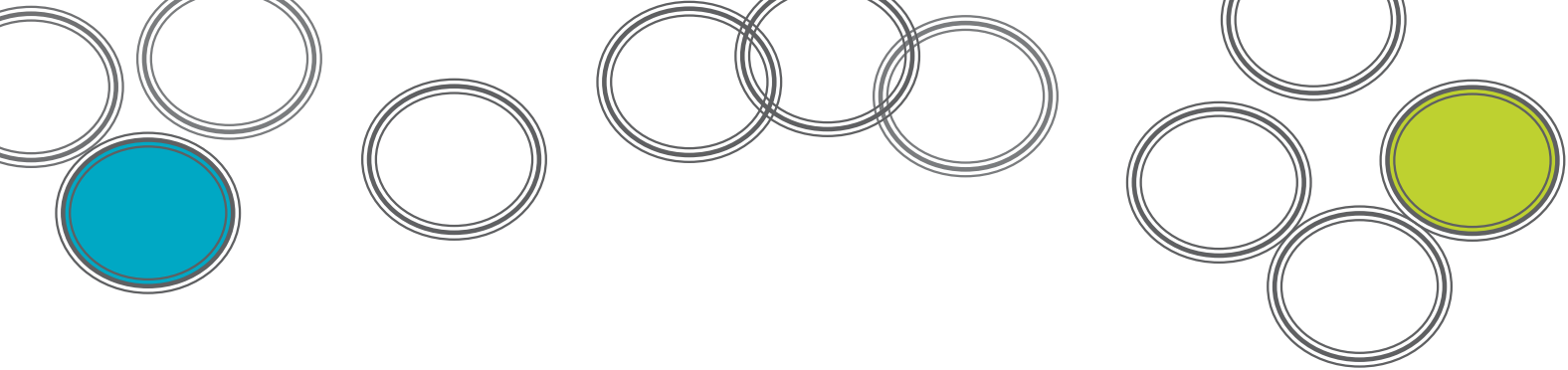
An even higher argument for human capital investment is the moral one. Human capital develops capability by enabling citizens to maximise their innate potential, thus increasing the range of life choices available to them. And it removes many of the bumps in life's playing field: in modern society, an individual's background is increasingly less important than their skills and experience. If we believe we have a responsibility to give our children the best chance of a full and rewarding life, we are morally obliged to invest in their human capital. In this vein, human capital investment offers us a new approach to tackling disadvantage. Despite the long years of the boom, concentrated disadvantage has proved hard to crack in our inner cities, urban fringes and regional towns. Human capital investment is a constructive way of addressing the capability and behavioural problems that we know can arise in a passive welfare environment. It does away with 'big stick' and 'big state' intervention, and gives individuals the tools to build the lives they want to lead.

What should be your government's role in all this? There are two stages in the effective production of human capital – accumulation and protection. The policy mechanism for human capital accumulation can be summed up in one word: education. One simple way to increase the rate of human capital development is to increase the amount of education each citizen receives in a lifetime. In rich countries with compulsory primary and secondary schooling, additional human capital can be created through pre-school or post-secondary education programs.

In Australia, we have fallen behind in this area. OECD research shows that Australia has underinvested in early childhood and tertiary education relative to other rich countries.¹³ Given this, it is little surprise that Australia's labour productivity has stagnated in recent years. As other countries out-invest us on education, we are becoming less competitive in high-growth, high-value service sectors. To rectify this, Prime Minister, human capital investment must be at the centre of your education revolution.

**The policy mechanism for HCI accumulation
can be summed up in one word: education**

The second challenge for your government is to protect the country's human capital stock and remove barriers to further accumulation. Individuals are vulnerable to a wide range of events that damage their human capital including disease, mental illness, accident, and self-harm. Young people are especially vulnerable as their life skills are less developed. Their potential future loss is also greater, both personally and to the country. Government's responsibility is to minimise this damage. Public health initiatives, active labour market programs, and counselling through major life-stage transitions are each important safeguards of human capital. For this reason, investing in measures which increase the protective factors shaping each Australian's progress through life is also integral to human capital investment.



A particularly important element of both these tasks is their extension to indigenous communities. It is no secret that well-being indicators for indigenous people lag far behind those for other Australians, and this constitutes a national failure. You've committed to closing the gap. This is another area where a policy of human capital investment, with a twin focus on accumulation and protection, is the best modern policy approach.

Prime Minister, you have made the case for an education revolution, recognising the importance of human capital. Your priorities must focus Australia not just on expanding and investing in the education and training systems that we have, but on increasing the investment made by everyone, in every sector, in the growth of people's capabilities. This should be measurable in our national accounts, as an ever-growing share of GDP; but it needs to go deeper and broader than monetary investment, into the workings and culture of all our institutions.



Section IV: The bold strokes to move the project forward

The character of your new government will be defined in its first 12 months. So we recommend an 'aero-dynamic' policy approach which offers maximum lift with minimum drag. The best way for the Investing Society project to begin is not with massive disruption of organisations and structures. Rather, it is with bold individual measures which form the project's 'leading edge'.

The archetypal example is the float of the dollar by the Hawke government nine months after its election. In the same way, your policy agenda should be high impact, qualitative changes – not just funding boosts. What you need is new ideas which stand at the beginning of your way of doing government. What you don't need is old money standing at the end of someone else's way of doing politics.

So what are the bold policy strokes which will launch the Investing Society? We propose four. Put a price on carbon, and set up learning accounts for individuals. Develop a national market for water. And turn the old Queen's Birthday public holiday into a new holiday – Kids' Day.

Put a price on carbon

You've already committed to do this in the campaign. The quickest way to move to a low-carbon economy is to put a price on carbon as soon as possible, effectively charging producers for the social cost of their emissions.

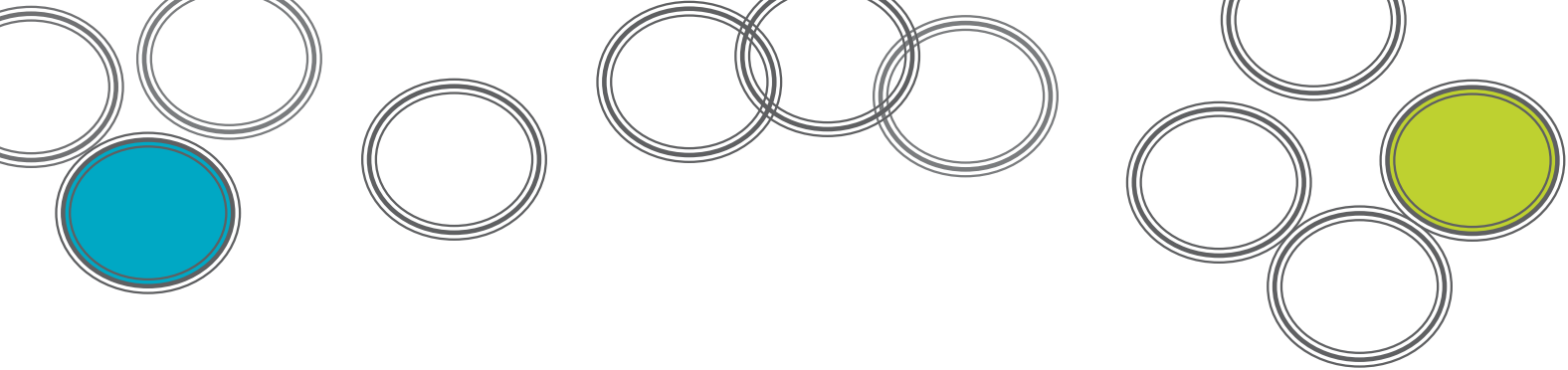
A carbon price can be achieved through a tax or an emissions trading scheme. While some economists prefer a tax as administratively simpler, we share your preference for a trading scheme with decreasing permit allocations. This allows producers to trade permits to achieve mutually beneficial outcomes while ensuring that total carbon emissions continue to decline.

You should be candid about the possibility that a trading scheme could throw up surprises, including prices far higher or lower than expected – as in the European experience. Despite this, it is vital that you push ahead with the idea and learn from teething problems, both our own and others', because a carbon price is the best way to channel the necessary investment into alternative energy technologies. It's also one of the most important test cases for the new approach of market design. You have promised to do this and it is critical that you do it early.

Deliver new education funding through individual learning accounts

Your government should establish individual learning accounts which allow parents, the state and the private sector to co-invest in human capital of our children. Similar to personal superannuation accounts, the lifelong learning account holds funds which can only be invested in education and skills training.

Government should make a founding contribution per child, which can be matched by parents and firms. Parents then decide how to allocate these funds across competing institutions at pre-primary, primary, sec-



ondary and tertiary levels. Before they are drawn down, parents could invest the funds in selected low-risk asset classes on behalf of their child.

More radical still, private investment funds could invest in the accounts, and contract with high school and post-secondary students for a share of their adult income stream. Government would design threshold levels and a progressive weighting, greatly incentivising private investment in our children's human capital. Personalised education accounts could be managed via individual websites where citizens are able to access a range of government services.

This kind of personal account, alongside increasing overall investment in human capital, could become a foundation for radical reform and personalisation of many key services currently provided, purchased and regulated by governments – a principle for reshaping our key public services.

Over time this would be a model for giving people new choices between government services and a market within government for services. Ultimately, even the current alphabet soup of financial benefits and payments for the benefit of children, from FTB A to CCB through to the Baby Bonus, could be rolled into a streamlined entitlement vehicle.

Develop a national water market

Australia's water markets are in crisis. The drought has only highlighted fundamental policy flaws. Some states provide large industrial users with water virtually free of charge, while in others the water price is fixed by fiat. There is no meaningful interaction of supply and demand, and almost no-one pays a price that covers the full cost of production.

The result? A structure which delivers neither efficiency of water use or investment in water infrastructure. It is a case that screams out for better market design.

Prime Minister, you can only overcome these failures by developing a national water market. The answer is not an old fashioned takeover proposal. The key is incentive and design, not command and control. The Commonwealth should act as the market designer, and the States and the private sector should deliver on the ground.

This will require difficult discussions with the state governments who will be asked to cede their existing control over water, in turn challenging entrenched interests. There will be winners and losers, but the Investing Society requires hard decisions. Above all, these decisions must combine full-cost economics with fairness. Those who use water should pay for the full production costs, with government assisting users such as low-income households who would be otherwise locked out of the market and whose inability to consume would itself incur social costs.



Replace the Queen's Birthday holiday with Kids' Day

The introduction of a Kids' Day holiday is a symbolic stroke that would speak volumes about your government's priorities. By replacing a holiday based on the past with a holiday based on the future, you demonstrate that the Investing Society is looking forward not back and is keenly focused on investing in tomorrow.

On Kids' Day, you should release a national report card on the state of our kids and the progress we've made in investing in their human capital. The announcement of existing youth prizes like Young Australian of the Year should be moved from Australia Day to Kids' Day.

Replacing a holiday based on the past
with a holiday based on the future

To celebrate the central role of educating children in the Investing Society, you could announce two new prizes on Kids' Day: say, a \$1m prize for Teacher of the Year and a \$4m prize for School of the Year. These prizes would draw attention to the quality and innovation that can occur within the school system, and foster competition and further quality improvement over time. While the amounts are tiny outlays for a government, they will quite literally change the lives of a teacher and a school full of students each and every year.

Risks: Facing up to the pressing questions

Governments are defined not only by ideas, but by events. You'll never be thanked for dodging a bullet. Risk management alone can't make your government a success but poor risk management will make it a failure.

For your governing project to succeed in the face of external shock, you need to build resilience into the Investing Society. So in all the enthusiasm of a new government with great hopes and great plans, you must spend some time asking, in effect, "what are the elephants in the room?"

This is one of the huge changes in your responsibilities as you move from Opposition to Government. Your job isn't managing a political argument about risk anymore – it's actually building an economy and society that can withstand it. Here are some of those elephants:

- **The Aussie dollar:** With buoyant markets for our commodities and a steady slide in the greenback, the world's reserve currency, the Aussie could be set for further strong gains. This could devastate even the most competitive sections of our export industries. The opposite case, where the commodity cycle ends and the dollar tumbles, is almost as bad.
- **The end of the boom:** What really does happen after the boom? The key question is whether we'll have invested enough in our human capital to be able to turn to high value-add services as the new bedrock of our economy. With existing middle-class service jobs under threat from graduates in India and China, we must use the boom years to prepare for this.
- **The housing bubble:** What if Australia's long housing bubble finally bursts? The US housing market offers a frightening precedent. As two American bankers argue, since foreclosure prices are typically 20-25% below unforced sales, US house prices will fall markedly in 2008-09, risking a recession and attendant job losses.
- **Concentrated disadvantage:** The Investing Society cannot succeed unless it improves the life chances of all its citizens. Despite an extended boom, over a quarter of a million families live in jobless households, indigenous life expectancy is at developing country levels and poverty is entrenched in the housing estates of the inner cities and the urban fringe. There's a gnawing doubt among policy elites that anything can be done to solve this.
- **National security:** The domestic politics of the War on Terror distracted conservative governments from the growing threats in North Korea, the Taiwan Strait and instability in our immediate region – while the debacle of Iraq has greatly increased the power and influence of Iran. Australia faces serious threats: terrorism, WMD proliferation, and interstate rivalry in North-East Asia, yet you can't fix them all, and in some cases, what helps deal with one threat can actually make another worse.

We don't pretend to have the answers to all these challenges, Prime Minister, but we do know this: you'll need to start making your own judgements about them, and soon.



Section V: Combining vision and values

Despite its importance, policy alone is not enough to build the Investing Society. The project must offer a clear vision of Australia's future which is firmly grounded in values. As an example of the importance of values in politics, never forget why the Howard government lost.

The Coalition won in 1996 and 1998 with a raft of big conservative ideas at its disposal. We all know the slogans: small government, strong defence, free markets, traditional family. But over time these themes became exhausted and they were unable to renew them in office.

Increasingly over its final two terms, the Howard government pursued a short-term, divisive agenda that diverted attention from future challenges and opportunities. This led it to adopt extreme policy positions like WorkChoices and nuclear reactors which were not only bad economics, but which failed to reflect any overarching, coherent set of values. At the same time, the conservatives failed to perceive the suburban anxiety underlying the nation's material prosperity. In the end, the Coalition lost the electorate's trust because its policies became increasingly expedient and tactical, devoid of vision and values.

Previous governments had lost trust by trading on anxiety and breaking promises. Think of the scare campaigns against the GST, refugees or over interest rates – or remember L-A-W tax cuts and non-core promises. Over time, this has led to a cumulative erosion of trust in government in Australia.

Policy alone is not enough to build an Investing Society

You, Prime Minister, are the only one who can reverse these trends. So the initial challenge for you in delivering a new progressive project is to rebuild the bonds of trust with the Australian people. As you outline a new project for Australia's future, you must deliver on your election commitments and explain your project in the terms from your campaign – new leadership, fresh ideas, education revolution, future beyond the boom.

Your success will be dependent on re-engaging with citizens, redefining the relationship between citizen and state. One reason people ignore politics and the state because politics and the state ignore people. Public service delivery agencies seem more focused on their internal processes than their service delivery.

Government is seen as monolithic and interacts with citizens on a one-size-fits-all basis. And when people really need something concrete like an important operation or a train that runs on time, government struggles to deliver in spite of our record prosperity.

To overcome this problem, your government must offer a plurality of services tailored to the needs of individual citizens – the Investing Society enables this.¹⁴

Above all, your project must be driven by the core progressive Australian values: forward not back, the importance of community and the virtuous circle of prosperity and fairness. These must permeate your government. Every time you are presented with a hard decision, ask yourself: which response is consistent with my progressive values? These are the passions which animate the *Investing Society*, these are the logic behind the bold strokes and they are what will underpin your success in the eyes of the Australian people.

vision

Final editorials: What you'd like them to say as you leave the job

HERALD SUN: Rudd kept trust while making the big early changes. Everything else has followed from that. He kept his promises. Then the new carbon price, personal accounts in education, and the national water market, were big policy measures. Above all though, the government's child-centred focus has changed the mold – making long-term economic investment a kitchen table issue.

SYDNEY MORNING HERALD: The focus of economic policy shifted from “budget management” to “human capital investment” and “full cost economics”. What Rudd tagged “the investing society” was really a program of designing growth on the supply-side of the economy through new tools, especially using economic incentives rather than social controls. Carbon emissions reductions are the obvious case. But new investment in water infrastructure plus industry and household efficiencies has followed the new water market, which lifted the price and enabled real economic returns to be gained.

CANBERRA TIMES: The “investing society” also universalised and personalised human services. For individuals, this has delivered historic boosts in private investment in human capital, alongside an uptick in public spending. It has also reformed crucial sectors of the economy, notably education. In effect, the reform forces that changed our private economy thirty years ago have finally reached the public economy this decade. The public sector will never be the same again.

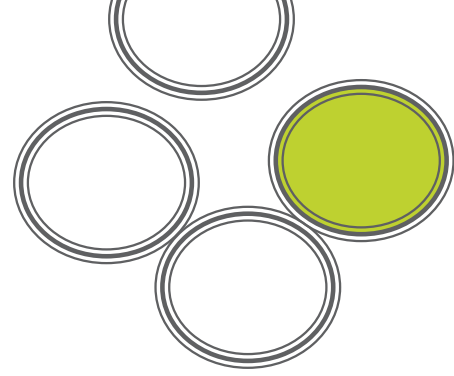
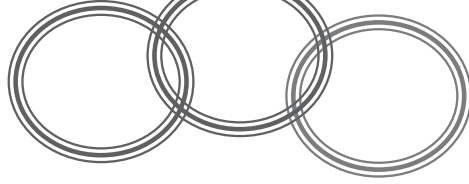
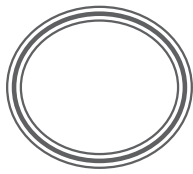
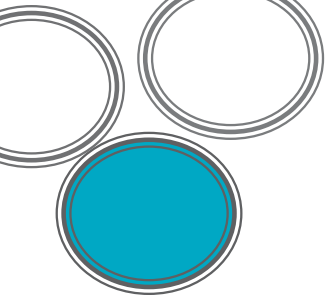
AUSTRALIAN FINANCIAL REVIEW: Rudd's economic policies lifted productivity, and the value of everything we sell. The wealth generated from the mining boom was invested in productive purposes. As our terms of trade declined when other mineral producers caught up with demand from China, the fall in export income in mining has been offset by growth of exports in other fields. All of this means prosperity has been maintained, with strong employment and stable inflation and interest rates, even as the mining boom has faded.

THE AUSTRALIAN: There has been good economic policy and good social reform. The genuinely progressive political achievements are broader again. Rudd has changed the way Australians talked about themselves and their politics. Through every event and emergency, he led Australians to a new logic. “Invest, invest, invest.” “Australians share and stick together.” “Fairness and prosperity go together.” “Don't forget the kids.” And like Hawke, but unlike Keating or Howard, he has been comfortable in his times – not futuristic, nor old-fashioned, simply contemporary.

COURIER MAIL: Rudd has overseen a progressive realignment of Australian politics. There are two proofs of this. First, when he came to power, the question hanging over Labor was whether it could be trusted with the economy, which meant budget control. Today, the question hanging over the Coalition is whether it can be trusted with the economy, which means investing in human capital and designing public markets. Second, his intellectual and policy leadership has forged new alignments of interests, and created a generation of Rudd Liberals: lower-income families in regional towns, especially in coastal Queensland, who had been the target of conservative populism for so long, and the “moral middle-class” who in Australia were historically attached to progressive Liberal politics.

Notes

- ¹ Henderson, G., "The slow creep of conservatism", *Sydney Morning Herald*, 30 October 2007 and Prasser, S., "Australians are all conservative now". *The Australian*, 20 April 2007
- ² See <http://www.heritage.org/research/features/mandate/2005/>
- ³ Kevin Rudd, The Leader's Debate, 21/10/07 (transcript downloaded from www.alga.asn.au/Election2007/pdf/p071023265.pdf)
- ⁴ Schweinhart, L.J., Barnes, H.V. & Weikart, D.P. *Significant Benefits: The High/Scope Perry Preschool Study through Age 27. (Monographs of the High/Scope Educational Research Foundation, 10)*. (Ypsilanti, Michigan,: High/Scope Press). 1993
- ⁵ Reserve Bank of Australia, September 2007 (see www.rba.gov.au/Statistics/Bulletin/H05hist.xls)
- ⁶ Authors' calculations based on Australian Bureau of Statistics, *Australian System of National Accounts*, 2006-07 (Cat. no. 5204.0, Table 18)
- ⁷ Kay, J., *Culture and Prosperity: The Truth about Markets – Why Some Nations are Rich but Most Remain Poor*, (New York: Harper Business), 2004, pp.105-114
- ⁸ OECD, *Social, Employment and Migration Working Paper No. 29*, 2005
- ⁹ For further explanation of intergenerational equity and social discount rates, see Dasgupta, P., Mäler, K. & Barrett, S. "Intergenerational Equity, Social Discount Rates and Global Warming", in Portney, P. & Weyant, J. (eds.) *Discounting and Intergenerational Equity*, (Washington D.C.: Resources for the Future), 1999
- ¹⁰ For details of FD-Trygd, see www.forskningsradet.no
- ¹¹ Australian Bureau of Statistics, *Measuring Australia's Progress*, 2006 (Cat. no. 1370.0)
- ¹² Leigh, A. & Ryan, C. "Estimating Returns to Education: Three Natural Experiment Techniques Compared", Australian National University CEPR, Discussion Paper No. 493. 2005
- ¹³ OECD, *Starting Strong II: Early Childhood Education and Care*, Paris, 2006 & OECD, *Education at a Glance*, Paris, 2006
- ¹⁴ For more on plurality in public service delivery, see Bennett, J. & Cooke, G. (eds.), *It's All About You: Citizen-Centred Welfare*, (London; IPPR), 2007 and Gallagher, N. & Parker, S., *The Collaborative State*, (London: Demos) 2007
- ¹⁵ For more on the challenges to the Australian service sector posed by India and China, see Charlton, A., *Ozonomics: Inside the Myth of Australia's Economic Superheroes*, (Sydney: Random House), 2007
- ¹⁶ Westhoff, D. & Srinivasan, V.S., "The Impact of Rising Foreclosure Supply on the Housing Market", (New York: Bear Stearns), 2007
- ¹⁷ Australian Bureau of Statistics, *Census of Population and Housing*, 2006 (Cat. no. 2068.0)



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